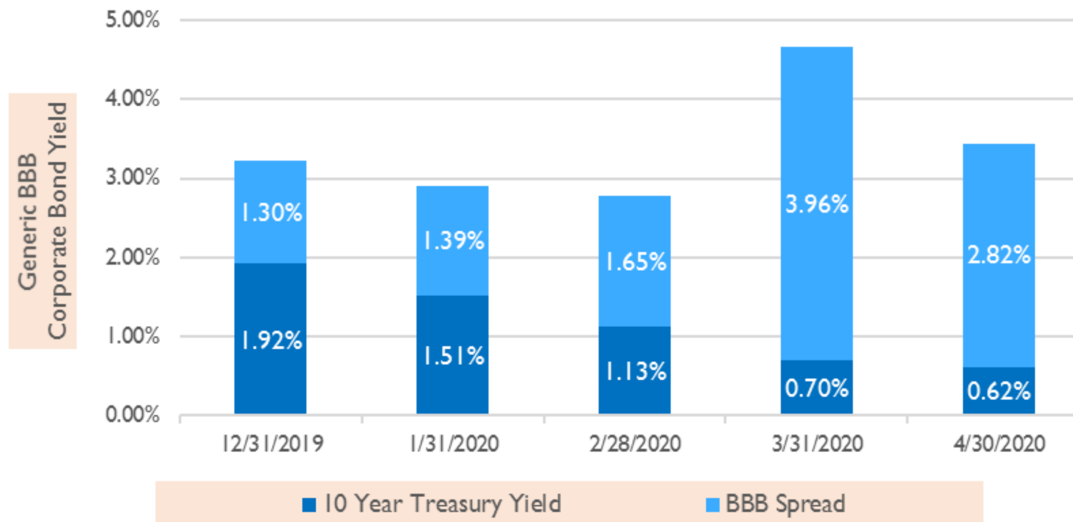
Active Fixed Income Review

Bolton

Dramatic Shifts in the 1st Quarter of 2020

In the first quarter of 2020, the yields of U.S. Treasury securities fell to record lows, producing high returns for that sector. At the same time, the "spread" on U.S. corporate bonds (the difference between their yield and the yield of a Treasury bond of the same maturity) rose significantly.



Bond yields and prices move inversely. A bond is issued with a coupon fixed at the current interest rate. As rates rise or fall, the bond's market price adjusts so that a buyer earns the new prevailing interest rate.

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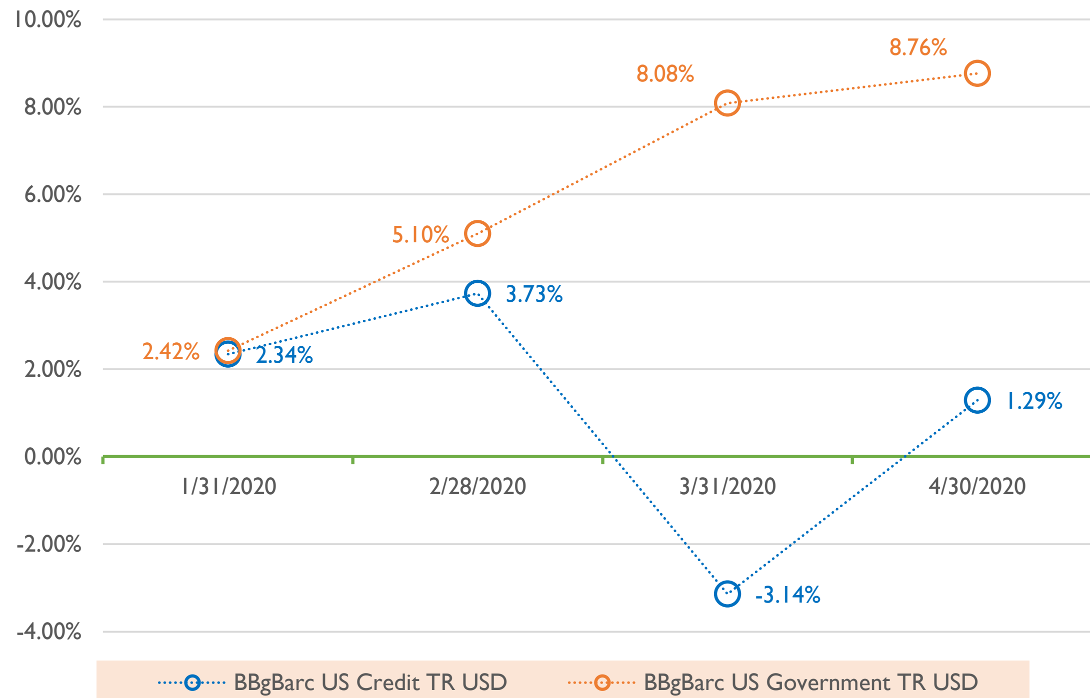
Dramatic Shifts in the 1st Quarter of 2020

The sharp rise in credit spreads produced negative returns for corporate bonds, both investment grade and high yield.



