Insight INVESTMENT

THE FIX FOR FIXED INCOME

DON'T BE A SLAVE TO YOUR BENCHMARK

AUGUST 2018

> **Embracing a more benchmark-agnostic approach has the potential to help investors maximise their returns from credit, through income-focused and total return credit strategies.**

Part of BNY MELLON

EXECUTIVE SUMMARY

Insight believes that a more benchmark-agnostic approach to fixed income investing, combining the base building block of smart income generation with an active total return credit strategy has the potential to maximise the earnings potential of an investment grade credit portfolio over time.

Based on the available data and on current market conditions, we believe such a strategy has the potential to deliver 2% pa above a credit benchmark over a market cycle.

[1] Forecast returns are estimates based on information that is currently available that may change in the future. As such, they are not a reliable indicator of future performance.

THE FIX FOR FIXED INCOME

Fixed income, as the name implies, was developed to deliver investors regular, contractual returns over a desired time horizon. However, with the rise of benchmark-aware investing, either explicitly (through passive mandates) or implicitly (via 'closet-indexing' active portfolios) much of the industry has appeared to lose sight of this income-oriented objective, focusing instead on price moves in a market where the instruments redeem at par.

Investors may be able to maximise returns in investment grade credit by:

- Refocusing on long-term sources of sustainable income
- Complementing this with total return credit investment strategies

DON'T BE A SLAVE TO YOUR BENCHMARK

Market cap-weighted benchmarks rose to prominence in the decades following the 1950s, when the concept of market 'beta' (representing the 'fully diversified market portfolio') was developed as part of modern portfolio theory[2]. Benchmarks are now the common proxy for beta.

Originally, these benchmarks were used as a guide to help measure a manager's performance. However, over time, market participants became fixated with analysing every difference between a portfolio and its benchmark, potentially tying investors closer to them and away from their core objectives.

In our view in the credit markets, this obsession with benchmarks raises four key problems:

1) Indices are structurally-biased towards the most indebted issuers

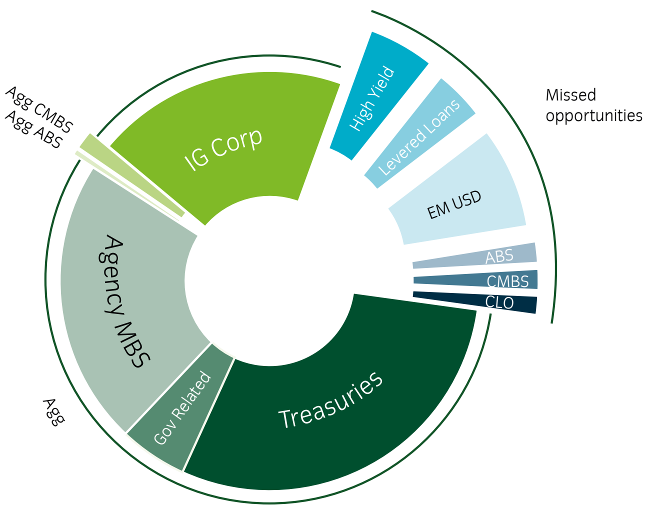
By definition, the largest index weights will be granted to the issuers and sectors with the most debt outstanding.

2) Market weights can lead to concentration risks

Aggregate bond indices (by far the most popular in the US) have an approximate 70% weighting in Treasuries and government-related debt. This severely diminishes the income potential of the index (particularly in a low yield environment) and reduces issuer diversification. Government-related securities also have the highest interest rate sensitivity, which has the potential to be a headwind for returns as monetary policy normalises.

Potentially compelling credit opportunities, such as emerging market debt or less mainstream areas of secured finance, are not included in the aggregate index and therefore often ignored by investors (Figure 1).

Figure 1: US aggregate indices are heavily concentrated and can exclude a large part of the universe[3]



[2] Source: Portfolio Selection, Harry Markowitz, *The Journal of Finance, 1952.* [3] Bloomberg, Bank of America Merrill Lynch, Insight, as at June 2018, for illustrative purposes only.

3) Passive funds are prone to forced selling

Passive funds are forced sellers of investment-grade issuers that become downgraded to high yield, and may have no choice but to sell at a time when market conditions may not be ideal. This can result in permanent impairments of capital.

Notably, this risk has increased as the average credit rating of US investment grade indices has migrated from high single-A to BBB (just above high yield) from 2007 to 2017[4] at a time the credit cycle is maturing, potentially making downgrades more likely.

4) Closet indexing ties active funds to flawed benchmarks

A recent study by GDC Research[5] indicates that 'closet indexing' is the largest flaw in active management. This type of investing potentially coerces managers to invest in assets they do not fundamentally believe in simply to align with benchmark weights, to minimise tracking error.

