Unconstrained Fixed Income: Strategies that can reach different portfolio goals

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Facing high stock prices, low interest rates and global economic uncertainty, institutional asset owners are seeking new ways to diversify and find sources of return. Unconstrained fixed-income strategies can play an important role in reaching both goals, but they require in-depth understanding. Investors need to be comfortable with what the strategies can — and cannot — do, how they can track the performance and how their managers are implementing the strategies. In this roundtable discussion, Todd Thompson, a senior portfolio manager at Reams Asset Management; Sean Banai, head of portfolio management at Voya; and David Zee, a senior vice president at Callan, talk about the pros and cons of carving out an allocation to unconstrained fixed income.

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Pensions & Investments: Unconstrained fixed income means different things to different people. What are the common defining characteristics?

TODD THOMPSON: Unconstrained fixed-income strategies are often characterized by the absence of a benchmark. In addition, unconstrained mandates typically employ a lower average duration in the portfolio versus traditional fixed-income mandates, but also a wider duration band. Both of these characteristics provide a good deal of flexibility. Unconstrained strategies are also characterized by broad participation across different sectors of the fixed-income universe, including more esoteric parts of the market that aren't generally included in larger flagship benchmarks, as well as more off-the-run and less-liquid areas.

SEAN BANAI: The only thing I would add to what Todd said, which I totally agree with, is that we believe that unconstrained fixed-income strategies should have lower correlations to equities and rates.

DAVID ZEE: It is diversified, and so you can think about it from the efficient frontier. You have the core strategy, which is a multisector-type of strategy benchmarked to the [Bloomberg Barclays U.S. Aggregate Bond index], and then core-plus, which introduces emerging market, high yield and bank loans; a little bit more opportunistic. And then core-plus-plus. Unconstrained is really in the core-plus-plus space, where you've got quite a bit of diversification across sectors, but you also have a higher concentration in aggregate exposure to spread duration.

P&I: Are there identifiable "flavors" of fixed income that might help investors frame their analysis of unconstrained?

THOMPSON: Unconstrained is a large tent, so to speak, with a lot of different strategies within its confines. However, within the tent, I see strategies molding to one of two general approaches. One is an income approach and the other is an opportunistic or total rate-of-return approach. We believe that unconstrained is best looked at as being an opportunistic strategy that seeks out attractive risk-adjusted total returns. This means being able to respond to opportunities wherever they may be, in whatever part of the fixed-income market they present themselves. The other approach tends to focus on generating high levels of income by drawing from a broad range of bond sectors and security types. Although this category may be classified as unconstrained by virtue of its absence of a traditional benchmark, it is not truly opportunistic in regard to responding to dislocations. We believe that a total rate-of-return mindset is considerably different from an income-oriented mindset, and investors may also want to draw a distinction between these two approaches.

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P&I: Are there any features of unconstrained fixed income that make it particularly relevant or compelling in today's market environment?

BANAI: We believe so. One thing we have observed is the rapid nature of sell-offs and recoveries in the market. In the fourth quarter of 2018, for example, we had a meaningful sell-off in credit markets, and by April 2019 we basically got everything back from that sell-off. Unconstrained fixed income allows you to take advantage of those occasions to a much greater degree than benchmark-relative strategies such as core-plus.

THOMPSON: Sean has made some interesting points. The acute instances of volatility can be very high, but in general terms, volatility for most of the fixed-income market has been fairly subdued since 2009. I believe the past 10-year period has been abnormal, as unconventional central bank monetary stimulus has artificially suppressed volatility. With that said, one could argue that we really haven't had the right opportunity for unconstrained to show its true potential. With respect to today's market environment, it appears that uncertainty may be on the rise, with a litany of risk factors asserting themselves. Those include global tensions, Brexit, trade wars and questions about the sustainability of global growth. With this backdrop, potentially, the appeal of unconstrained, a product that should benefit from elevated volatility and higher tail risk, is rather compelling.

P&I: How should institutional investors think about unconstrained fixed income if they're looking at potentially adopting the strategy? How difficult is it to compare managers?

BANAI: The universe of unconstrained strategies contains a broad array of investment styles. Because of this, investors really have to do a lot of work to pick the right manager and the right strategy for their portfolio. We look at unconstrained as a complement to other strategies, not a substitute for core or core-plus. Therefore we believe it is important to find a manager that is additive to the portfolio and helps meet the overall objectives of the fixed-income allocation as well as the total portfolio.