For a security with credit risk, credit spread is the yield margin above a Treasury security of the same maturity. Investors require more return for holding a security with higher volatility and/or risk of default.

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Why Did Active Managers Underperform?

Active managers of intermediate maturity US fixed income portfolios are generally categorized as Core or Core Plus. Core managers invest almost entirely in the investment grade securities included in the Bloomberg Barclays US Aggregate Index. About 90% of the index is accounted for by three large sectors:

3/31/2020	2020 YTD
Broad US Bond Market Average:	
BBgBarc US Agg Bond TR USD	3.15
Core US Investment Grade Sectors:	
BBgBarc US Government TR USD	8.08
BBgBarc US MBS TR USD	2.82
BBgBarc US Corp Bond TR USD	-3.63

Even for a Core manager, any diversification away from the Government sector resulted in underperformance. The Index ranked in the 15th percentile of the Core category.

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Why Did Active Managers Underperform?

Core Plus managers invest a portion of their portfolios in sectors outside of the Aggregate index. Below are the returns through March 31 of several common “Plus” sectors:

Typical "Plus" Sectors		
BBgBarc US Treasury US TIPS TR USD	1.69	*Inflation exposure*
BBgBarc Global Treasury Ex US TR USD	-1.53	*Foreign currency*
BBgBarc EM USD Sovereign TR USD	-11.36	*Emerging Markets (ex currency)*
BBgBarc US Corporate High Yield TR USD	-12.68	*US non-investment grade*

Even small allocations to these areas produced significant underperformance relative to the Aggregate Index.

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Will Our Manager Recover This Year's Underperformance?

- In March, corporate bonds faced two problems: A loss of liquidity in the market, and the prospect of a prolonged economic recession and higher defaults by borrowers.
- Since March 31, liquidity has improved, and corporate spreads have narrowed. By April 30, the Core Plus managers we follow had reduced their margin of YTD underperformance by about half.
- Liquidity was increased by having the Federal Reserve buy bonds, which also freed up capital at banks when those banks were sellers
- Credit remains an outstanding issue, as the depth and persistence of the current recession remain unknown. But spreads have narrowed for both investment grade (shown above) and high yield bonds.
- When a bond is issued, its coupon and principal value are fixed (in simple terms, there are exceptions). If the bonds held by active managers are sound, then much of this year's underperformance should be earned back over the remaining life of the bonds.

A market for an asset is described as more "liquid" when buyers and sellers can easily transact at the most recent price. It helps if the asset class is homogenous – that is part of why Treasury bonds are more liquid than houses.

What are the Future Implications for Investors?

We think it is possible that the fixed income market has a "new normal," with lower risk-free (US Treasury) rates and higher credit spreads.

- Moderate returns will be accessible to fixed income investors, but will likely come with higher volatility, because both the risk-free rate and the spread can change.

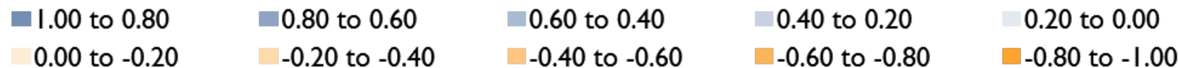
- Securing those returns will likely require holding a higher proportion of securities with a credit spread, which historically have had a higher correlation with equity returns.

Investors construct a diversified portfolio in order to reduce the overall volatility of their returns. Correlation describes whether the returns of two assets move in the same direction.

Correlation Matrix

Time Period: 5/1/2005 to 4/30/2020

		1	2	3
1	Russell 3000 TR USD	1.00		
2	BBgBarc US Government TR USD	-0.34	1.00	
3	BBgBarc US Corp Bond TR USD	0.38	0.43	1.00



- This may create a choice between low returns to provide true diversification, and seeking more complex assets (real estate, infrastructure) that could be non-correlated.

- Investors seeking to annuitize will find that process more expensive.