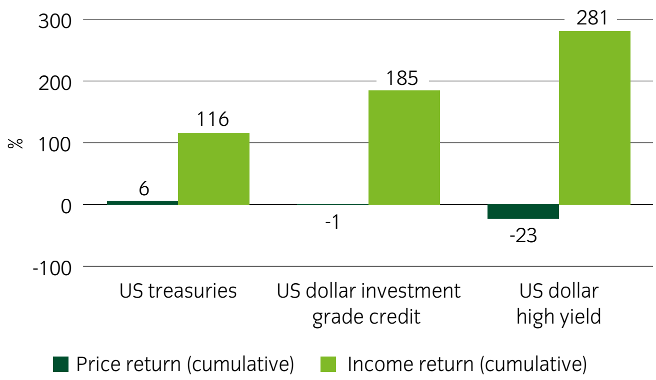
In our view, being more benchmark-agnostic, through looking for the most compelling credit opportunities, maximises the potential to capture beta and alpha more efficiently.

GENERATE A SMARTER BETA: FOCUS ON LONG-TERM SUSTAINABLE INCOME

Putting the 'income' back into fixed income

Despite the attention paid to price movements in the media and throughout the industry, prices have contributed very little to long-term total returns in fixed income (Figure 2). In government debt, investment grade and high yield markets, 90% of the total returns have instead come from coupon income through multiple credit cycles.

Figure 2: Income has dominated the total returns of fixed income indices[6]



[4] Source: Bloomberg, Bank of America Merrill Lynch, Insight, as at February 2018. [5] Source: GDC Research, "Active Management Unleashed: Addressing Mutual Fund Design Flaws and Re-establishing Value", as at March 2018. [6] Source: Bank of America Merrill Lynch, January 1999 – December 2017 (cumulative returns).

GENERATE A SMARTER ALPHA: EXPLOIT MARKET INEFFICIENCIES

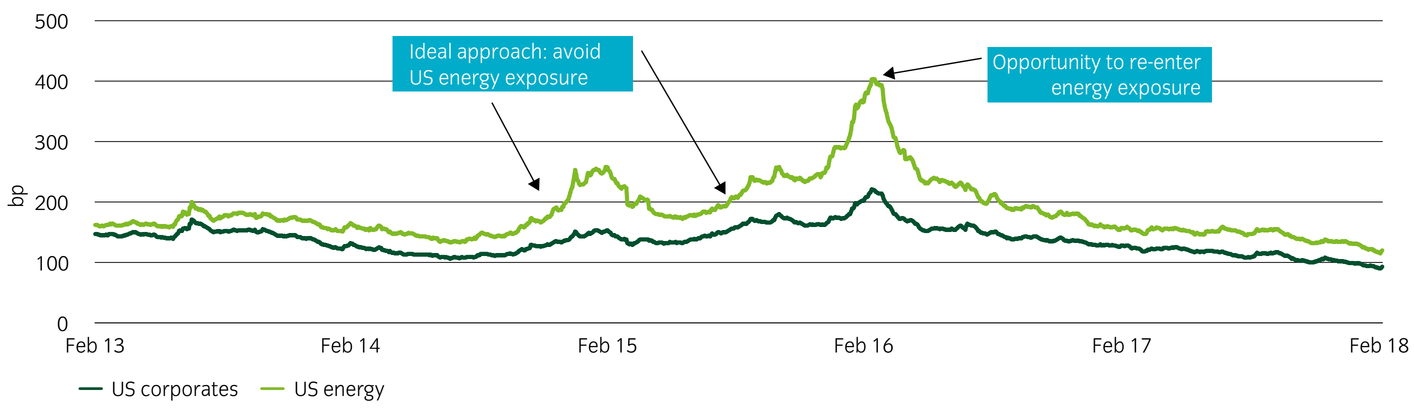
A 'total return' credit strategy can also help investors overcome the flaws of benchmarks in our view. Unlike traditional active funds, total return portfolios are not tied to benchmark weights. This affords them greater flexibility to exploit mispricings and market inefficiencies across global credit markets by complementing credit market income with multiple small tactical trades.

Flexible strategies can exploit the artificial barriers created by benchmarks

The very popularity of benchmark-aware approaches has created artificial barriers between asset classes within the fixed income markets, often creating relative-value opportunities across them. This offers an advantage to flexible investors able to allocate to areas such as secured finance, high yield, bank loans and emerging market debt.

Total return portfolios also have a greater ability to navigate falling markets than a benchmark-aware portfolio. When markets offer little value, they can build up cash reserves, rather than merely adopting an underweight. When markets re-price, they can spend the cash opportunistically (Figure 3).

Figure 3: Flexibility can allow investors to navigate sell-offs to generate outperformance[7]



[7] Source: Bank of America Merrill Lynch, as at June 2018.

COMBINING SMARTER ALPHA AND BETA APPROACHES INTO A SINGLE OPPORTUNITY SET

The smarter beta and alpha approaches outlined above can be executed as standalone strategies but given their potential overlap, combining them within a single strategy has the potential to provide a more consistent source of risk-adjusted returns.

Income and total return strategies naturally fit together

An income approach can strategically generate much of a portfolio's long-term beta exposure, while a total return approach can complement this by extracting more tactical shorter and medium-term alpha opportunities.

Certain bonds will likely prove suitable for both strategies (Figure 4) making separate allocations potentially less efficient. Combining the approaches also ensures a portfolio is never dependent on one strategy-specific performance driver, likely increasing the reliability of the return stream.

