Unconstrained Fixed Income, Really?

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Fixed-income math and related performance is fairly clear. A core fixed-income investor expects the coupon to deliver most of the investment’s total return. Unfortunately, the reality of the math suggests an uncomfortable future for taxable fixed-income investors. The Barclays Aggregate generates a 3.3-percent coupon today; clearly a place holder investment in core, taxable fixed income will struggle to generate solid total return in the coming years. Performance relative to the past 30 years will be muted. The antidote in many investors’ minds is an allocation to absolute return or unconstrained fixed-income strategies. The approach promises to save investors from the certainty of a future of low returns without additional volatility relative to a traditional core investment.

Since 2010 retail investors have fully embraced this notion with interest intensifying during 2013’s bond selloff (see figure 1). Morningstar’s nontraditional bond fund category, which contains the majority of funds classified as unconstrained, grew from $20 billion in total assets in January 2010 to $119 billion in total assets as of November 2013.¹ But what, really, is “unconstrained” fixed-income investing, and how does it fit within a diversified portfolio? This article defines unconstrained fixed-income investing, discusses potential pitfalls, and explores the use of unconstrained fixed-income funds within a broader fixed-income portfolio.

Unconstrained Fixed-Income Investing

In its truest form, unconstrained fixed-income investing, in our opinion, reflects a multi-sector approach akin to a core-plus strategy.² Managers utilize the tools of a core-plus mandate but, by prospectus, managers invest with little restriction. Market-value allocations and contributions to risk among the sectors may vary substantially relative to a traditional core-plus mandate. Portfolio managers may take both long and short positions to produce exposure to any level of risk and, likewise, the use of derivatives in addition to cash bonds is common. Benchmarks vary between LIBOR (London Interbank Offered Rate) plus a set percentage or spread, the Barclays U.S. Aggregate, and the Barclays Global Aggregate.

Before the advent of quantitative easing and the nadir of U.S. rates, there was little demand or need for anything like multi-sector, unconstrained fixed-income investing, at least for traditional retail investors. Historically, some mutual fund strategies strayed from the standard core/core-plus metric, but traditionally these strategies were listed as strategic income funds. Such funds were (and remain today) fairly unconstrained in their approaches. However, in most cases the portfolio manager maintained an investment style bias. As a result of this history, today an assortment of unconstrained approaches is available to fixed-income investors, and finding a true multi-sector approach is fairly difficult. In reality there are a number of variations of unconstrained fixed-income investing, making an uninformed investment decision in this space potentially treacherous.

How treacherous? In 2013 we found that the funds in our unique universe of unconstrained fixed-income strategies generated a wide range of results, with no discernible trend regarding risk, as measured by standard deviation, relative to return. Results were highly random, with returns in the range of ±13 percent (see “Survey and Methodology” below). This is counter to traditional core
fixed-income investments where investment performance is fairly predictable. With as many investment approaches and mandates in the unconstrained fixed-income space as there are unconstrained fixed-income managers, investors need to make informed decisions (see figures 2 and 3).

Given the variations and breadth of performance in unconstrained fixed-income mandates, we developed a scoring system to better identify trends in our universe. We specifically were looking to determine the flexibility, level of diversification, and fixed income-related risk exposures across the space, and our goal was to find strategies that delivered results aligned with a truly multi-sector unconstrained approach—strategies that could generate a return stream that added value on a risk-adjusted basis relative to core fixed income.

Unfortunately, we found the performance histories of most strategies too limited and manager-reported data too intermittent and inconsistent, making this evaluation particularly difficult. We ultimately found considerable bias toward corporate credit both in terms of allocation and correlation within our universe. A significant portion of the universe maintains high and persistent exposures to credit and generates return streams that mimic those of high-yield and bank-loan strategies. To be fair, this bias may reflect the evaluation period; corporate credit probably offered the best potential risk-reward tradeoff for an unconstrained investor over the past three years (see “Survey and Methodology” below). However, if the corporate credit bias is perpetual, most unconstrained strategies are essentially credit funds in disguise. This is unfortunate, because the pitfalls around investing in this manner are clear: Corporate credit investing is asymmetric and in risk-off periods, losses will mount.

Investing in an Unconstrained Strategy

Use of an unconstrained strategy depends upon an investor’s goals and tolerances. Despite the depressed return forecast, we believe that fixed income will remain the ballast and primary diversifier of a portfolio. Investors should expect that when other asset classes are experiencing losses, fixed-income investments will remain resilient and mitigate a portfolio’s overall decline. The appropriate vehicle to administer this strategic allocation, in our opinion, is a core bond portfolio. Strategically long-term and less-tactical investors should stick with this investment. The lack of constraint available to unconstrained portfolio managers introduces too many variables and ultimately may result in greater drawdown precisely at the point when risk mitigation is needed most.

More tactical investors, utilizing the various fixed-income sectors in a core/satellite
approach, may want to consider unconstrained fixed-income mandates as a potential investment. A truly multi-sector unconstrained fixed-income strategy, as defined above, may be a replacement for capital allocated to all fixed-income satellites. In many respects, the difference is that adopting a core/satellite approach implies that the timing and satellite allocation decisions are made by the advisor or end investor, whereas an unconstrained approach implies that those decisions will be made by the fund portfolio manager (see figure 4).

