Unconstrained global credit: a dynamic approach to fixed income investing

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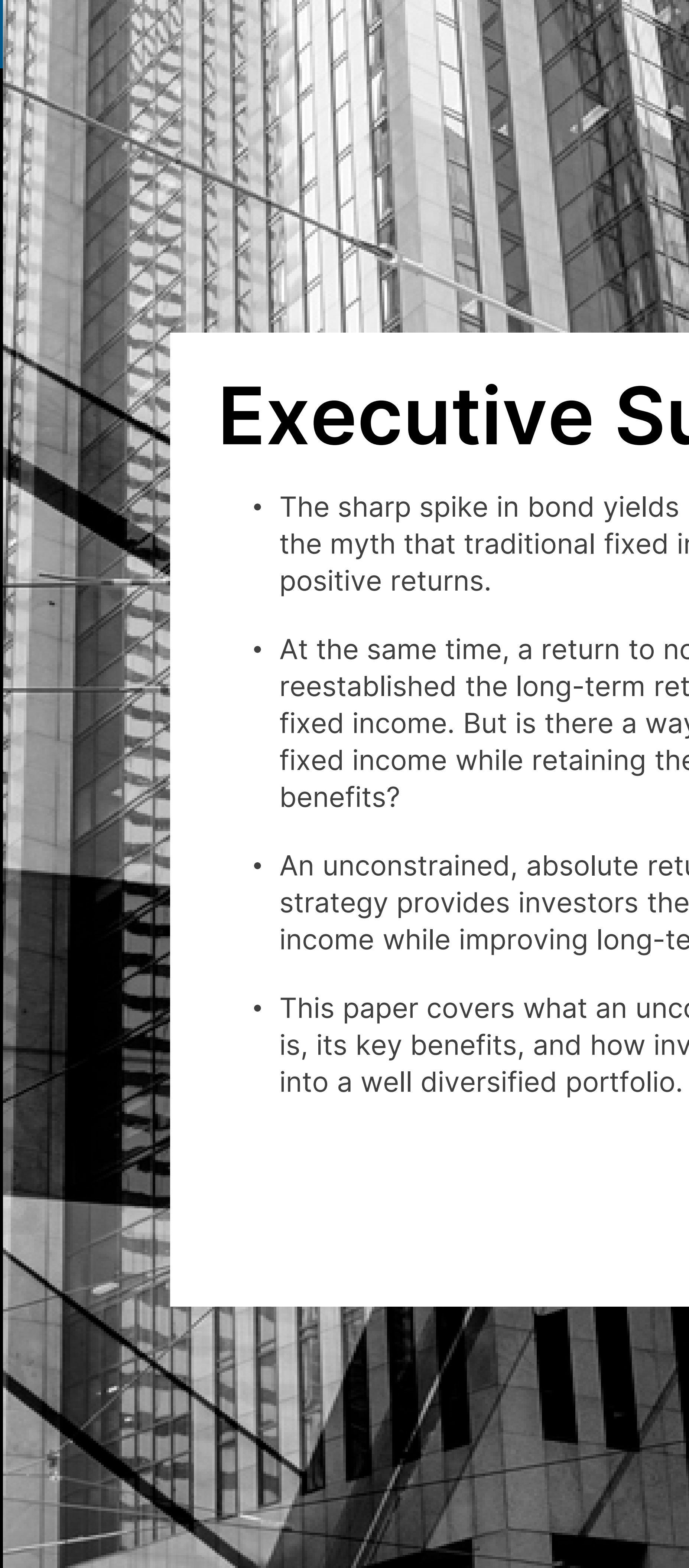

Executive Summary

- The sharp spike in bond yields in 2021 and 2022 shattered the myth that traditional fixed income only ever generates positive returns.
- At the same time, a return to normal bond yields reestablished the long-term return potential of traditional fixed income. But is there a way to mitigate drawdowns in fixed income while retaining the asset classes' key benefits?
- An unconstrained, absolute return focused global credit strategy provides investors the core benefits of fixed income while improving long-term expected returns.
- This paper covers what an unconstrained credit strategy is, its key benefits, and how investors can incorporate it into a well diversified portfolio.

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Overview

After decades of falling yields provided a tailwind for fixed income returns, rising yields over the past few years proved a nasty headwind. In fact, investors experienced two straight years of losses in their traditional bond portfolios in 2021 and 2022[1] , the first back-to-back negative returns since 1997/1998.