THOMPSON: The main consideration is the functional role one is looking to attain with the allocation. Other key considerations should be the tracking error or volatility introduced, the correlation to other fixed-income sleeves in the portfolio and the expected alpha target. Manager comparison should focus on which high-level approach each manager fits into, income or opportunistic.

ZEE: I think the best way to describe this holistically would be to look at unconstrained strategies from an absolute-volatility perspective and to tranche them into different volatility buckets. The second thing would be to look at them from a perspective of whether or not managers are consistently and systematically overweight spread duration or do they tend to be more tactical in interest rates and other types of opportunities away from just being long spread.

P&I: What are the key benefits of unconstrained fixed income, and how are asset owners utilizing the strategies in their portfolios?

BANAI: In our view, the key benefit of unconstrained fixed income is the lack of underlying market beta, which aids in portfolio diversification, but also allows managers to allocate where they are finding the best risk-adjusted returns. With unconstrained, you can take advantage of different asset classes that provide better Sharpe ratios. The way we think about risk and return is what maximizes Sharpe ratio, and in an unconstrained format, that allows you to look globally to see what markets and sectors provide the best Sharpe ratio and focus on those opportunities.

Again, we don't see unconstrained as a standalone solution but more as a complement to other strategies. We recently did some work looking to see how much unconstrained you should have in your portfolio. We looked to optimize the Sharpe ratio while maintaining key fixed-income attributes when combining unconstrained with a core-plus mandate. Our research concluded that a 30% allocation to unconstrained, within the fixed-income portfolio, was the optimal allocation. This can be refined based on client needs and objectives, but 30% of fixed income provides a good starting point for that discussion.

THOMPSON: To add to that, if you truly view and utilize the product as being opportunistic — and I want to keep highlighting that as the key attribute in contrast to income — you typically tend to do better when volatility is elevated. One could argue that the unconstrained investor is essentially long volatility. The opposite, being short volatility, basically entails selling various structural attributes or risk factors to collect incremental income. Looking at it from the standpoint of diversification, unconstrained could be a natural offset to other parts of a portfolio that are inherently short volatility, such as securitized risk, corporate credit, private debt or even high yield.

P&I: Many corporate defined benefit plans are derisking. Can unconstrained fixed-income strategies play a role in these efforts?

BANAI: It depends on the client what their expectation for duration is, but we recently had an institutional client fund an unconstrained fixed-income mandate as part of their risk-seeking bucket. Part of the decision they were making was moving away from equities and replacing some of the equity risk with an unconstrained mandate. When we showed them the drawdown on Voya's Unconstrained Fixed-income strategy versus equities, it was a lot lower for unconstrained. If your expected return for equity is maybe 6% or 7%, then unconstrained could provide you LIBOR plus 300 or 400 basis points, which would compete with that return expectation for equity with a lower drawdown. But it really depends on how much duration a client needs. We have talked to some clients who have considered unconstrained fixed income with a futures overlay to extend their duration, and in that case, unconstrained would provide them with an alpha return on top of that. We have also had more plan sponsors consider unconstrained as a way to hedge cash balance plans.

THOMPSON: Sean is spot on with the drawdown factor, which is evidenced by capture ratios. The risk symmetry is skewed in your favor versus equities; so I agree with the inclusion of unconstrained for derisking purposes in certain circumstances. In regard to [liability-driven investing] clients or pensions specifically, I think unconstrained has a role as a plan's growth assets are being reduced for clients who are at the later stages of the derisking process and are almost out of equities altogether. A plan may have a funded status in the high 90% range, but may still need some kind of alpha generator to hit its targeted level, perhaps 105% to 110%, in order to exit or terminate. I believe adding unconstrained fixed income as a supplemental alpha generator in lieu of equities makes perfect sense in this scenario. One caveat to adding unconstrained: The cash flows from the unconstrained allocation should be sequestered and not included as part of the hedge assets, which are higher quality and more predictable.

