Active Management in Fixed Income: Conviction is Key

Active Management

Central banks seem likely to remain accommodative and keep monetary policy rates lower for a while to come. Consequently, real policy rates will presumably remain negative over the longer-term both in Europe and in the US. A new approach is therefore needed. Investors should expect lower market returns ("beta") for the foreseeable future. All of this makes outperformance ("alpha") a more important component of overall investment returns[1].

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[1] See: "The new Alphabet of Investing", AllianzGI, September 2014

[2] As of November 2014

Understand

The yield on the fixed-income index most commonly used by portfolio managers in Europe – Barclays Capital Euro Aggregate – currently stands at 0.89%[2]. Clearly, changing times demand a new approach. Acting with conviction by going global, remaining flexible and seeking higher degrees of freedom is the path to higher returns.

Expand the Investment Opportunity Set: Go Global

Expanding the investment universe and the range of opportunities can lead to (see chart 1):

- Increased returns
- Lower portfolio volatility (thanks to diversification)
- Higher information ratios
  (a measure of a portfolio manager's skill)

Conviction is Needed

Capturing alpha in the fixed income space requires conviction, which can be built, for example, on a fundamental investment process using a macro-driven, top-down approach. This investment process starts with an in-depth analysis of the main macroeconomic indicators, such as economic growth, monetary policy developments, and inflation expectations. It looks at the impact that these factors have on interest rates in the long term. The findings – combined with an assessment of investors' risk appetite, which is largely influenced by the decisions of the central banks – allow investors to compare their expectations with the market consensus. This reveals investment opportunities. The more expectations differ from those of the market, the higher the conviction in the investment idea. Global fundamental analysis is also leveraged to strengthen portfolios with strategies that enhance returns and lower volatility.

An approach that recognises the role of conviction takes the traditional strategy for investing in the European fixed income market to a new level. It is an evolutionary approach aimed at helping investors realize alpha through greater degrees of freedom – that is to say, greater discretion.

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Understand. Act.

Chart 1: Rule of Active Management

Source: Allianz Global Investors

Chart 2: Active Management in Fixed Income – Three main strategies

Increasing degree of freedom and discretion

Core Strategy	Diversified Strategy	Absolute Return
Target • Active vs. benchmark	Target • Total return approach vs. benchmark	Target • Absolute return approach, no benchmark
Investment universe • European focus	Investment universe • Global universe with European focus	Investment universe • Global universe with European focus
Risk Profile • T. E. vs. benchmark – medium	Risk profile • T. E. vs. benchmark – high	Risk Profile • Max VAR defined ex-ante

Source: Allianz Global Investors

Depending on the degree of discretion, several investment strategies associated with conviction are possible (see chart 2).

1) Core Strategy

2) Diversified Strategy

3) Absolute Return

The process, involving the analysis of key macro trends, is characterized by active management of duration, country allocation, yield curve and credit exposure, which results in a very dynamic bond-sector asset allocation. The tracking errors[3] of these active fixed income strategies are not pre-defined, as they depend on the degree of conviction in portfolio positions.

Active management is the key to generating returns in a low-yielding environment. What does active management mean for a fixed income approach with conviction? Here are the main points for the evolution of a traditional approach for investing in the European bond market to a more flexible investment approach:

[3] The tracking error ("TE") is a measure of how closely a portfolio follows the index to which it is benchmarked.

Core Strategy

A traditional strategy for investing in the European fixed-income market can generally be described as follows: Portfolios are very well diversified within the European investment universe, but the degree of freedom is limited, as the TE from the benchmark is normally not very high.

Diversified Strategy: Extracting Returns from the Global Investment Universe

With a larger degree of freedom and discretion, a strategy for investing in the fixed income space could seek sources of return outside the benchmark universe and the European theatre. For example, core strategies with a high degree of conviction are magnified and then coupled with out-of-benchmark diversification strategies. This means looking beyond the traditional Euro Aggregate benchmark securities, perhaps by including a mixture of high-yield bonds, convertible bonds, foreign exchange, inflation-linked bonds, government bonds and corporate bonds from non-Eurozone countries (such as Australia and the US, including selected active currency positions when necessary). This expanded opportunity set tries to combine the best of both worlds: a wider investment universe that provides additional sources of alpha and lower portfolio volatility.

