NAVIGATING INCOME INNOVATION

Simplify Modern Fixed Income with a Goals-Based Approach

By Adam Hetts, CFA®
In a world starved of yield for a decade, there has been a proliferation of new income investment solutions spanning public and private markets, equities, and fixed income. These innovations have been welcome, but many of these new solutions use complex, esoteric instruments that tend to increase risk.

The speed of innovation in some fixed income categories has created secondary challenges: primarily simplicity, transparency, and managing client expectations. The combination of innovation and short track records is leading to difficulties for professional investors on all these fronts (see figure 1).

We believe that portfolio income approaches, like other asset allocation constructs, should be rooted in a risk-based approach and tuned to client goals. Even considering that many current income solutions didn’t exist in 2008, the Global Financial Crisis (GFC) makes a good starting point for examining the hidden risk in today’s portfolios. One lens through which we can study this hidden risk is the GFC drawdown that occurred between September 2008 and March 2009 and how it affected fixed income strategies grouped by current yield (see figure 2).

Note that (1) this analysis is based on each fund’s current yield as of February 28, 2019, not its 2008 yield; and (2) we don’t expect the GFC to repeat.

We believe that portfolio income approaches, like other asset allocation constructs, should be rooted in a risk-based approach and tuned to client goals.
Regardless, figure 2 provides some valuable risk-based insight about income portfolios: No amount of innovation has escaped the fact that increased yield requires increased risk. Too narrow a focus on too few income instruments creates the potential for this risk to undermine the conservative income goals for a given portfolio.

NEW FIXED INCOME RISKS MET WITH NEW SOLUTIONS
Figure 3 illustrates a typical advisor fixed income allocation. The information shown in figure 3 is an “industry portrait” based on our proprietary database of thousands of advisor portfolios.

With core duration near all-time highs and core yield not commensurate with that level of risk, many investors have traded interest-rate risk for credit risk. This trade has helped generate income, but it also has increased equity-like correlations in fixed income at a time when credit spreads are tight and recently near or below long-term averages. We believe there are ample opportunities in higher-yielding, equity-like fixed income markets, but we also believe that investors must employ discretion when using these higher-octane fixed income strategies within their portfolios.

The effect of this diversification in fixed income portfolios is straightforward—it shifts the portfolio risk posture. Figure 4 illustrates the effects of four historic market events on each of these three types of fixed income investments.

A good solution, however, is less than straightforward. Figure 4 highlights the role of core fixed income in managing risk during market crises. Not shown, however, is the potential interest-rate risk inherent during a rising-rate environment. Seeking portfolio yield requires balancing interest-rate risk and credit risk.

The average advisor allocations in our fixed income industry portrait have major implications. First, with nearly half the average fixed income portfolio allocated outside the core, many portfolios may carry too much risk for a conservative income investor. But note that half of the non-core is allocated to the highest-risk portion of the fixed income universe—single-sector approaches. Investors can de-risk conservative income allocations by moving from single-sector approaches to dynamic approaches.

Second, the universe of dynamic managers is far from homogeneous and

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A DISORIENTING ENVIRONMENT

- Double-digit dispersions among major fixed income asset classes
- Ranked from lowest 10-year volatility to highest
- Figures represent best and worst 12-month returns

Source: Morningstar.
*Calculated using 12-month rolling windows with one-month step over 10 years trailing through December 31, 2018.
Categories represented by corresponding indexes from Bloomberg Barclays, JPMorgan, and Credit Suisse.

A GOALS-BASED APPROACH

- Janus Henderson’s proprietary forward-looking approach
- Reduce the universe of fixed income managers into three distinct objectives
- Allocate across these objectives according to one’s goals

There is no shortage of innovation in this category. This has raised the hurdle for manager due diligence. Recall that no amount of innovation has escaped the fact that increased yield carries increased risk. Therefore, investors need to scrutinize existing and potential dynamic credit holdings and the complexity with which yield is created.

Numerous strategies in the dynamic credit space rely on derivatives, leverage, currencies, and potentially significant allocations to equities and emerging markets—all of which might provide greater yield but also can increase risk. Our philosophy is that the most complicated solutions are often the wrong solutions. Therefore, we look for managers who streamline their approaches with straightforward solutions in the dynamic credit space. These managers limit exposure to esoteric
asset classes and complex approaches that can generate unintended risk.

GOALS-BASED FIXED INCOME
Recall that our fixed income industry portrait shows that nearly half the average advisor fixed income portfolio is now diversified outside the core. This level of diversification isn’t surprising. Since the GFC, traditional fixed income investing has been disrupted by large price swings, high-duration risks, and a proliferation of new strategies. Fixed income has evolved from a fairly straightforward asset class into one that investors may find confusing (see figure 5).

This new environment has created a slew of questions, such as: “Is high yield the new risk manager, because it might perform better than Treasuries if rates rise?” or “Even with historically low rates, are Treasuries still the best risk manager?” We think there has been too much focus on finding a single solution. The best solution is probably a mix of core, unconstrained, and dynamic solutions—and the mix depends on an investor’s goals (see figures 6 and 7):

FIXED INCOME OBJECTIVES
Assigning the breadth of fixed income instruments among three objectives can be confounding. Figure 7 outlines how core, unconstrained, and dynamic credit can be defined by their respective goals, personalities, and criteria.

IMPLEMENTATION: THE MAJORITY STAYS IN CORE
Even in today’s low-rate environment, core fixed income remains essential: Clients rely on core bond allocations for capital preservation during a crisis. In other words, core fixed income is the primary tool to make a moderate portfolio truly moderate. Therefore, most (50–75 percent) of a fixed income portfolio should stay in the core (see figure 8).

Outside the core, we advocate allocations to both unconstrained and dynamic credit strategies. Each has its own benefits and

**Figure 7**

**THREE FIXED INCOME OBJECTIVES**

**DEFEND with Core: What Makes Core “Core”?**
> Goal: Seeks to provide capital preservation during a market downturn
> Personality: Lowest volatility fixed income, high interest-rate sensitivity
> Criteria: Currency-hedged, global developed government debt

**DIVERSIFY with Unconstrained: Screening for Unconstrained.**
> Goal: Potential to perform during rising rates and/or widening spreads
> Personality: Generally lower volatility than high yield and higher than core
> Criteria: Low correlation to other fixed income, long and short across all global fixed income sectors

**INCREASE INCOME with Dynamic Credit: Find Risk-Adjusted Income.**
> Goal: Broad exposure to equity-like fixed income on a global scale
> Personality: Potentially similar income and return as equity-like fixed income benchmarks with lower risk
> Criteria: Dynamic and global credit and government exposure, primarily long only

Note: Equity-like fixed income vehicles are investments that may be less susceptible to changes in interest rates or other factors than traditional fixed income. They are higher risk than traditional fixed income, without necessarily the same returns as a true equity investment.
costs in different market environments. Advisors are best served by having a balanced exposure to each and strictly defining the managers deployed for each objective, as discussed above. This combination allows advisors to adequately manage client expectations.

Working within this framework helps organize the huge universe of fixed income managers and, most importantly, conveys a clear, forward-looking approach to fixed income for clients.

Adam Hetts, CFA®, is a vice president and head of portfolio construction and strategy at Janus Henderson Investors. For more information, please visit janushenderson.com.

ENDNOTES


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