Reevaluating Fixed Income Risks Amid Increased Market Volatility

By Kevin M. Winters, CFP®, CIMA®, Justin Blesy, CFA®, and Ryan E. McMahon

As market volatility continues to unnerve investors, advisors are reevaluating their approaches to fixed income. Most advisors tell us they still seek the traditional benefits of fixed income: capital preservation, equity risk diversification, and an attractive yield. However, it has been challenging to achieve all three simultaneously in the current market environment amid historically low yields, rising U.S. interest rates, and policy divergence that has exacerbated market volatility.

We analyzed trends across 143 asset allocation and risk analysis studies during the second half of 2015 and found that many investors have opted to stretch for yield in an environment of low returns. This trend takes multiple forms, including expanding exposure to multi-sector credit portfolios, reassessing the role of nontraditional bond managers, and resizing allocations to diverse global fixed income strategies. This positioning may be desired, but careful implementation is critical when assessing an increasingly diverse array of strategies to avoid leaving clients exposed to hidden risks.

The turbulent start to 2016 was a reminder that a clear understanding of risk is paramount in an increasingly volatile environment. This can be challenging, especially in strategies that allocate across sectors with significant flexibility. We use a rigorous analytical framework to help our clients understand the key risk factors embedded in their portfolios (see table 1). Through a sophisticated regression algorithm, the tool estimates intuitive risk factor exposures for funds and portfolios based on historical returns. Armed with this knowledge, advisors are able to make more-informed investment decisions across fixed income, equity, alternative, and multi-asset portfolios.

Figure 1 shows the allocation of the average client fixed income portfolio in our review. Core bonds continue to be the largest allocation as clients seek to preserve capital and diversify equity risk, albeit at lower levels of yield than they have enjoyed historically. However, advisors are using the next three biggest allocations—multi-sector, nontraditional, and world bonds—to compensate for lower yields and generate higher return potential. The traditional benchmark-oriented spread strategies are next in size, including high yield bonds, bank loans, corporate bonds, and emerging market bonds. Finally, smaller allocations provide liquidity, including short-term bonds, short-term government bonds, and ultrashort bonds.

Fixed Income Portfolios: More Credit Risk, Less Interest-Rate Risk

Although the asset allocation mix is important, an analysis of a portfolio’s risk factors can provide a better understanding of how the portfolio may react to changes in markets.1 For example, it is not enough to know the market value allocation to Treasuries—the duration of that allocation is what will indicate the sensitivity to changes in interest rates. Similarly, it’s not enough to recognize that allocations to multi-sector and nontraditional bonds may have more credit risk than a core allocation. It is more important to understand what percentage of that risk is driven by high yield spreads compared with currency risk in emerging markets, for example, which can move in distinctly different ways. For example, figure 2 compares the risk allocation of the average fixed income portfolio against that of the Barclays U.S. Aggregate. The portfolio experienced a similar level of realized volatility over the analysis period,2 but its credit risk through investment grade, high yield, and emerging market currencies was higher. This may result in a higher yield and return potential for the average fixed income portfolio, but it may result also in less diversification potential versus equities, an important consideration for overall portfolio construction. Additionally, despite the current rising rate environment in the United States, a credit-oriented portfolio typically is more susceptible to drawdowns on a stand-alone basis.
given the traditionally higher volatility of credit and emerging market risks versus interest rate risk.

**Risks More Challenging to Measure with Traditional Tools**

Once aggregate portfolio risks are understood, often the focus turns to the sources of each risk. This is where careful analysis of the multi-sector bond, nontraditional bond, and world bond managers becomes important. These categories have increased significantly in size over the past five years as investors have sought ways to increase yield and return potential as they attempt to maintain some capital preservation and equity diversification potential. The more traditional satellite allocations of high yield, investment grade, and emerging markets are still present as well, but they have declined in prominence. However, when the risks of the multi-sector bond, nontraditional bond, and world bond categories are decomposed, investors are still exposed to many of the same risks as presented by these traditional satellite allocations. The difference in these newer categories is that