Furthermore, we believe a truly unconstrained strategy is best paired with a core offering, one that avoids investments in the plus sectors such as high-yield bonds, currencies, and so forth. Unfortunately, and as highlighted, the challenge is finding the appropriate unconstrained approach given the strong sector bias exhibited by the universe.

An alternative approach to unconstrained investing is to acknowledge the bias inherent in many of these funds and invest appropriately. For example, a tactical investor may look to replace a high-yield taxable bond solution with an unconstrained corporate credit solution when high-yield bond valuations look less compelling and core bond performance looks unattractive.

This unconstrained solution may take advantage of both long and short credit situations and invest along the entire capital structure versus concentrating on long-only high-yield credit. This adds a bit of a twist to core/satellite investing, but we believe this may be a superior approach.

**Review of Survey and Methodology**

We embarked on a comprehensive survey of the unconstrained bond peer group as preparation for this article. To evaluate variations of the unconstrained theme, we started with Morningstar’s nontraditional bond fund category. We then added in selected strategies from the multi-sector and global fixed-income universes utilizing keywords such as strategic income, opportunities, and unconstrained as a search tool. This second layer of search was intended to capture anything in fixed income that suggested flexibility. We found a total of 133 unique options. Return data were analyzed for funds with sufficient track records and allocation data, if reported.

We evaluated strategy data for three years ending August 31, 2013. Eighty-three percent of offerings had performance data back to August 31, 2010. Seventy-five percent reported sufficient sector-level information. We wanted to answer the following major questions:

- Do managers actually take advantage of the flexibility that their prospectuses grant them?
- Are managers taking on diversified sources of risk to generate return or are they sector-biased?
- How do the answers to the above two questions impact the return streams these strategies generate and their effect on a broad portfolio?

To quantify flexibility and diversity, we examined historical sector exposures that managers reported to Morningstar. The five broad sectors we looked at were government (any country), municipal, corporate (of any credit quality and across the capital structure), securitized (anything where cash flows are generated by another financial asset), and cash or cash-like instruments. Managers that reported sector positioning nine or more times for the three years ending August 31, 2013, were examined. We note several pitfalls with trying to aggregate historical sector positioning across a large group of funds. Reporting periods were inconsistent, managers have differing standards on sector categorization, and the distinction between cash bonds and derivatives is poorly defined. However, a fair number of managers did have regularly updated histories, and the data reported, by and large, corresponded
with our pre-existing knowledge of strategies and firms in the space.

To quantify flexibility, we looked at the standard deviation of manager-reported sector exposures over time. Managers qualified as flexible if they adjusted their positioning modestly across several sectors or aggressively in one sector. For diversity, we examined average sector positioning over time and designated a fund as diversified if it did not have average exposure in any sector that exceeded 50 percent. Under these criteria, flexibility and diversity are independent; a fund could alternate positioning between one sector and cash, at which point it is flexible but not diversified, or conversely, it can have exposures in several sectors but not make material adjustments, which would make it diversified but not flexible. Of the 100 funds with available data, 26 were flexible and 43 were diversified. Only 15 funds were both flexible and diversified, and 46 funds were neither (figure 5).

We then looked at return streams to discern the degree of impact sector allocation decisions had on performance. The main factor we used when evaluating return streams was rolling correlations against major indexes (we looked at domestic equity, investment-grade taxable fixed income, high-yield bonds, securitized fixed income, and the U.S. dollar). A fund was judged to have consistent correlations if the average rolling correlation against any one index was higher than 0.7 (a fund can have high correlations against more than one index due to correlations between indexes). Return streams evaluated were at least one-year old as of August 31, 2013; information was utilized if available going back to August 31, 2010.

Examining both allocation and correlation data, the most striking finding is that the peer group as a whole is highly correlated to corporate credit. Seventy of the 100 funds in our study had consistent correlations to at least one index (see figure 6). Of those 70, only six did not have high-yield bonds as their highest correlation. To generalize, funds that were neither flexible nor diversified tended to have the highest exposure and correlation to credit. Funds that were both tended to have more balanced credit exposure and correlation.

Our study suggests that investors need to be cautious when allocating to unconstrained fixed-income funds. A significant portion of the universe maintains high and persistent exposures to credit and generates return streams that mimic those of high-yield and bank-loan strategies. At best, investors in these products are replicating existing satellite exposures. Or worse, they can find themselves inappropriately positioned during flights to quality when their unconstrained fixed-income exposure moves in unison with other risk assets in their portfolio.

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Endnotes
2. Core strategies, which account for the majority of ‘40 Act fixed-income alternatives, involve a multi-sector methodology with portfolio managers investing in the U.S. investment-grade fixed-income universe. This encompasses a mix of Treasury, securitized, and corporate investments to generate an excess return relative to the Barclays U.S. Aggregate index. Adding allocations to high-yield bonds, loans, non-U.S. debt, currencies, etc. results in a core-plus strategy with the benchmark usually being the U.S. or Global Aggregate.

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