WHAT SHOULD AN ALLOCATOR DO WITH THEIR CORE BOND PORTFOLIO?

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Facing Difficult Choices Amid Current Volatility

After two years of fiscal and monetary largesse, the current year is expected to be one of transition as macroeconomic policy supports temper. Although we believed that the tailwinds of the past few years would increasingly become headwinds, the volatility of the past month accelerated this concern and made it difficult to ascertain whether markets are more concerned about inflation, policymakers' attempts to control it, Omicron, the possibility of a recession, geopolitics, or something else. What does seem clear however, is that owners of investment portfolios need to deflate their return expectations as the possibility of a net negative return year should be taken seriously.

Faced with such a return environment, pension and endowment investors are presented with some difficult choices.

- On the one hand, they can maintain prior return objectives and consider increasing contributions and/or reducing target payouts; but each of these solutions is extremely difficult to accomplish.
- Alternatively, one might consider reducing portfolio risk given the rich valuation levels evident in most asset markets, but risk-free asset returns are minimal.

Moreover, most bear markets have historically been associated with recessions and/or credit crunches and at present, it is difficult to imagine a central bank precipitating such a path for the economy. Given the greater than normal uncertainty regarding the outlook, neither of the above approaches seems optimal.

In times like this, initiating a thoughtful review of the composition of one's portfolio is an especially valuable endeavor. Core components of such an exercise should include:

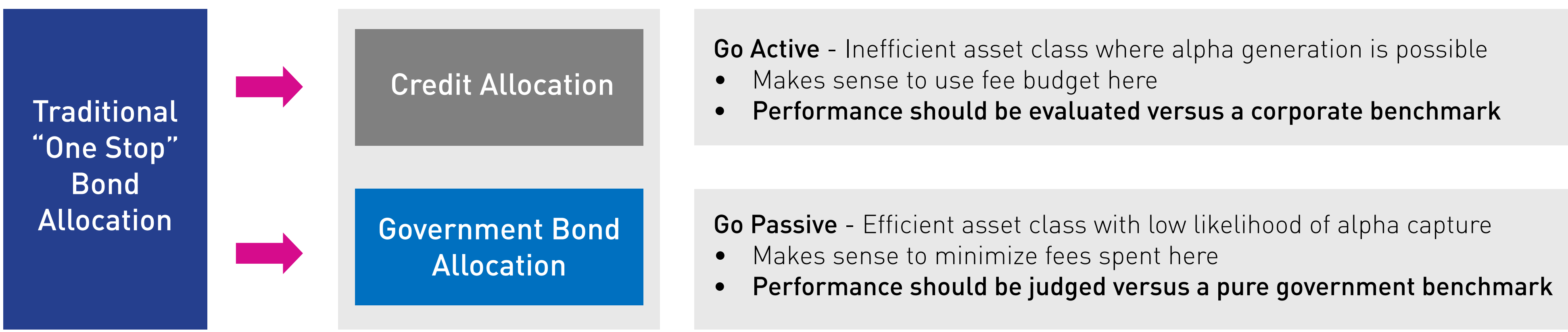
1. Re-assessing passive exposures
2. Re-underwriting conviction levels, and the size of allocations to, existing active managers
3. Ensuring that the portfolio has adequate liquidity and flexibility

Un-coring the Traditional Fixed Income Allocation

Another relatively simple, but valuable exercise to consider is to 'un-core' the portfolio's traditional fixed income allocation since such an allocation is unlikely to play the role in portfolios that it once did. With government real yields still near historic lows, bonds are not generating meaningful income. And with inflation risks more significant, the correlation between government bond and equity returns is likely to shift in a positive direction, thereby limiting traditional fixed income's ability to be a portfolio stabilizer unlike in the past. The one area where government bonds still offer considerable benefit is their contribution to portfolio liquidity in times of stress and as a result, the ability for the portfolio manager to meet prior commitments, to rebalance weightings, or to exploit idiosyncratic opportunities.