<table>
<thead>
<tr>
<th>Key Risk Factors</th>
<th>Definition</th>
<th>Long Exposure</th>
<th>Short Exposure</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. duration (years)</td>
<td>Duration to U.S. nominal interest rates</td>
<td>Change in 10-year U.S. nominal yield</td>
<td></td>
<td>For each year of duration, a 1% instantaneous increase in nominal yields will lead to a 1% instantaneous decline in portfolio return</td>
</tr>
<tr>
<td>2–10 slope (years)</td>
<td>Duration to the slope of the intermediate portion of the yield curve</td>
<td>Change in 10-year U.S. Treasury yield</td>
<td>Change in 2-year U.S. Treasury yield</td>
<td>For each year of 2–10 spread duration, a 1% instantaneous increase in the 10-year yield over the 2-year yield will lead to a 1% instantaneous increase in portfolio return</td>
</tr>
<tr>
<td>10–30 slope (years)</td>
<td>Duration to the slope of the long end of the yield curve</td>
<td>Change in 30-year U.S. Treasury yield</td>
<td>Change in 10-year U.S. Treasury yield</td>
<td>For each year of 10–30 spread duration, a 1% instantaneous increase in the 30-year yield over the 10-year yield will lead to a 1% instantaneous decrease in portfolio return</td>
</tr>
<tr>
<td>European duration (years)</td>
<td>Duration to European interest rates</td>
<td>Change in European Generic 10-year yield</td>
<td></td>
<td>For each year of European duration, a 1% instantaneous increase in the European 10-year yield will lead to a 1% instantaneous decline in portfolio return</td>
</tr>
<tr>
<td>Japanese duration (years)</td>
<td>Duration to Japanese interest rates</td>
<td>Change in Japanese Generic 10-year yield</td>
<td></td>
<td>For each year of Japanese duration, a 1% instantaneous increase in the Japanese 10-year yield will lead to a 1% instantaneous decline in portfolio return</td>
</tr>
<tr>
<td>U.S. muni spread (years)</td>
<td>Duration to muni spreads</td>
<td>Change in Municipal Market Advisors AAA General Obligation Consensus 30-year yield</td>
<td>Change in 30-year U.S. nominal yield</td>
<td>For each year of muni spread duration, a 1% instantaneous increase in the 30-year muni yield over the 10-year U.S. Treasury yield will lead to a 1% instantaneous decline in the portfolio</td>
</tr>
<tr>
<td>U.S. mortgage-backed securities (MBS) spread (years)</td>
<td>Duration to agency mortgage spread</td>
<td>Change in Barclays MBS Fixed Rate spread</td>
<td></td>
<td>For each year of MBS spread duration, a 1% instantaneous increase in MBS spread will lead to a 1% instantaneous decline in portfolio return</td>
</tr>
<tr>
<td>Investment grade spread (years)</td>
<td>Duration to investment grade credit spread</td>
<td>Change in Barclays Global Aggregate Corporate Average option adjusted spread</td>
<td></td>
<td>For each year of investment grade credit spread duration, a 1% instantaneous increase in investment grade credit spreads will lead to a 1% instantaneous decline in portfolio return</td>
</tr>
<tr>
<td>High yield spread (years)</td>
<td>Duration to high yield credit spreads</td>
<td>Change in Barclays Global Corporate High Yield Average option adjusted spread</td>
<td></td>
<td>For each year of high yield credit spread duration, a 1% instantaneous increase in high yield credit spreads will lead to a 1% instantaneous decline in the portfolio</td>
</tr>
<tr>
<td>Emerging market (EM) sovereign spread (years)</td>
<td>Duration to the spread of emerging market external bonds</td>
<td>Change in JP Morgan EM Bond Index Global Diversified Sovereign spread</td>
<td></td>
<td>For each year of EM sovereign spread duration, a 1% instantaneous increase in EM sovereign spread will lead to a 1% instantaneous decline in portfolio return</td>
</tr>
<tr>
<td>Developing market foreign currency (DM FX) (beta)</td>
<td>Beta to developed market currencies</td>
<td>Inverse return of the DXY Index</td>
<td></td>
<td>For a 1.0 DM FX beta, a 1% increase in DM FX will lead to a 1% increase in portfolio return</td>
</tr>
<tr>
<td>Emerging market foreign currency (EM FX) (beta)</td>
<td>Beta to emerging market currencies</td>
<td>Return to JP Morgan Emerging Local Markets Index + Index</td>
<td></td>
<td>For a 1.0 EM FX beta, a 1% increase in EM FX will lead to a 1% increase in portfolio return</td>
</tr>
</tbody>
</table>
these risks may not always be as apparent or understood.

Figure 3 shows the top two managers by assets under management (AUM) across each of these different categories compared with the traditional satellite allocations. Even though two managers may fall under the same category, the approaches used are distinctly different in the multi-sector bond, nontraditional bond, and world bond categories. These risks may be in line with investor expectations (and even desired), but it can be more challenging to discern them from allocation information alone. Interestingly, even in some traditional categories such as emerging market bonds, the risks may not be homogeneous across strategies. For example, the largest fund in the emerging market debt category is primarily exposed to emerging market local bonds, which carry significant currency risk, whereas the second-largest fund concentrates on U.S. dollar-denominated bonds, whose main risk is widening spreads.

Below are additional details of the challenges investors face when allocating to multi-sector, nontraditional, and world bond managers.