This type of strategy may be well-suited to long-term investors looking for:

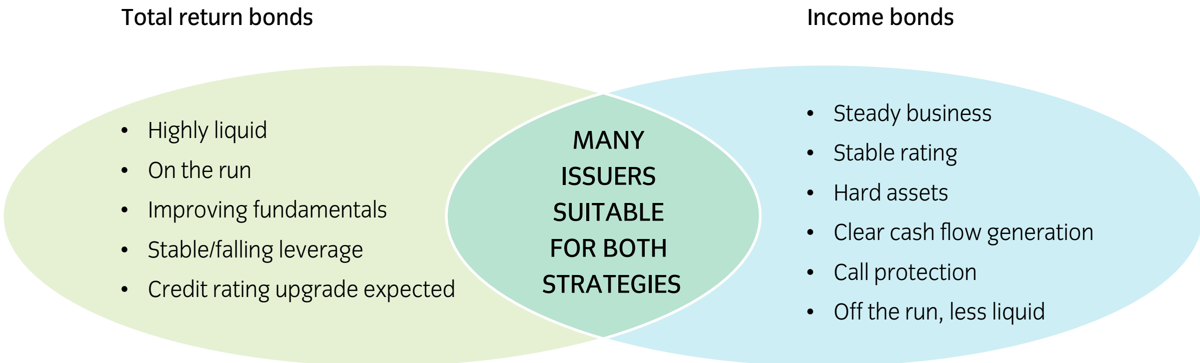
- Coupon income from structurally long credit exposure (which, as mentioned, has tended to dominate credit returns over the long-term)
- Participation in positive long-term US economic growth trends (which have historically smoothed out the effects of shorter-term cyclical downswings)
- A portfolio that will likely offer some correlation to the value of their liabilities

MAXIMISING THE POTENTIAL OF INVESTMENT GRADE CREDIT

As investors increasingly struggle to generate the yields they require, before they chase higher risks, they may first wish to consider if they are really maximising the potential of investment grade credit.

In our experience, with smarter and more benchmark-agnostic approaches they can consistently target 2% pa above an credit benchmark over the long term. As the credit cycle matures this could potentially provide a more sustainable and attractive solution for meeting their needs.

Figure 4: The overlap between strategic beta and tactical alpha strategies indicates a combined approach may be most effective[8]



CONTRIBUTORS

Gautam Khanna,
Senior Portfolio Manager,
Insight Investment

James DiChiaro,
Senior Portfolio Manager,
Insight Investment

Amol Chitgopker,
Senior Content Specialist,
Insight Investment

[8] Source: Insight, for illustrative purposes only.

IMPORTANT INFORMATION

RISK DISCLOSURES

Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

The performance results shown, whether net or gross of investment management fees, reflect the reinvestment of dividends and/or income and other earnings. Any gross of fees performance does not include fees and charges and these can have a material detrimental effect on the performance of an investment.

Any target performance aims are not a guarantee, may not be achieved and a capital loss may occur. Strategies which have a higher performance aim generally take more risk to achieve this and so have a greater potential for the returns to be significantly different than expected.

Portfolio holdings are subject to change, for information only and are not investment recommendations.

ASSOCIATED INVESTMENT RISKS

Fixed income

Where the portfolio holds over 35% of its net asset value in securities of one governmental issuer, the value of the portfolio may be profoundly affected if one or more of these issuers fails to meet its obligations or suffers a ratings downgrade.

A credit default swap (CDS) provides a measure of protection against defaults of debt issuers but there is no assurance their use will be effective or will have the desired result.

The issuer of a debt security may not pay income or repay capital to the bondholder when due.

Derivatives may be used to generate returns as well as to reduce costs and/or the overall risk of the portfolio. Using derivatives can involve a higher level of risk. A small movement in the price of an underlying investment may result in a disproportionately large movement in the price of the derivative investment.

Investments in emerging markets can be less liquid and riskier than more developed markets and difficulties in accounting, dealing, settlement and custody may arise.

Investments in bonds are affected by interest rates and inflation trends which may affect the value of the portfolio.

Where high yield instruments are held, their low credit rating indicates a greater risk of default, which would affect the value of the portfolio.

The investment manager may invest in instruments which can be difficult to sell when markets are stressed.

Where leverage is used as part of the management of the portfolio through the use of swaps and other derivative instruments, this can increase the overall volatility. While leverage presents opportunities for increasing total returns, it has the effect of potentially increasing losses as well. Any event that adversely affects the value of an investment would be magnified to the extent that leverage is employed by the portfolio. Any losses would therefore be greater than if leverage were not employed.

FIND OUT MORE

Institutional Business Development
businessdevelopment@insightinvestment.com
+44 20 7321 1552

European Business Development
europe@insightinvestment.com
+49 69 12014 2650
+44 20 7321 1928

Consultant Relationship Management
consultantrelations@insightinvestment.com
+44 20 7321 1023

Client Relationship Management
clientdirectors@insightinvestment.com
+44 20 7321 1499

@InsightInvestIM

company/insight-investment

www.insightinvestment.com

14103-08-18