INVESTMENT INSIGHTS

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The Importance of Unconstrained and Multisector Bond Funds in Today's Market

Following the decade of low yields since the Great Recession, investors now look at their fixed-income investments to not only protect against volatility and risk, but also to deliver higher returns.

"A lot of times, the market conditions are the catalyst," said Randall Parrish, Voya Investment Management's head of credit. "It's the plan that has a high return hurdle, and they come to us and say 'How am I going to get there? I can buy equities, but I've got to have some fixed income. What role does that play?'"

Traditionally, investors in that position have either looked to riskier credit products or extended the duration of their fixed income portfolio, but today they are just as likely to consider more innovative credit products with a broader opportunity set. Often, that means investing in some combination of multisector credit or an unconstrained fixed income strategy. Both exhibit relatively low correlation to interest rates, but unconstrained strategies can also offer lower correlation to equity markets and have the potential to deliver some protection against a broad risk sell-off. That's particularly important at this point so late in the market cycle.

BUILT-IN FLEXIBILITY

"The way that you construct a product and the right fit for a given client depends on what their return target is and how much volatility they are willing to take," Parrish said. "There's quite a bit of flexibility around a mandate for any given opportunity."

Multisector credit typically includes a blend of high-yield bonds and bank loans that look and act like credit investments but gives managers the flexibility to react to changing market conditions. Unconstrained fixed income employs a broader set of investment opportunities that involves additional asset classes.

The right mix of multisector credit and unconstrained fixed income will depend on an individual client's needs. One might prefer a multisector credit investment that has a high beta to credit markets. That might include high yield and bank loans as well as emerging market corporate and a few other asset classes as well.

Multisector credit is easier than unconstrained fixed income for clients to understand, Parrish said, since it behaves like credit, is easier to benchmark and includes asset classes with which they typically have experience.

By comparison, an investor interested in more of an absolute return approach might be more interested in an unconstrained product that's more complex and might bring less liquidity in exchange for the prospect of higher returns.

MANY FLAVORS

"Where multisector credit is more homogenous, unconstrained can mean a lot of things to a lot of people, but probably not the same thing to any two," Parrish said. "That opens up a broad range of products."

In addition to emerging market debt, an unconstrained fixed-income strategy might also include private credit or more flavors of securitized products. If less liquid assets are included, it may feature gated redemptions. When credit is attractive, unconstrained fixed income may own a lot of it, but it can own very little when credit markets are stretched or other investments are more attractive.

Fund managers have more leeway with unconstrained strategies to choose where to invest and to take advantage of short-lived opportunities that pop up in a volatile market. The product has evolved in recent years, and today's unconstrained fixed income strategies use duration to minimize risk over a full market cycle. They're also not benchmarked in a traditional way.

"There might be a LIBOR benchmark instead of a credit benchmark," Parrish said. "The idea is that you're looking for more sources of alpha, less correlation of returns and for positive returns regardless of the market environment. So even if the credit markets are weaker, you are still looking for that LIBOR-plus-something return. But you also have to look at the price that you're willing to pay in terms of volatility to get there."

ROOM FOR BOTH

Multisector credit and unconstrained strategies are not always mutually exclusive, but they typically fit in different buckets inside an investor's portfolio.

"They can co-exist within a broad portfolio, but you really have to think about those different buckets," he said. "You don't want to take a multi-credit fund and put that in somewhere you're really looking for absolute return and limiting downside. Because when credit markets sell off, that fund might outperform a credit benchmark, but it's probably still going to give you a negative return."

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Parrish said he spends a lot of time in discussions with clients trying to understand their particular needs in order to determine the right product or mix of products for them.

"There's a lot of flexibility, so often it's just about understanding their risk tolerance and desire," Parrish said. "We can build products tailored to fit a client. Like everything else, your return target is directly related to the amount of risk that you're willing to take. Telling yourself otherwise is kind of silly."

Interest in these strategies cooled a bit last year when interest rates looked set to rise more than they did, but Parrish said that no matter what the broader market does, he expects to continue seeing more interest in both multisector credit and unconstrained fixed income.

"It's a conversation that's here to stay and even beyond rates picking back up," he said. "You move forward a year or two, if there's a downturn in the credit cycle, multisector credit won't be as popular, but once you come through on the other side of the next downturn, credit is always going to be a part of investor portfolios." •

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