ZEE: Can unconstrained play a role in an LDI program? I would say it could, and here's my thinking: Since a good portion of LDI programs invest in long corporate debt to match that long liability, you may have an unintended consequence of having a diverse set of managers managing long duration, but they're all invested in the same long corporate bonds. And so we're starting to do some more work on looking at unconstrained fixed income for that higher spread component but then pairing it with interest rate futures so that we can stretch duration to match that liability duration. The goal is to have a different diversifier of risk than what you would typically see in the long LDI portfolio.

At the end of the day, it really comes down to portfolio construction as to how many managers you have on your existing platform and what differentiated strategies you can find to pair them as complements.

P&I: Many institutional investors have allocations to private debt, distressed debt as well as more traditional liquid credit mandates. How does unconstrained fixed income interact with these strategies at various points in the credit cycle?

ZEE: There's a healthy group of investors handing allocations to private debt, and I would say there's going to be a rising-tide-floats-all-boats kind of phenomenon where unconstrained strategies, private

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debt, liquid credit, all have some sort of exposure to spread duration. So in theory, unconstrained may be the only strategy that can or should have exposure to safe haven securities in late or down cycles because, in theory, managers would be allocating out of credit and into let's say government or sovereign debt to reduce their spread exposure and protect on the downside.

THOMPSON: All of these would be on a typical unconstrained manager's radar screen for inclusion. You want to take into consideration where you are in the credit cycle to weigh the merits of private versus distressed versus liquid credit. But I think the key component is that it depends on the value proposition at the time. For sectors that are less liquid, such as distressed and private debt, they come with a price. The decision to invest in these areas must weigh the risk-reward proposition against the sacrifice of liquidity.

BANAI: I agree. I think valuation and credit cycle are extremely important if you want to allocate to an illiquid asset, but that is only part of the equation when evaluating in the context of unconstrained. Liquidity is also an important factor. It's the exact same thing that Todd mentioned. We do believe there should be a limit of how much illiquid assets you put in the portfolio. With unconstrained, you need to maintain liquidity so that you can adjust the portfolio to take advantage of dislocations, and you want to be able to move around the different sectors. Even if the valuation is very appealing and you are an early part of the cycle as well, you still need to limit allocations to illiquid assets in the portfolio.

P&I: Are there any guidelines in terms of what a client should allocate to an unconstrained strategy?

BANAI: The first question a client needs to ask themselves is, "Am I looking for a market beta?" The majority of clients that are considering multi-asset strategies and multisector credit strategies are looking for beta. They want the portfolio to act like a particular market beta. In our view, unconstrained is less of a beta source because you have more alpha opportunities generally coupled with a very flexible duration range. Based on the work that we've done, if your goal is to improve the efficiency of your fixed-income portfolio (measured by the Sharpe ratio) while maintaining bond attributes, then we believe a 30% allocation to unconstrained would be a good place to start. Now, as I mentioned before, every manager is different. This is just looking at the universe of unconstrained, but if you run the same basic statistics versus other managers, you may get very different results because of the broad array of approaches implemented across the unconstrained universe.

P&I: How do you define success for a strategy that's so heterogeneous and flexible in terms of portfolio guidelines?

THOMPSON: I think the market seems to have coalesced around LIBOR plus 300 [basis points] as a performance expectation for unconstrained products over a full market cycle. It's important to stress having a longer time horizon for judging performance. A three-to-five-year market cycle is preferable to assess the efficacy of the product, as we believe the best of what this strategy can bring to bear is witnessed over longer time periods. We also believe that information ratio is a good measure of success, which gauges how much volatility is being converted to bottom-line returns. Finally, capture ratios are a good tool to assess the long-term symmetry of return profiles versus various fixed-income sectors as well as other asset classes. It is this metric where the unconstrained product shows such favorably skewed

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symmetry versus equities, as mentioned in a prior question.

BANAI: We think of it very similarly to what Todd mentioned. Most unconstrained managers have a return objective in the ballpark of LIBOR (or some cash index) plus 200 to 400 basis points. We look at that performance and the volatility of our portfolio versus the [Bloomberg Barclays U.S. Aggregate Bond index]. When we talk to a client, we review how much return we have generated versus LIBOR and then how much volatility our portfolios have had versus the Aggregate [index]. Our goal is to maximize Sharpe ratio and information ratio. For us, success is to beat LIBOR plus 200 to 400 basis points with less volatility than the Aggregate [index]. That's really what our goal is for unconstrained fixed income.

