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Abigail Babson, CFA
Fixed Income
Investment Director

Amar Reganti
Fixed Income
Investment Director

Anand Dharan, CFA
Fixed Income
Investment Director

About the authors

Abigail Babson, Amar Reganti, and **Anand Dharan** work closely with the investment teams to help ensure the integrity of our investment approaches by overseeing and communicating portfolio strategy, positioning, performance, and risk exposures.

An insurer's guide to fixed income: Setting the record straight on rates and credit

This spring, investors experienced one of the most volatile periods in modern market history. The speed with which financial markets sold off in March, and then rallied following unprecedented steps by the US Federal Reserve (Fed) and the US Treasury, shook even seasoned market participants. There has been active intervention in nearly every major fixed income sector. As of this writing, we face 10-year Treasury yields at historic lows (again) and mounting uncertainty about how insurers should be investing in fixed income markets in order to pursue their investment objectives.

Low yields and tight credit spreads pose quite the challenge for insurers who are beholden to fixed income investments. And, with economic and public-health uncertainty likely to be the norm for the foreseeable future, it's safe to say that markets will remain volatile. In this environment, we would argue that insurers need to think even harder about how fixed income can best meet the needs of their business.

Furthermore, we find that record-low interest rates and recent spread behavior have increasingly led to misconceptions about the ability of fixed income to perform its traditional roles in investor portfolios. That, in turn, is holding many investors back from using fixed income as effectively as they otherwise could. Here we: 1) address common misconceptions around rates and credit; and 2) propose portfolio implementation ideas to potentially make fixed income work harder for clients going forward.

Dispelling false interest-rate narratives

Investor allocations to interest-rate-sensitive products tend to be bounded by two core beliefs, neither of which is necessarily accurate:

1. Interest rates are simply too low at current levels and, at some point, will have to go up from here.
2. As long as rates are this low, duration will be a less effective counterbalance to credit and equity risk.

Rates have been directional (downward) for the better part of four decades now, so to argue that they are anchored to some arbitrary nominal value is at best theoretical and, in practice, incorrect.

These beliefs are rooted in long-held assumptions that are only now finally being shaken loose, with important implications for investing in fixed income. Many investors' thinking about fixed income has been (and remains) shaped by the dreadful scenario of the late 1970s/early 1980s, when inflation and interest rates ran rampant, while economic growth languished. This narrative has persisted for decades, even as rates have continued to trend lower. In recent years, even the occasional rate spike has often been followed in short order by an even sharper movement downward.

In our view, it's time to stop saying "rates are too low" and to understand that developed-market rates probably should be low given slowing demographic trends, along with the "flight-to-quality" benefits and the considerable liquidity that developed-market rates, particularly Treasuries, can offer investors. Here is how we would further respond to common objections to this line of reasoning:

A) **"Rates are below fair value"** – It is important to note that rates — and currencies, for that matter — have no inherent mean-reversion characteristics. Indeed, rates have been directional (downward) for the better part of four decades now, so to argue that they are anchored to some arbitrary nominal value is at best theoretical and, in practice, incorrect.

B) **"Yes, but inflation has to go higher…"** – We find the concept of inflation to be far more nuanced than traditionally believed. In early 2018, when labor markets had tightened significantly and the Fed's balance sheet was large by historical standards, realized inflation remained tame, while wage inflation failed to accelerate. This contravened many conventional beliefs about inflation, suggesting a more complicated issue than one based on monetary policy alone.[1] Indeed, beyond the impact of "animal spirits" in capital markets, it is highly suspect whether the exchanging of one government liability for another — effectively "quantitative easing" when the Fed purchases Treasuries and replaces them with reserves — is, in itself, inflationary in a real-world context.

C) **"Well, government spending/deficits must go higher, so therefore rates must go higher…"** – Again, this may not necessarily be the case. In reality, in most developed countries, as total stock of debt increases, interest rates typically decrease. We have seen little to no evidence that this relationship is likely to change anytime in the near to intermediate term.

Of course, all of this begs the question: If the traditional bogeyman of interest rates appears to have lost some of its power (at least temporarily), what can interest-rate-sensitive investments still do for an end allocator? Quite a bit, actually.

What rates can still provide: Liquidity, convexity, diversification

Liquidity – The ability to enter and exit trades in US government securities (and associated derivatives markets) is virtually unmatched. If you need almost instantaneous liquidity with your investments, a government securities-heavy portfolio is almost akin to a bank account (albeit with duration). And when securities dealers are challenged in intermediating large sizes, the central bank is typically forced to intervene to guarantee liquidity *because the government securities market is one of its primary methods of implementing monetary policy.*

Convexity – Consider the role of duration and its value in what is becoming a relatively high-volatility/low-growth world. In our view, for too long have end allocators shied away from duration, particularly the long end of the

[1] In his 10 June 2020 press conference, Fed Chair Jerome Powell stated, in response to a question, "So, I think we have to be humble about our ability to move inflation up…"

RISKS

Below-investment-grade – lower-rated or unrated securities may have a significantly greater risk of default than investment-grade securities and can be more volatile, less liquid, and involve higher transaction costs.

Capital – investment markets are subject to economic, regulatory, market sentiment, and political risks. All investors should consider the risks that may impact their capital before investing. The value of your investment may become worth more or less than at the time of the original investment. The fund may experience high volatility from time to time.

Concentration – concentration of investments within securities, sectors or industries, or geographical regions may impact performance.

Credit – the value of a bond may decline, or the issuer/guarantor may fail to meet payment obligations. Typically, lower-rated bonds carry a greater degree of credit risk than higher-rated bonds.

Currency – the value of the fund may be affected by changes in currency exchange rates. Unhedged currency risk may subject the fund to significant volatility

Derivatives – derivatives may provide more market exposure than the money paid or deposited when the transaction is entered into (sometimes referred to as leverage). Market movements can therefore result in a loss exceeding the original amount invested. Derivatives may be difficult to value. Derivatives may also be used for efficient risk and portfolio management, but there may be some mismatch in exposure when derivatives are used as hedges. The use of derivatives forms an important part of the investment strategy.

Leverage – the use of leverage can provide more market exposure than the money paid or deposited when the transaction is entered into. Losses may therefore exceed the original amount invested.

Emerging markets – emerging markets may be subject to custodial and political risks and volatility. Investment in foreign currency entails exchange risks.

Hedging – any hedging strategy using derivatives may not achieve a perfect hedge.

Interest rates – the value of bonds tends to decline as interest rates rise. The change in value is greater for longer-term than shorter-term bonds.

Manager – investment performance depends on the investment management team and its investment strategies. If the strategies do not perform as expected, if opportunities to implement them do not arise, or if the team does not implement its investment strategies successfully, a fund may underperform or experience losses.

Short selling – a short sale exposes the fund to the risk of an increase in the market price of a security sold short; this could result in a theoretically unlimited loss.

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