People don't expect to lose money in fixed income. While fixed income retains many of its key historical benefits, losses should lead to a critical examination of the type of fixed income an investor holds. We recommend an examination followed by a reformulation of one's fixed income exposure rather than outright elimination. Investors should consider a strategic allocation to an unconstrained global credit strategy because of the attractive risk-adjusted returns that are targeted by dynamically managing credit risk and interest rate risk throughout the investment cycle.

What characterizes an unconstrained global credit strategy?

There are many different flavours of unconstrained global credit (UGC) strategies: the degree of geographic exposure, the mix of asset class exposure (investment grade, high yield, loans, private credit), the risk budgets and return objectives and so on. However, despite the diversity, there are a number of common ingredients that should be present to constitute a UGC.

- **Broad corporate investment universe**
- **Dynamic investment approach**
- **Absolute return focus**
- **Enhanced risk awareness**

Broad corporate investment universe

UGC strategies tend to focus on investments within a segment of the capital structure as well as different parts of the broader credit capital markets.

[1]ICE BofA Global Bond Index

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Chart 1: A plethora of fixed income sectors to chose from

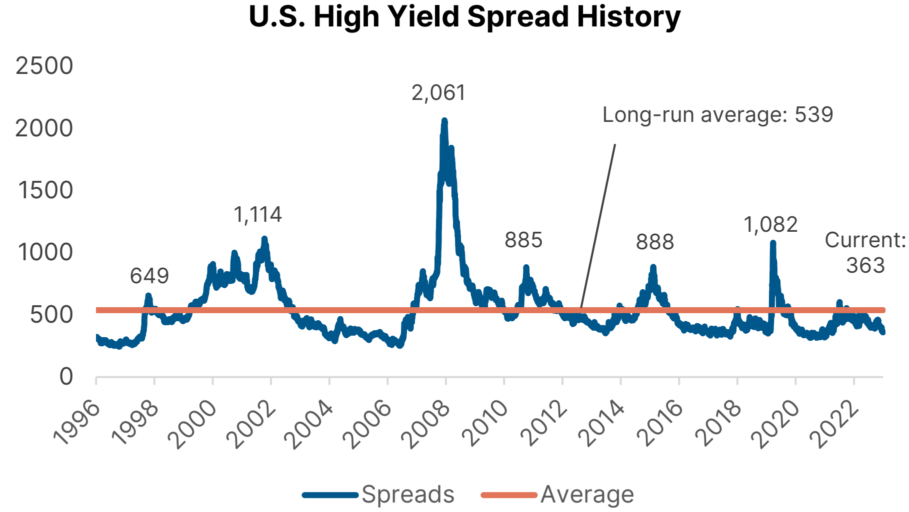
Fixed income sectors	Key Characteristics
Global corporate bonds	Investment grade rated bonds issued by companies domiciled in developed economies.
Global high yield	Sub-investment grade rated bonds issued by companies domiciled in developed economies. Typically higher credit risk and offering higher interest rates than investment grade issuers.
Bank loans	Floating rate loans issued to sub-investment grade companies.
Convertible bonds	A bond that pays interest but can be converted into a pre-determined amount of common stock.
Asset-backed securities	Bonds and loans secured against auto loans, credit card receivables, mortgages, and other financial assets.
Private placements	Bonds and loans that are typically unrated and do not have a liquid secondary trading market.
Emerging market corporate bonds	Corporate bonds issued by companies domiciled in emerging markets. Tend to be sub-investment grade rated issuers.

Large Canadian pension plans began moving away from concentrated allocations of Canadian securities decades ago and smaller institutional and high-net-worth investors are following suit. Diversification is the one free lunch in investing—a broader investment universe, all else equal, should lead to better portfolio outcomes over time.