ZEE: I would say how we measure whether or not they're successful is really whether they are able to deliver the results they're promising. They don't have to all be investing in the same way for us to see whether or not they are successful or not. And that's the beauty of some of these strategies, they don't all have to march and sound alike. They can focus on different types or different places in the market and still be able to deliver return. So are they able to deliver the promised results with the intended risk? I think that is something that should be compared. I think that's probably a good apples-to-apples comparison.

P&I: What are the biggest risks that investors need to understand about unconstrained fixed-income strategies?

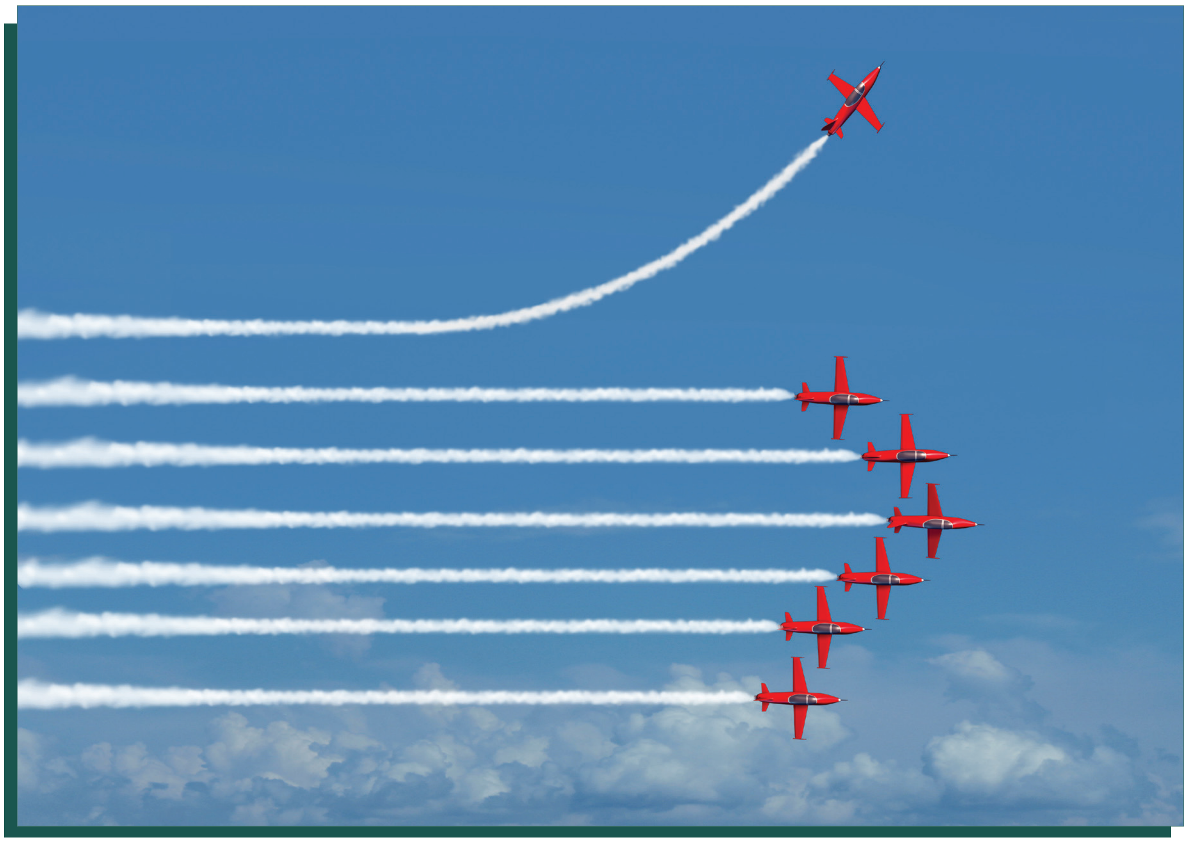
BANAI: One thing we talk about quite a bit in our firm is that unconstrained fixed income is different across managers, so the biggest risk in our view is the manager's style. If you look across the unconstrained landscape, it's unequal. The [range among] unconstrained managers is large, so depending on the style of the manager, you cannot just say, "I want an unconstrained mandate," and go get one. You really have to make sure that the unconstrained manager that you pick fits well with all the other strategies that you have in your portfolio. That's the biggest thing we talk about to our clients, and we feel that that's the biggest risk when people talk about unconstrained mandates.

