The case for tactical fixed income portfolios

Christian Pariseault | Head of Fixed Income and Global Asset Allocation Institutional Portfolio Managers

Introduction

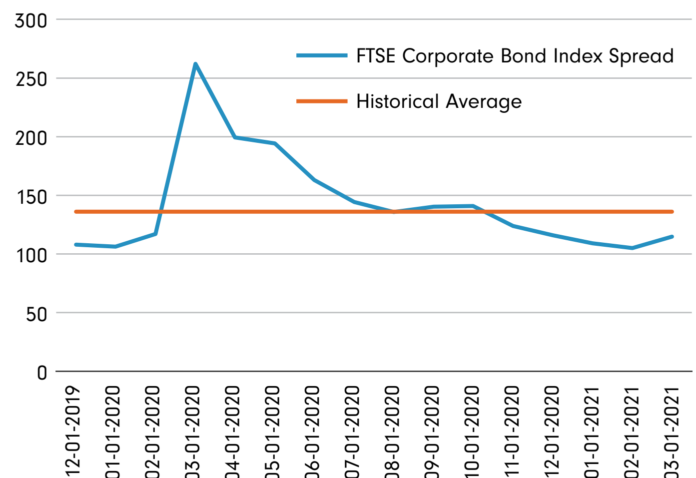
Institutional investors currently face a tough question: What should my bond playbook look like in our current low-yield world?

Institutional investors are known for being able to play a long game, but sometimes fundamental assumptions change so dramatically that a rethink may be in order. The impact of the unprecedented quantitative easing undertaken by the world's central banks is leading many investors to wonder what to do with their fixed income allocations in an environment where long-term return assumptions of 4–6% now seem far-fetched.

When the COVID-19 pandemic arose in the first quarter of 2020, central banks around the globe responded with an extraordinary wave of quantitative easing and lowered rates to unprecedented levels. In Canada, the Bank of Canada lowered its target policy rate to 0.25%, the effective lower bound as announced by then-Governor Stephen S. Poloz; south of the border, the Federal Reserve lowered its policy interest rate to near zero. Corporate spreads quickly widened on the economic fallout from the pandemic, with spreads on the FTSE Canada Corporate Bond Index closing the first quarter of 2020 at 262 basis points, the highest level since the global financial crisis.

Supportive fiscal and monetary policy, in combination with COVID-19 containment measures, helped stabilize the economic crisis in the following months. Corporate spreads in Canada continued to grind tighter as economic and financial conditions improved, and less than a year later, spreads on the Index had returned to near historical lows. This combination of historically tight spreads and rates at their effective lower bound has meant that our domestic fixed income index closed the calendar year with a yield that ranked historically in the lowest percentile.

EXHIBIT 1: Canadian Corporate Spreads Q1 2020 to Q1 2021



Source: FRED Graph Observations, Federal Reserve Economic Data and Economic Research Division, Federal Reserve Bank of St. Louis

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While yields have risen quickly over the past couple months, statements from the Bank of Canada and the Federal Reserve suggest that a "lower for longer" fixed income environment is here to stay. No longer can investors think they are looking at a bearable short-term headwind. Instead, they must look for solutions that can help them reach their return goals, while continuing to benefit from the attractive risk characteristics that fixed income offers.

In this environment, investors can benefit from turning to a consolidated tactical bond portfolio in order to maximize return for a targeted level of risk. Fixed income portfolios can better achieve this by having the flexibility to employ a wide variety of investment strategies and alpha levers that they can quickly manipulate based on prevailing market views.

Alpha generation with multiple levers

The strength of active management is underpinned by the informational advantage that quality research can provide, and this advantage can be further compounded by the ability to implement these insights tactically across a spectrum of fixed income asset classes. In the current low-yield environment, fixed income investors need to take full advantage of both aspects in order to fully realize their return objectives. In order to maximize the benefits of tactical implementation, portfolio managers need the flexibility to manipulate important levers.

Fixed income portfolio managers have four primary levers at their disposal to generate alpha within a portfolio:

- duration management
- yield curve positioning
- sector rotation
- security selection

At a high level, deciding how to best employ these tools is a direct product of a combination of top-down macro research and bottom-up fundamental research. Performing in-depth analysis of individual companies and sectors can uncover attractive opportunities for managers to add value by identifying securities that may outperform.

For example, the early days of the COVID-19 pandemic created opportunities for two main categories of Canadian retailers: essential retailers that remained open and benefited from a surge in demand and high-quality businesses that faced a near-term revenue shock due to lockdown measures. Following initial uncertainty, these businesses subsequently benefited from the pandemic environment, with Canadian investment-grade retailers seeing their sales growth more than double year-over-year, and their credits provide strong returns for the year. Informed by bottom-up research, portfolio managers may have identified these trends and provided alpha to investors through security selection and sector rotation.

