Diversified portfolios of higher-yielding credit securities are hitting the sweet spot with investors as the search for ‘liquid alternatives’ gathers momentum.

Price, value and QE

Over recent years, the liquidity funnelled into markets via quantitative easing (QE) has generally had the intended effect of staving off economic disaster and providing a chance for growth to reassert itself. However, one key consequence of this unprecedented flow of liquidity has been to distort the ‘fair valuation’ of many securities; at times the primary valuation driver of many fixed income security prices has been central bank policy, rather than underlying real economics. These distorted valuations are of course ephemeral - history is clear that true economic market forces always trump policy driven valuation, it is just a question of when.

A challenge for investors is that competent fund managers are quite adept at anticipating changing economic circumstances and profiting from such moves. Changes in policy, such as uncertainty around ‘forward guidance’, are much harder to predict with a high degree of conviction and our expectation is that the gradual unwinding of QE will lead to less predictable bursts of market volatility for some time.

A natural corollary of this is to consider what approach might actually profit from the uncertainty, or, at the minimum, provide some degree of protection against market falls.

Three key ingredients

The title of this paper clearly gave the hint that we believe higher yielding areas of the fixed income market provide downside protection and this is simply a function of the higher income these securities deliver each year. Just investing in these areas of the market is not enough in our view. We believe investors are better placed by combining three ingredients:

- **Natural downside protection** afforded by a diversified universe of higher-yielding fixed income securities
- **Flexibility to asset allocate** between different areas of the market
- **Tail risk hedging** (for occasional use only!) when market uncertainty peaks

In the last 30 years high yield bonds had five years of negative returns and in four of those years returns fell less than 5%
Combining these three ingredients may also deliver something greater than the sum of the parts, namely effective capital preservation. We shall come back to this point, but first we shall discuss each of the ingredients.

**Ingredient 1 - Natural downside protection**

**Which areas of the market are we considering?**

The six higher yielding sectors of the market we will focus on are high yield bonds, bank loans, convertible bonds and emerging market external, local and high yield corporate bonds. There are other areas of the fixed income markets which provide higher yields, but the trade-off is primarily one of liquidity; in order to be able to move between areas of the market effectively, there has to be adequate liquidity. Transaction costs and the ability to hedge with liquid derivatives are also key considerations.

**Downside protection**

Most fixed income securities provide an income (coupon) each year, although the amount of income varies greatly. We can think of income in terms of yield for each 100 invested and the chart on the right shows different sectors of the bond market and their corresponding yields.

Ten year US Treasuries, or ten year UK Gilts, currently provide an income of around 2.7% each year. How much would yields have to move upwards before a negative return is generated in a particular year – i.e. what magnitude of yield curve move creates a loss equal to the income? It’s only 0.3% (see note 2 at end of this paper for calculation).

The chart also shows the income from high yield bonds, or emerging market debt, are higher and therefore the yearly income cushion protecting against negative returns is greater. It is of course true that any asset with a higher return should have an associated higher risk, and this rule holds here - higher yields compensate for higher risks. However, we believe by diversifying amongst higher yielding areas of the fixed income market, and moving between them over a credit cycle, creates a very attractive risk/return trade-off.

How many negative returns have there been in our six sectors? The diagram below highlights which years recorded negative benchmark returns. Other than in 2008, we can see that negative returns are relatively infrequent and tend not to happen across all sectors at the same time. Convertibles have had more frequent negative returns due to their equity sensitivity.

**But aren’t those sectors all quite correlated?**

To an extent they are, and in an increasingly globalised world those correlations are unlikely to fall. Diversification, by definition, is a result of a lack of correlation between assets, and the difficulty in recent years has been ‘fair weather’ diversification in calmer markets and short, sharp spikes in volatility undermining the benefits of diversification.

The chart to the right shows our (stylised) estimation of the general risk drivers underlying these six sub-asset classes. As can be seen they are quite different: bank loans is exclusively credit risk; high yield a mix of credit and rates risk;
convertibles have equity market sensitivity; emerging market local currency debt has FX risk. These different characteristics provide diversification in most years and also suggest asset allocation could take advantage of changing market conditions.

**Ingredient 2 - Asset allocation**

Many fund managers have traditionally veered away from focussing on asset allocation, instead favouring security selection as a way of generating alpha given its traditionally higher reward/risk ratio. We also take the view that asset allocation is difficult as, to some extent, it involves trying to see around corners.