The traditional fixed income allocation in portfolios is a combination of interest rate and credit risks. In Canada, the FTSE Russell Universe Bond Index is often used as the main benchmark for traditional fixed income allocations. Government bonds (interest rate risk) represent 73% of the market value of this index and corporate bonds (default risk) account for the balance. Many fixed income managers outperform this benchmark by simply tilting the portfolio slightly to credit and many allocators have done the same by adopting Core Plus allocations. But in a traditional 60/40 portfolio, this implies that the bulk of the fixed income exposure remains government bonds, resulting in interest rate exposure.

Consider Unbundling the Fixed Income Allocation



Given the reduced benefits noted previously, it is worth considering whether explicitly unbundling the fixed income allocation into its two components and reducing the government bond weighting (i.e., un-coring it) can lead to a higher return and a more efficient fixed income portfolio.

Government Bonds

Government bonds are an efficient asset class with a low likelihood of capturing an excess return from active management. Abstracting from any liability hedging considerations (and Liability-Driven Investment strategies), the amount and type of government exposure should be determined by the likely liquidity needs of the portfolio and a rigorous stress-case scenario analysis. Having said this, several empirical studies using simple mean-variance analysis have suggested that an approximately equal allocation between rates and credit is more optimal. Implementing such a change will result in a higher return and lower overall duration for the portfolio, which can produce lower rates exposure than usually found in core mandates. Further, this segment of the portfolio is likely to be best managed passively against a pure government benchmark. Consequently, it should also attract lower management fees.

Currently, with the yield curve quite flat and uncertainty regarding the trajectory of inflation and upcoming interest rate increases, it is also worth considering keeping the duration of this exposure quite short (perhaps 1-2 years) rather than accepting the 9-year duration that characterizes the Canadian government bond index.

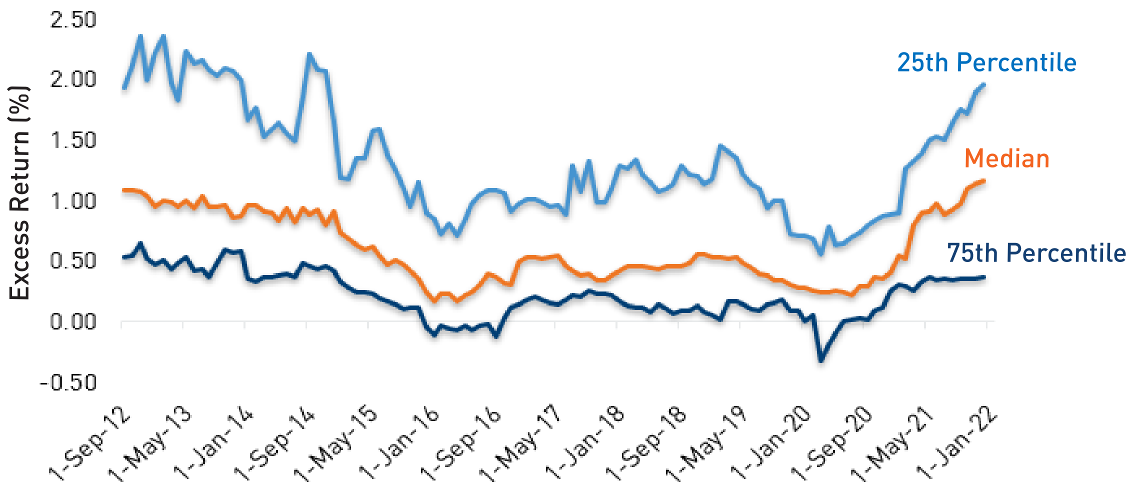
Credit

Turning to the credit component, increased bank regulation and the central bank policies of the last few years have had a lasting and significant impact on the financial sector, and this has created a meaningful increase in opportunities for credit investors. Theoretical and empirical studies support the view that credit is a distinct asset class with a significant positive excess return over time that also has a low correlation to interest rate and equity excess returns. Historically, the duration-adjusted excess return appears to have been approximately 100bps (1%) or a level very comparable to investment grade spreads currently available in the market.

Importantly, traditional credit markets have several characteristics that offer a meaningful potential for earning an additional return from active management. Many investors are highly constrained and limited in what they can hold as there is constant financing activity, no centralized exchange, and many obligors have issues trading in various currencies. All these factors present a fertile hunting ground for an active manger, especially if that manager has the freedom to exploit the crossover segment of the market.

