Investment Manager Performance - Overview of Fixed Income Levers

Unlike other investor types, insurance companies and government risk pools allocate the majority of their assets to investment-grade fixed income. These allocations typically range from 70% to 100% of their portfolios depending on regulatory and other constraints *(i.e. net position, business dynamics, etc.)*.

As most insurers and risk pools outsource management of the fixed income portfolio to a third-party investment manager, it is import the selected manager generate a consistent, superior risk-adjusted return in excess of the applicable benchmark *(and better than those of other managers)*.

Investment grade fixed income managers can utilize a number of levers *(or tools)* within the portfolios they manage.

1. Duration

Duration is an approximation that measures the interest rate risk of the security or portfolio.

The higher than number, the more risk from movement in rates.

- *Approximate Change in Market Value = Duration * Change in Rates*

Example: if a security or portfolio has a duration of 10 years, a 1% increase in rates will instantly result in a 10% decrease in the market value. However, longer duration typically means higher yield.

2. Convexity

Convexity shows the relationship between a bond prices and yield.

Duration is used to forecast the change in market value as a result of interest rate changes. But it is an estimate.

Convexity makes the estimate more accurate for bonds that have uncertain cash flows like mortgage backed securities (MBS) or callable securities.

In a security or portfolio, positive convexity is better than negative convexity.

Example: a manager may improve convexity by buying less MBS than the benchmark.

However, this usually comes at a cost: less yield.

3. Yield Curve

Yield Curve is related to duration but focuses on how a portfolio's maturities are structured across the yield curve from short maturities *(i.e. 3 months, 1 year)* **to long maturities** *(i.e. 30 years)***.**

Different structures provide benefits in terms of additional yield or better return potential if rates rise or fall on that specific part of the curve.

4. Sector Selection

Managers who use this lever allocate more assets than the benchmark does to sectors that they like and less assets to the sectors they do not like.

If they are correct, this will help them outperform the benchmark. If they are wrong, they may underperform.

Within overall sectors, there are numerous subsectors.

Common Sectors: *Treasuries, Agencies, Corporates, Residential and Commercial Mortgage Backed Securities, Asset Backed Securities (ABS), and Municipals.*

5. Security Selection

Related to sector selection, security selection is typically used by "bottom-up" fixed income managers.

A "bottom-up" fixed income manager looks for specific bonds they like or don't like and will then buy more or less of them than are contained in the benchmark.

They may do this if the bond has better yield or structural/credit characteristics, which will help the bond outperform.

6. Credit Quality

Some managers make an explicit "bet" on quality levels of the bonds they hold.

Lower credit quality bonds typically pay higher yields to compensate for the additional credit risk *(i.e. the risk that an organization won't get its money back at the maturity date)*.

Some think that overall rating categories of bonds are over or undervalued and then structure their portfolios to take advantage of this.

Example: If they think "BBB" rated securities offer good value, they may own more of these than the benchmark.

7. Liquidity

Liquidity has become a more important factor over the past several years as yields have fallen. Some managers will trade liquidity, or ease/cost of trading a security, for yield/ total return.

In general, more liquid bonds trade at a lower yield than less liquid bonds of the same type.

By owning less liquid securities, managers can boost yield/income. However, if they unexpectedly need to liquidate these securities, this strategy can backfire.

8. Structure

Some managers purchase bonds that have unique aspects that might not be understood by the market and thus the bonds yield more and may not be as liquid.

In many cases this is related to liquidity.

For managers who understand these structures, this can be a great way to add value.

Key Takeaways

1. Fixed income managers have many tools at their disposal and it is important to have an understanding of these tools and the benefits and risks involved in using each of them.

2. It is important to know what tools your investment manager is using, why they are using them, and how these tools will help them outperform the benchmark (and potentially other managers).

3. Use the reports that managers provide to help understand what they are doing. If the manager doesn't provide this information, ask for it.

4. All investment managers should provide a quarterly attribution analysis, which provides clarity on how they are managing the portfolio, for example:

   - *If a manager says they don't make bets on quality levels, their attribution analysis should show that the return attributable to the credit quality of the portfolio is similar to the benchmark's.*

   - *If a manager says they don't make duration bets, their attribution analysis should show that the return attributable to duration is similar to the benchmark's.*

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About Strategic Asset Alliance

SAA is an independent investment consulting firm that works exclusively with insurance companies and pooling organizations.

Founded in 1994 by our President Alton Cogert, our experience and focus enables us to help our clients improve their investment process and enhance the value added by their portfolios which are critical components of their business.