Evaluating the macroeconomic environment requires a robust analysis of the key factors that drive the global economy, balancing a quantitative analysis of data points such as GDP growth against a qualitative analysis of central bank and government policy decisions. This analysis provides the background information that guides decisions on sector rotation and security selection; more directly, it can provide an insight into how portfolio managers should manage duration and yield curve positioning.

For example, while the sudden interest rate decrease in the first quarter of 2020 may have been prompted by a "black swan" event – the COVID-19 pandemic – the recent rate rise was driven by a more traditional factor: rising inflation expectations. On the back of extraordinary monetary and fiscal stimulus, economic reopening and renewed consumer optimism, market expectations for inflation rose sharply higher in the first quarter of 2021, leading rates to rise correspondingly. Prescient portfolio managers may have tactically positioned their portfolios to underweight duration and reduce exposure to key rate durations on the curve that rose faster than others. Guided

by insightful research, employing these levers could have lessened bond portfolio price depreciation and helped protect against downside risk.

While it is easier to provide retrospective commentary, alpha is generated by the ability to forecast rather than explain, and the question of inflation remains an important one.

> "Inflation is a tough one. There's a lot of animal spirits in the market."
>
> Chris Pariseault, Head of Fixed Income and Global Asset Allocation Institutional Portfolio Managers, Fidelity Investments

Chris Pariseault notes that with the significant stimulus in the economy, the expansion of household balance sheets and economic reopening, we could certainly see an uptick in inflation this summer.

However, there remain secular trends that may keep a lid on inflation over the longer term. Demographics is one of these key trends. Many developed global economies are facing an aging workforce with a high propensity to save and a demand for fixed income instruments, and this is likely to have an impact on keeping rates and inflation lower.

> "Demographic trends are something we've been paying attention to for a long time."
>
> Chris Pariseault, Head of Fixed Income and Global Asset Allocation Institutional Portfolio Managers, Fidelity Investments

Timely implementation of investment decisions

Fixed income portfolio managers may be hamstrung by their ability to manipulate key levers if they are not afforded the flexibility, or do not have the capability, to implement their investment decisions quickly and in a timely manner. This may be particularly true for institutional investors, where the investment model is often beholden to a variety of investment stakeholders and governance procedures. An institutional investor may employ a series of specialized, best-of-breed portfolio managers dedicated to covering individualized components within a client's overall portfolio. While these managers may generate strong returns within their specific areas, the rigidity of the model can limit a client's ability to move into a certain sector and take advantage of market opportunities. A consolidated approach may better allow investors to manipulate the four primary levers in order to maximize total return.

The benefits of a consolidated portfolio in which investment decisions can be made in a timely fashion were highlighted during the fallout from the COVID-19 pandemic. High-yield spreads quickly ballooned, and the ICE BofA U.S. High Yield Index closed the first quarter of 2020 with option-adjusted spreads at their 96th percentile relative to history, while yields in the leveraged loan market looked similar. Skilled portfolio managers could have identified this as a buying

EXHIBIT 2: High Yield Spreads Q1 2020 to Q3 2020

Source: FRED Graph Observations, Federal Reserve Economic Data and Economic Research Division, Federal Reserve Bank of St. Louis

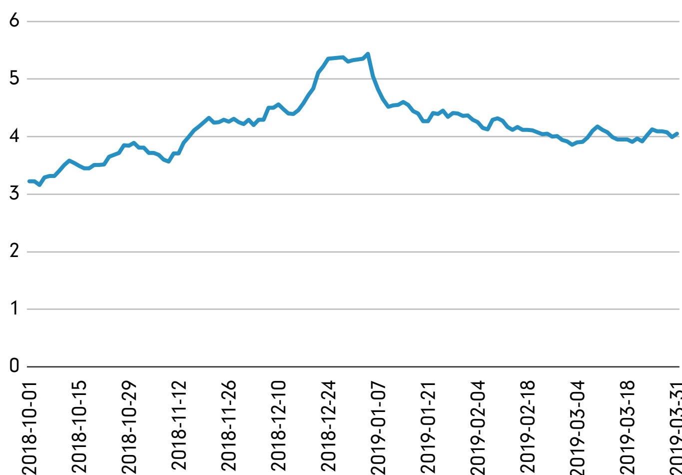
opportunity – a chance to allocate to an asset class that could offer an attractive risk-reward tradeoff as spreads tightened from near-historical widths.

However, this opportunity proved relatively fleeting: by the third quarter, spreads had returned to near their historical average levels. While they continued to tighten to near cyclical lows in the second half of the year, nearly half of the trade had been completed.

Another example of the need for swift action occurred in the fourth quarter of 2018, when hawkish rhetoric from newly appointed Federal Reserve Chair Jerome Powell sent shock waves through the equity markets. Equity markets crashed, while high-yield spreads widened rapidly over the last two weeks of the year, and hit their cyclical widths immediately after New Year's Day.