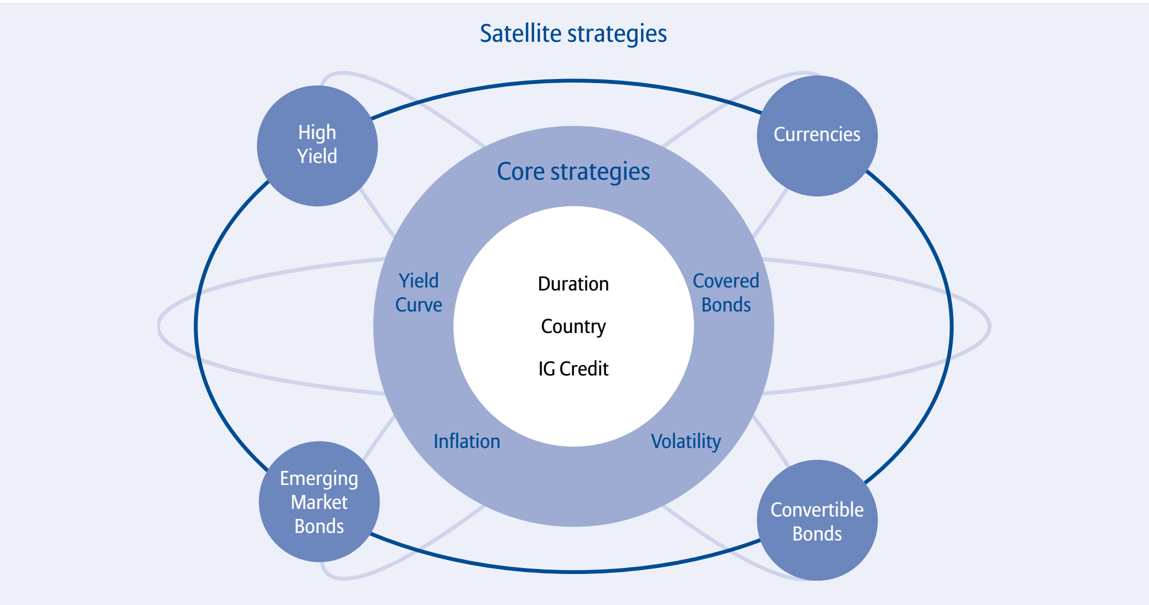
As a result, diversification within active strategies, and a distinction between core and satellite strategies (see chart 3), becomes highly relevant:

1. Core strategies: Core strategies are related to duration, yield-curve positioning, country allocation, covered bonds and investment-grade credit. These strategies must be selected based on market cycle in order to obtain the best risk/return profile. They represent the most important part of the portfolio and need to be managed through careful fundamental analysis. Country exposure is a key element, for example, as the spread dynamics inside the Eurozone offer attractive investment opportunities. Corporate bonds are a necessary portfolio component in a low-yield environment in order to improve portfolio return, but require a rigorous investment approach that leads to the proper selection of issuers.
2. Satellite strategies: Satellite strategies include sectors such as emerging market bonds, convertible bonds and currencies, which can significantly increase a portfolio's return in some market phases. The mix between core and satellite has to take into account a satellite strategy's higher degree of volatility, together with its capacity to improve the degree of diversification in the overall portfolio.

A robust risk-management approach incorporating value-at-risk plays an essential role in this combination.

Chart 3: Extracting returns from a global investment universe

Utilizing core & satellite strategies



IG = investment-grade. Source: Allianz Global Investors

Think Outside the Box and Abandon the Benchmark: Absolute Return

Flexibility and negative duration capabilities could be key factors in a low-yield environment characterized by risk-on and risk-off markets.