However, asset allocating between the higher yielding sectors of the fixed income market is, in our opinion, more predictable than wider asset allocation such as, say, equities versus property versus bonds versus cash. The reason is that the underlying economic relationships between the various areas of the fixed income market tend to be impacted by similar macro factors, and whilst each sector will react in a different way due to different risk drivers, there are overlapping relationships between the sectors providing a narrower set of outcomes.

Asset allocation decisions are generally made relative to a neutral position and the selection of this neutral position is a key driver of ultimate performance. In constructing a neutral position we use a mixture of efficient frontier analysis and a pragmatic, forward-looking view of how markets may develop. One difficulty of using historic data to construct an ‘optimal’ portfolio is that some areas of the market, particularly emerging market local and corporate debt, do not have long performance histories and have undergone significant structural change.

Once a neutral allocation has been selected, the next consideration is the potential asset allocation ranges around that neutral position. We are advocates that a high degree of flexibility is preferred in order to meaningfully shift the overall exposure based on relative attractiveness of returns or risk mitigation. Further than that, we also favour the ability to move a significant amount of a portfolio into cash in times when market predictability is very low or expectations are very negative across the board. In all of these circumstances, transaction cost considerations are critical as they also tend to spike around times of market uncertainty.

Another noteworthy point on asset allocation is that we believe the expected volatility created by the unwinding of QE over the next few years provides ‘greater than normal’ scope to potentially add value.

**Man versus machine**

There are a number of ways of approaching asset allocation decisions, stretching from the purely quantititative to the purely qualitative. We believe each has an important role to play, albeit in the policy-driven markets of today a slight emphasis towards qualitative factors is, in our opinion, paramount. The reason is that risk and forecasting models, no matter how complex, do not sufficiently capture the impact of unexpected one-off surprises, particularly as they relate to central bank or political announcements.

**Ingredient 3 – Tail (or macro) hedging**

Tail hedging refers to the process of (hopefully) mitigating losses in negative markets by significantly reducing a portfolio’s risk or market exposure. We believe this is an important ingredient, albeit it is to be used sparingly, somewhere between twice a year and once every two or three years. It’s primarily for protection at market turning points which, by their nature, are harder to predict, but usually have a significant performance impact.

In practice a tail hedge is generally a derivative position which is not used to generate alpha, but instead to minimise negative market returns (negative beta). For example, in a year where markets produce a negative return, a tail hedge, correctly deployed, will produce a positive offsetting return.

*In a post-QE world, asset valuations will have to stand on their own. The adjustment phase creates opportunities for managers that can asset allocate between sectors of the market.*
One advantage of tail hedging in the current market is that at those times when very significant announcements are expected, such as further QE tapering, it is possible, for short periods, to dramatically reduce risk in a portfolio using derivatives. This is often more cost effective than selling assets, waiting for a better environment, then repurchasing exposure.

Why don’t more managers use tail risk hedging? Because most portfolios are managed against a benchmark and there is a significant benchmark underperformance risk in moving too far away from that benchmark. We believe that in order for a manager to feel comfortable taking a meaningful amount of risk off the table, a portfolio needs to have either no benchmark or a cash benchmark i.e. the benchmark underperformance risk of the tail hedge decision needs to be minimised.

Summary: whole > sum of the parts

When combined, our three ingredients – natural downside protection, asset allocation and tail risk hedging – lead to a portfolio where capital preservation is intrinsic. Higher-yielding asset classes provide a natural buffer for down markets; asset allocation allows a migration away from those sectors likely to suffer; and tail risk hedging provides the potential to avoid being caught wrong-footed in a market turn.

We believe portfolios constructed along the lines mentioned herein can target total returns of between 5% and 10% over the credit cycle, with similar levels of volatility.

Fixed income markets in general have had a very strong run for several decades on the back of falling yields, falling inflation and a secular increase in bond demand. We believe a flexible approach towards bond mandate construction, particularly in an environment of gradual central bank stimulus withdrawal, may be well rewarded over the coming years.

Notes:
1 Indices: High Yield: Merrill Lynch Global High Yield Constrained Index USD Hedged; Bank Loans: JP Morgan Leveraged Loan Index USD Unhedged; EMD Externtal: JP Morgan EMBI Global Diversified - USD Unhedged; EMD Local: JP Morgan GBI-EM Broad Diversified Index - USD Unhedged EM HY Corporates: JP Morgan CEMBI Diversified High Yield Index USD Unhedged; Convertibles: UBS Global Convertible Focus Index USD Unhedged
2 The duration of the 10 year UK Gilt was 8.8 years as at 30 September 2013. The calculation is 8.8 (duration) x 0.30% (yield move) = 2.7% (the income)