**Multi-sector.** There are key differences in approaches. First, the range of opportunity sets is quite wide. Some funds are limited to a handful of fixed income sectors; others are managed to a broad range of fixed income sectors and some even include equities. These differences can significantly affect the yield generation potential and diversified nature of the risk. The second major difference is the goal and willingness of managers to balance income generation with capital preservation. As they stretch for yield, some managers expose themselves to significant drawdown potential, especially during times of market stress (see figure 4). Conversely, a low yield environment makes it difficult to generate an attractive yield and significantly limits potential drawdowns. Our firm favors a balanced approach; however, the role and use of multi-sector strategies will differ by investor.

**Nontraditional.** Typically, with broad mandates and flexibility, nontraditional
bond approaches are even more varied than those of multi-sector bond strategies. To diversify U.S. interest-rate risk and seek additional return, some managers focus on income generation through global credit markets, not unlike their multi-sector peers. Others have adopted more of a global macro approach that targets global rates and currency markets; some combine elements of both approaches. Note that a strategic income approach may concentrate the portfolio on a limited number of sectors and expose it to bouts of volatility as shown with Nontraditional Manager A (figure 5). Other approaches, such as shown with Nontraditional Manager B (figure 6), have proven more dynamic and diversified over time.

**World bond.** World bond managers differ most notably in the geography and currency denominations of their exposures. Managers within the same category may allocate their investments across a wide range of geographies in search of the best opportunities. Although a broad opportunity set is welcome, often strategies focus on a subset of countries with varying levels of exposure to the U.S. markets, developed markets (ex U.S.), and emerging markets. Additionally, strategies range from fully unhedged to fully hedged. This is an important consideration because currency risk can be a large portion of a world bond strategy’s overall risk and change its diversification potential. For example, strategies with significant emerging market allocations may offer high yields and return potential, as shown with Manager E in figure 7, but they also may be exposed to bouts of volatility and underperform in a risk-off environment, reducing their ability to diversify equity risk. In contrast, Manager D focuses its exposures on developed markets outside of the United States on a fully hedged basis. Yields may be lower, but this manager is more likely to serve as an effective equity diversifier.

**Conclusion**

Advisors continue to face a challenging environment of lower return prospects and increased market volatility, making it difficult to construct well-diversified portfolios that meet their clients’ goals. It is more important in this environment to understand the true risks in portfolios and ensure they align with your clients’ risk and return goals.

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*Justin Blesy, CFA®, is a senior vice president and product manager on the investment solutions and asset allocation teams in PIMCO’s Newport Beach office. He earned an undergraduate degree from Dartmouth College and an MBA from the University of Chicago Booth School of Business. Contact him at justin.blesy@pimco.com.*

*Ryan E. McMahon is a specialist in PIMCO’s New York office and a member of the global wealth management team. He earned an undergraduate degree from Colgate University and is a CFA Level III candidate. Contact him at ryan.mcmahon@pimco.com.*

*Continued on page 40*
Variety of Sectors

Figure 5: Nontraditional Bond Manager A—Limited Sector Exposure Creates Bouts of Volatility

- Residual
- EM FX
- DM FX
- EM Sov spread
- HY spread
- IG spread
- U.S. MBS spread
- U.S. Muni spread
- JP duration
- EUR duration
- 10–30 slope
- 2–10 slope
- U.S. duration
- Total

Source: PIMCO, Bloomberg, Morningstar as of December 31, 2015. Hypothetical example for illustrative purposes only. Manager A in figure 5 and Manager B in figure 6 are two of the top five funds by AUM within the Nontraditional Bond category. They were selected to illustrate some of the different approaches used within the category. Based on returns from June 30, 2010, to December 31, 2015. Realized volatility calculated using a multi-factor regression model of 12 factors as defined in table 1. Realized volatility may not be representative of forward-looking volatility.

Figure 6: Nontraditional Bond Manager B—Steadier Volatility Profile across Variety of Sectors

- Residual
- EM FX
- DM FX
- EM Sov spread
- HY spread
- IG spread
- U.S. MBS spread
- U.S. Muni spread
- JP duration
- EUR duration
- 10–30 slope
- 2–10 slope
- U.S. duration
- Total

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Figure 7: Currency Risk Can Increase Volatility in World Bond Managers

- Residual
- EM FX
- DM FX
- EM Sov spread
- HY spread
- IG spread
- U.S. MBS spread
- U.S. Muni spread
- JP duration
- EUR duration
- 10–30 slope
- 2–10 slope
- U.S. duration


Endnotes

1. Risk factors are the underlying exposures within asset classes that justify a return premium and drive variations in returns. Examples of fixed income risk factors include duration (estimated portfolio movements to changes in interest rates) and credit spread duration (estimated portfolio movements to changes in credit spreads).

2. December 5, 2011, to December 31, 2015, representing the maximum period of data availability.

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