Dynamic investment approach

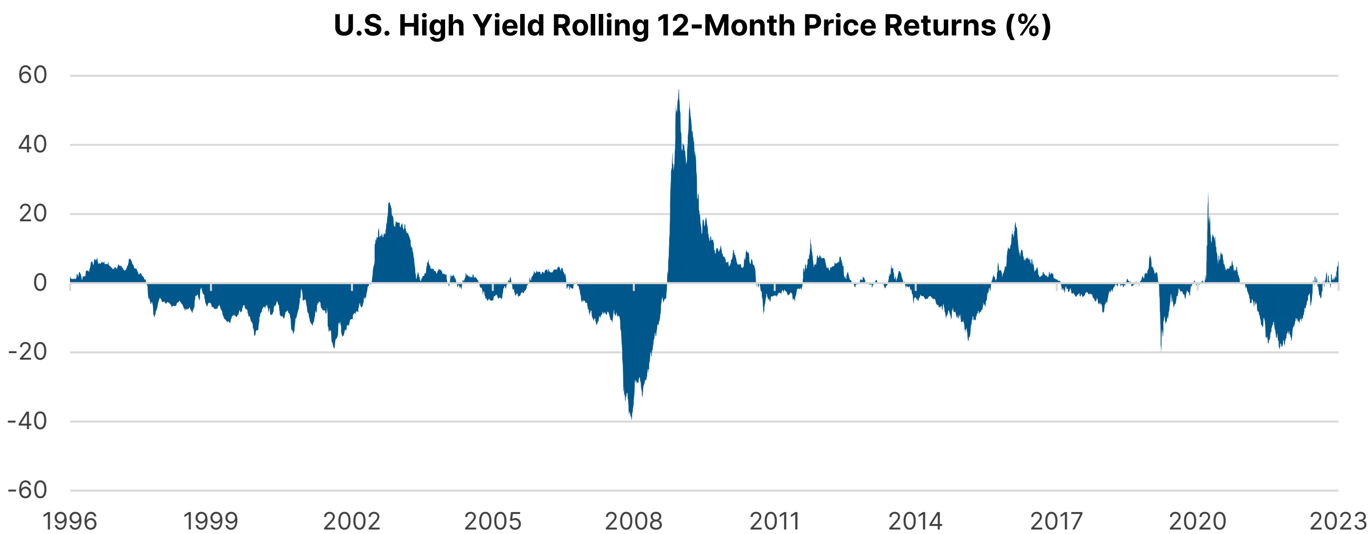
Active management acknowledges and respects credit spreads can stay tight, and yields low, for long periods. Shifting to higher credit quality and shorter duration mitigates risk in expensive markets. When markets are cheap or distressed, a dynamic approach calls for taking advantage of the opportunity by rapidly and decisively shifting into lower credit quality positions.

Chart 2: Valuations are highly cyclical in credit markets



Source: ICE BofA data as of December 31, 2023

Chart 3: Valuations are highly cyclical in credit markets



Source: ICE BofA data as of December 31, 2023

Credit exposure must be actively managed as there are times when spreads rapidly increase (e.g., the Great Financial Crisis of 2008 and COVID-19 in March 2020). These periods lead to substantial short-term losses but offer the potential to reap significant long-term recoveries, rewarding investors that dynamically increase exposure and risk after credit selloffs and patiently hold on during the recovery phase of the cycle.

Absolute return focus and benchmark agnostic

Absolute return focus is defined by the goal of generating positive returns regardless of market environment, independent from a benchmark return.

Benchmark agnostic means portfolio characteristics, including credit exposure and duration, are a byproduct of the individual credit determinations driven by bottom-up analysis, not a result of trying to be within plus/minus of a benchmark.

An absolute return, benchmark agnostic investment approach builds a resilient portfolio of best ideas, not necessarily the highest yielding ideas. The approach targets positive returns in all markets. Free from the typical constraints of a benchmark-relative mandate, the strategy has the license to capitalize on market dislocations whenever and wherever they occur.

Risk aware

There are layers of risk management embedded in a UGC. Some are in common with traditional fixed income strategies such as bottom-up security analysis and minimum diversification requirements at the issuer level.

Traditional funds “constrain” risk by mandating relatively close adherence to a benchmark. These constraints target tight tracking error but often increase risk with poor investment outcomes. It is not always an effective way of managing downside risk, the risk that a strategy has negative absolute returns.

For example, a traditional bond strategy may be allowed to deviate from a benchmark which has eight years duration by one or two years. Being two years short the duration of a benchmark would be a bold call by a portfolio manager managing a benchmark-relative bond mandate. However, the reality is that if bond yields rise by 1 percent, the portfolio manager will outperform their benchmark by 2% but still lose 6% in absolute terms[2]. Hardly an ideal outcome for investors!

UGC strategies are unconstrained with respect to credit and duration positioning. To be clear, it’s not that UGC strategies won’t take on risk. Assuming risk is a necessity when trying to generate returns above the risk-free rate. However, UGC can be selective about when and how much risk it takes on and can avoid certain risks entirely if the compensation is deemed insufficient. Many traditional fixed income strategies do not have this flexibility.