THOMPSON: A key risk that investors need to understand about an unconstrained strategy is the potential for short-term underperformance. If you think about it, if unconstrained is truly an opportunistic product, then missing out on the last phase of whatever is hot in the market, so to speak, goes with the territory. If you're supposed to be responding to volatility and being opportunistic, you don't want to be reaching for income in leveraged loans or high yield, or whatever it might be. This requires a bit of discipline. Sometimes over very short periods, when you're not a momentum investor — in fact the way this product is run, you're the opposite of a momentum investor — you're typically going to lag, especially when everyone's whipped up in a frenzy. It goes with the territory of managing expectations, and it goes back to not being so focused on short-term performance but instead having that long-term view.

ZEE: I think the key risk is that you're buying one thing and getting another. What I mean by that is if you think your unconstrained strategy is going to be, for example, more focused on currency and interest rate management but then you get a trunk full of spread duration, that's a risk that could be very real. So many of these strategies focus on different areas; you really have to do your homework to make sure you're buying the right one for you.

P&I: Do you spend a lot of time educating clients, making sure they understand what the category is about?

THOMPSON: There's definitely some education that takes place. At the heart of unconstrained is being



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opportunistic and, at times, being aggressively cautious, in contrast to a strategy that is fully invested in risk all the time. The unconstrained portfolio is structured to perform better when volatility picks up, as you move and reorient the risk profile to take advantage of those dislocations. If the client understands the strategy and their expectations are clear, there are no surprises about what the portfolio should do and what it should not do, and how it will behave under certain market conditions.

BANAI: It's important to acknowledge that the unconstrained category is ill-defined. Because of this, it does take time to educate and explain to clients how we define and approach unconstrained fixed-income investing. To us, "unconstrained" refers to the investment universe, not the risk budget. Although we use the global fixed-income opportunity set, we seek a risk profile that is consistent with [the Bloomberg Barclays U.S. Aggregate Bond] index. Because most clients have allocations to core-plus, we typically frame the discussion by comparing core-plus and unconstrained. The way we describe it is if you look at core-plus mandates, the majority of risk comes from duration. If you take duration away from a core-plus mandate, your risk profile substantially changes. Many of our peers in the unconstrained space use duration to generate alpha or to take a directional view on rates. That is not how we approach duration management in our portfolio. We view duration as a risk-management tool. We don't use duration as an alpha generator or to bet on the directionality of interest rates; rather, we deploy duration as a risk offset in the portfolio.

P&I: What are best practices in terms of due diligence and ongoing monitoring?

ZEE: I think the best practice is to have a deep understanding as to exactly what you are buying or investing in. I would add that many managers have certain tendencies, or what I call favorite honey wells, that they tend to go back to time and time again because they have higher success rates from investing in that part of the market or niche. And so knowing where managers tend to travel would be something that you need to understand.

Another aspect would be the importance of risk management. Understanding how managers buy their risk based on their conviction and in what magnitude, or when they take losses and profits, can help set expectations. On top of that, who's really monitoring the investors and what kind of systems are those people utilizing to get that transparency? These are all really important because the only thing managers can control is how much risk is in their portfolios; performance is really a byproduct.

P&I: How difficult is it to help clients understand the importance of long versus short-term in this context?

THOMPSON: I think it is absolutely, front and center, one of the first conversations you must have with a client. In order to implement an unconstrained approach properly, you must have the ability to evaluate opportunities over a long time horizon with a value investor's eyes, measuring performance over three to five years and not quarter to quarter. Often investors have a natural inclination to focus on short-term results. Two of the "essential ingredients of unconstrained" we always walk through with our clients are the focus on total return versus income and having a longer time horizon. Establishing this requires a bit of coaching on the front end and good communication along the way, but these are critical concepts.

BANAI: I totally agree. When you're talking to institutional investors, that's the No. 1 objective, to make sure they understand the risk and return expectations for this type of strategy. Setting realistic expectations is critical for success with any strategy, but particularly within the context of unconstrained. ■