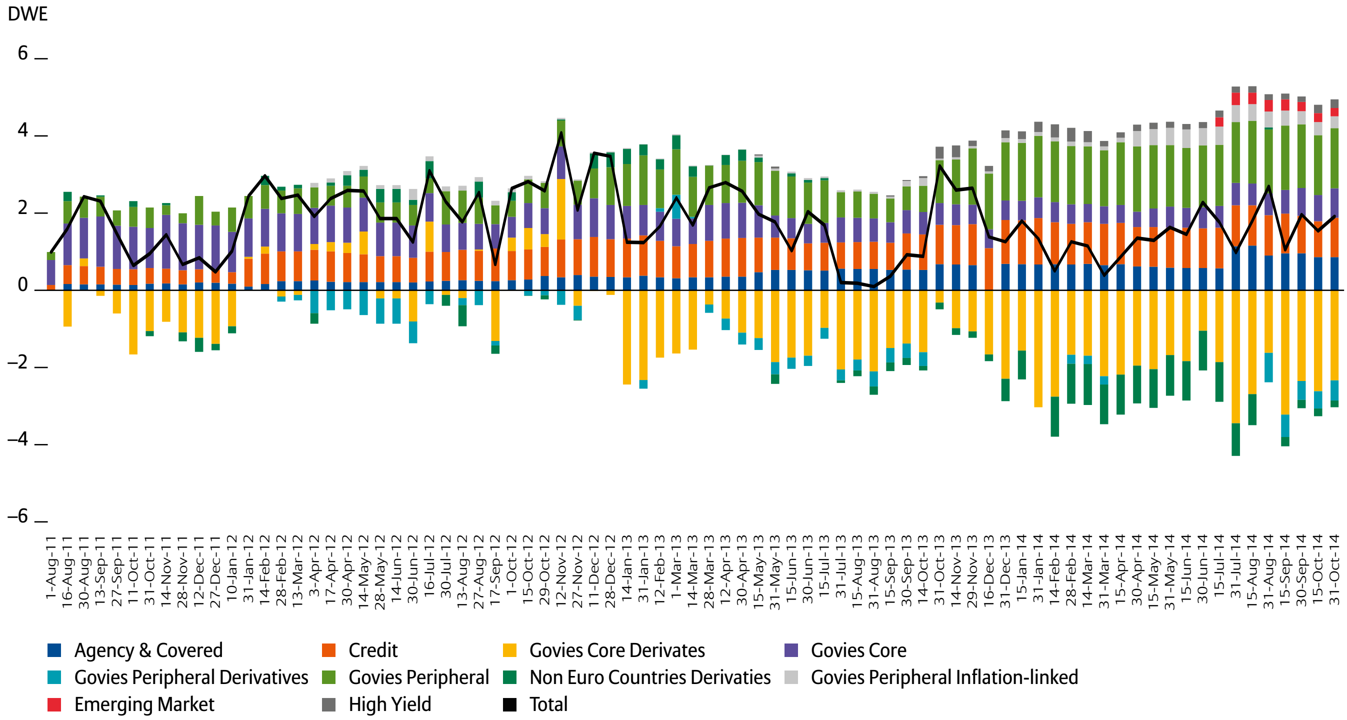
First of all, investors who want to capture alpha need to think outside the box and abandon the benchmark logic that, by its very nature, represents a limited basket of securities. By abandoning the traditional benchmarking approach, bond portfolio managers have room to move towards the largest possible investment universe, with the objective of selecting only the asset classes that are likely to offer a positive return based on the time horizon being considered. This makes the absolute return of the portfolio the main objective to be considered.

Second, active interest-rate risk management is an essential element of a truly flexible approach. The high volatility and, in some ways, the unpredictability of current bond markets have modified the present concept of duration, which now needs to be adjusted to accommodate "risk-on" and "risk-off" markets. In this context, the total duration of a bond portfolio does not represent the only relevant information for a portfolio manager. Instead, the main issue becomes how duration is allocated between the different asset classes. This means being able to modify the interest rate elasticity of each bond asset class separately according to different market expectations.

Although government bond yields in core countries are currently close to historic lows, this type of investment continues to represent a fundamental point of reference for bond portfolios. A very small increase in bond yields can generate negative returns for investors, as current yields are no longer sufficient to compensate for even very limited capital losses. As a result, bond-portfolio managers need the skills and ability to manage negative duration levels for different bond asset classes in order to achieve positive returns – even under circumstances that are normally unfavourable for traditional benchmark-managed fixed-income products.

The chart below shows how duration might be actively managed for different bond sectors in an absolute return investment process.

Chart 4: Duration-weighted contribution per strategy



Govies = government bonds. Source: Allianz Global Investors, data as of November 2014

Although duration management in the example above is very active (black line), the changes of duration in the individual bond sectors (government, credit, emerging markets, etc.) is of greater significance. Different bond sectors perform differently depending on the stage in the economic cycle, and a portfolio manager can allocate assets to those sectors that will outperform. Interest rate futures and options are the best way to offset interest rate risk.

Given current market dynamics and our expectation that the low-yielding environment will remain a phenomenon for the next few years, investors should opt for a flexible and active approach to bond management. Only by fully utilizing all the tools available to them can bond managers maximize returns and provide protection from rising yields.

Act

How should investors proceed?

1. Jump out of the crowded passive playing field dominated by benchmarks. Passive or index investing in today's low-yield environment will not deliver the returns investors need.
2. Think and invest "outside the box". Invest globally and flexibly to take advantage of a global investment opportunity set.

An expanded investment universe provides the best conditions for leveraging investment skill to capture alpha.

Imprint

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