[2]We are outlining a highly simplified scenario where things such as credit spread and yield curve changes and running yield are ignored to isolate the impact of the duration positioning decision.

Why investors should consider investing in unconstrained global credit

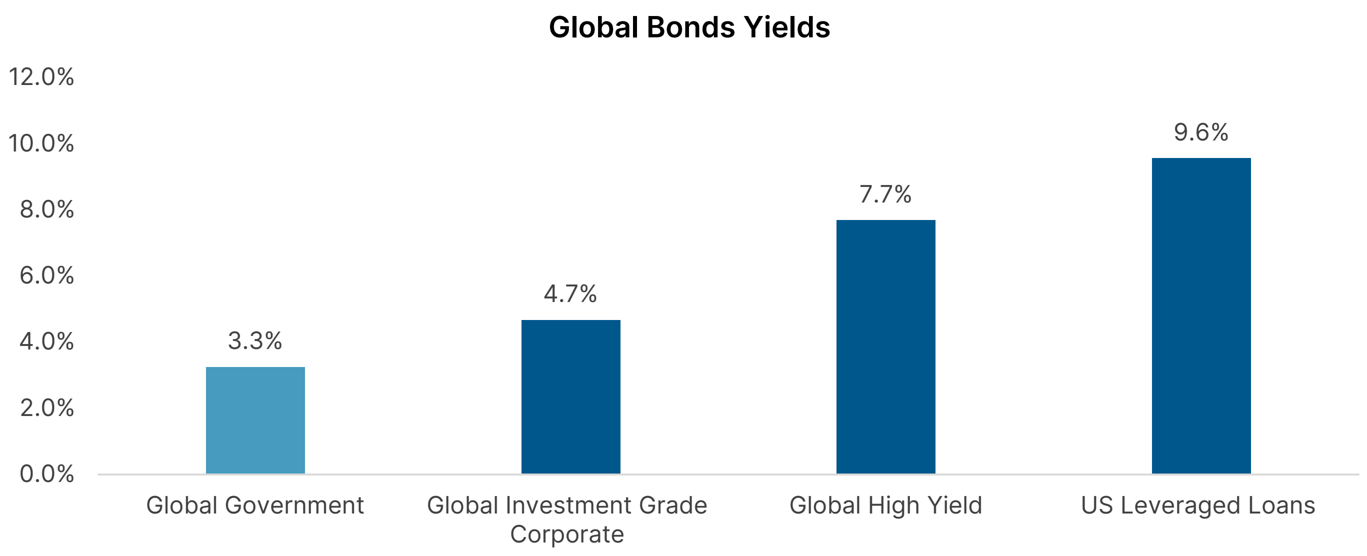
UGC aims to retain the key benefits of fixed income while enhancing and smoothing out returns.

- **Diversification.** Fixed income is a diversifier and a risk mitigator versus other asset classes including equities or real estate which tend to dominate many investors' portfolios.

- **Income.** Fixed income can provide meaningful portfolio cash flow. Corporate bonds can provide return over and above government bonds.

- **Capital Preservation / Capital Appreciation.** Fixed income can and should act as a preserver of capital but can also, in periods of market dislocation, provide substantial capital appreciation potential.

Chart 4: An attractive yield pick-up from diversified global credit



Source: ICE BofA and S&P Global data as of December 31, 2023.

How to allocate

A core fixed income substitute: Some investors commonly see UGC as a substitute for a large portion of an existing traditional fixed income allocation. UGC strategies can target a more attractive expected return profile than traditional fixed income without a commensurate increase in risk.

A fixed income satellite: For investors that want to maintain a traditional core fixed income exposure (for example pensions that want duration exposure to hedge liabilities), a satellite allocation to this strategy can be a return-seeking credit focused compliment.

An equity substitute: Some investors use UGC strategies to reduce the equity concentration risk in their portfolios without materially sacrificing return potential. UGC strategies also target a smoother return profile than equities. In other words, the long-term destination may be similar but the experience along the way can be more comfortable in a UGC strategy.

Conclusion

Fixed income remains an important part of a well diversified portfolio, especially after the recent normalization in bond yields. An UGC provides diversified exposure to a breadth of credit sectors through opportunistic positions. Ideally, well compensated risks are assumed, poorly compensated risks are avoided.

Ultimately, UGC provides a way for investors to lessen the home county bias in their portfolio while either enhancing the return potential of existing fixed income allocations or de-risking equity allocations. In either case, it’s another potential tool in investors’ toolkits to help meet their long-term objectives.

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