For example, over the last 10 years, the median corporate bond manager has outperformed the corporate index by an average of 59bps (0.59%) and top quartile managers added another 73bps (0.73%)

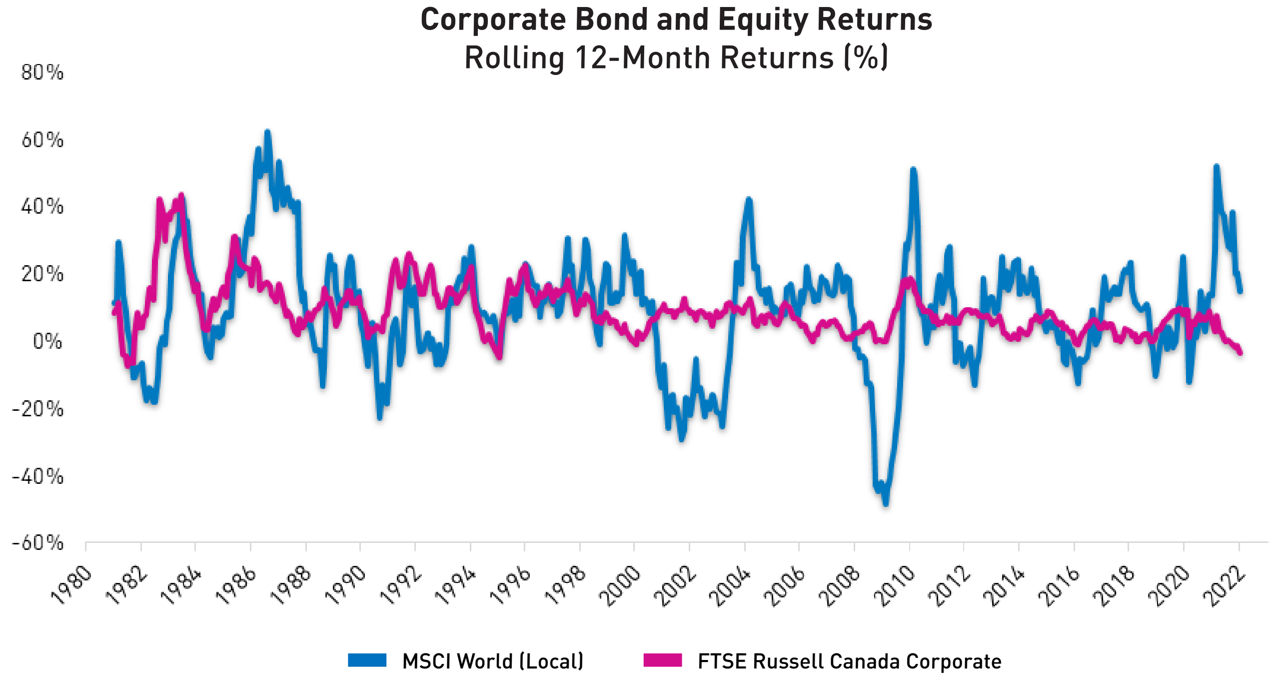
Over the last 10 years, Top Quartile Managers have delivered an average of 73 bps more than the Median Manager



	Max	Min	Avg.
25th Percentile	2.36	0.55	1.32
Median	1.17	0.17	0.59
75th Percentile	0.65	-0.33	0.21

As of March 31, 2021. Source: eVestment FTSE, Universe quartile rankings as per eVestment Canada Corporate Bond Universe. Benchmark: FTSE Canada All Corporate Bond Index

In conclusion, a thoughtful unbundling of the fixed income allocation can preserve liquidity needs and generate more income than a traditional core allocation without increasing portfolio risk. While government bonds have historically provided balance to equity risk in a portfolio, corporate bond exposure also provides balance (see chart below). Although adopting these types of changes is unlikely to be enough to achieve an investors original return requirement, the opportunity to generate additional return without an increase in standard deviation should be helpful.



Source: MSCI, FTSE Russell, RPIA

Important Information

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