For opportunistic tactical portfolio managers (such as Jeff Moore and Michael Plage), the widening represented an opportunity to add exposure to the asset class at attractive levels. However, the window was brief and fleeting; within a week, the Federal Reserve had changed its tune and had become more supportive of risk-on assets,

EXHIBIT 3: US High Yield Market Q4 2018 to Q1 2019



Source: FRED Graph Observations, Federal Reserve Economic Data and Economic Research Division, Federal Reserve Bank of St. Louis

and the high-yield index had already tightened by close to 100 basis points – illustrating the importance of expedient portfolio decision-making and implementation.

This principle remains pertinent and true in our current low-yield environment.

> "While spreads may have compressed, we are taking advantage of higher quality, very idiosyncratic names – but we remain ready to dial in some of that dry powder if opportunities present themselves again."
>
> Chris Pariseault, Head of Fixed Income and Global Asset Allocation Institutional Portfolio Managers, Fidelity Investments

Of course, a change to allow for greater flexibility in timely investment decision making and "dialing in dry powder" best occurs before the investment opportunities arise.

Risk as a strategic tool

Risk is top of mind for many fixed income investors. Fixed income's low-volatility profile and low-to-negative correlation to equities and other asset classes make it an essential part of a portfolio. However, risk can also be viewed as a lever that, in the hands of an astute manager, can increase both total return and risk-adjusted return.

Investors should be aware of three main strategies that can be employed to the benefit of a portfolio.

First, managers may choose to invest across the credit spectrum based on where market opportunities prevail. During times of improving economic conditions, securities lower down the spectrum may offer increased return. For example, in high yield, Chris Pariseault notes that owning higher-quality BB-rated securities has offered increased carry and served strategies well over the years. Alternatively,

Canadian investment-grade investors may consider investing in shorter-duration BBB-rated securities, which have historically offered higher risk-adjusted returns than higher-quality peers.

Second, investors without an immediate need for liquidity, such as pension plans or public plans, may consider adding illiquid investments to their portfolio. If you are not worrying about mark-to-market risk, illiquid securities can offer a premium above what is on offer in liquid markets.

Finally, Canadian investors can look outside of Canada to tap into foreign bonds, such as those issued in the U.S., Eurozone and emerging markets. These foreign markets can offer a number of attractive characteristics for North American investors, including increased yield after hedging currency, diversification benefits from different geographic exposures and reduced portfolio sensitivity to the domestic yield curve. In addition to these benefits, increasing the geographic opportunity set also allows skilled portfolio managers and research analysts to identify alpha opportunities in undervalued or mispriced bonds, through bottom-up research. However, Chris cautions that if you invest in lower-quality international credits, it pays to do your research and be "very, very selective."

In combination, these different levers (credit quality, liquidity and geographic markets) can produce a higher-yielding, well-diversified portfolio with a risk level that resembles that of the index, even while holding individual, idiosyncratic risk-on bets. In addition, a portfolio that features securities with a low correlation to equities, such as riskier bonds, in addition to historically negative-correlation securities, such as treasuries, allows fixed income investors to participate in the gains of an equity bull market rally without having fixed income be a drag on the portfolio.

Conclusion

For the past forty years, fixed income has experienced a secular bull run of declining yields and rising prices. Investors could rely on a rigid portfolio of investment-grade bonds to produce stable returns while offering an attractive risk profile. However, in our current low-yield environment, institutional investors would benefit from looking at new solutions to help them reach their return targets, while enjoying the diversification and risk benefits that the asset class has to offer. With strong secular tailwinds, investors used to be able to get everything they needed out of a basic Canadian fixed income portfolio. Without these tailwinds, Canada may be too small a region in which to use all the tools needed to get the most out of a low-yield environment. Looking outside of Canada, while implementing currency hedging programs to limit unintended risk, offers a greater opportunity set. Consolidated tactical bond portfolios with the flexibility to generate alpha through multiple levers, the ability to implement investment decisions expeditiously and manipulate risk based on the market environment should be considered.

Author

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Christian Pariseault is head of fixed income and global asset allocation institutional portfolio managers at Fidelity Investments. In this role, Mr. Pariseault is responsible for a team of institutional portfolio managers focused on the management, innovation, development and delivery of fixed income strategies, target date strategies, and multi-asset class solutions for global clients and business partners.

Prior to assuming his current position in March 2017, Mr. Pariseault served as senior vice president and director of bonds for North America. Previously, Mr. Pariseault was an institutional portfolio manager in Fidelity's Fixed Income division, and a senior vice president and investment director at Fidelity Institutional Asset Management (FIAM).

Before joining Fidelity in 2006, Mr. Pariseault was a fixed income portfolio manager at Deutsche Asset Management, and a senior credit analyst covering tax-backed municipal bonds, colleges, and universities. He has been in the financial industry since 1993.

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