Janus Henderson INVESTORS

REDEFINING DURATION:
CREATIVE SOLUTIONS FOR EVOLVING MARKETS

Adam Hetts and Sabrina Geppert from the Portfolio Construction and Strategy (PCS) Team examine the opportunities across government, credit and alternatives markets for fixed income investors to navigate rising rates.

The PCS Team partners with investment professionals, guiding the portfolio allocations of clients to meet their objectives. In recent portfolio consultations, we have heard many clients ask for our perspective on reducing fixed income duration through the use of alternatives or short duration strategies.

The concern is that rising interest rates could derail objectives for their portfolio. However, as our portfolio consultations tend to unpack these interest rate fears, we find that what is initially broad pessimism can be organised into a few specific concerns, and importantly, specific portfolio solutions.

Even in an environment defined by low interest rates and tight credit spreads, there are ample risk-adjusted opportunities across government, credit and alternatives markets. Many of which are not the typical 'short duration' solutions but nonetheless deliver important ways for fixed income investors to successfully navigate the risk of rising rates.

In this article, we aim to distil our recent client portfolio consultations into three typical client 'personas' we encounter and how, throughout each, we find opportunities to redefine what they view as their ideal 'short duration' solution.

1 Investor persona 1: reducing duration but maintaining yield

"I want high quality fixed income with a competitive yield but more defence against rising rates"

With most global sovereign bond rates below 1% or even negative, traditional benchmarks with large, passive weightings to sovereign debt are no longer a bond investor's North Star. Instead of abandoning core fixed income, investors should consider digging deeper into the defensive tool kit to understand new opportunities and trade-offs within core fixed income.

KEY TAKEAWAYS

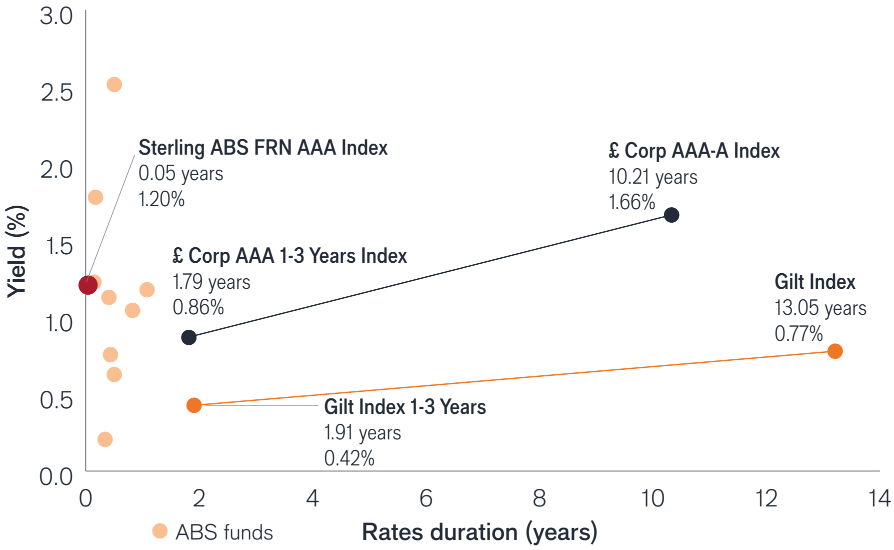
- Asset-backed securities (ABS) typically provide many essential features of core fixed income instruments. However, the large dispersion in risk and return behaviour of the underlying assets requires a skilled manager with the ability to understand and analyse the risks in a securitisation transaction, as well as a robust due diligence process.
- Strategic bond funds allow flexibility in actively managing duration and credit exposures. However, the large amount of flexibility in this category is a detriment to the sector with a very diverse set of outcomes among managers.
- Breadth is both the biggest opportunity, and the biggest challenge, when allocating to liquid alternatives, which potentially serve to diversify a portfolio, but there are a wide range of characteristics among them, both across categories and within.
- However inevitable it may seem that bond yields should rise, we believe bond portfolios still have a core role to play in investors' diversified portfolios.

Opportunity: high quality asset-backed securities

Asset-backed securities (ABS) are not typical short duration strategies, but on a comparable ratings basis, they offer a relatively higher yield versus corporate bonds along with a relatively low interest rate duration and shorter average spread duration (reducing potential price sensitivity to interest rate and credit spread moves in the market). All of which makes ABS an underappreciated and sensible diversifier to sovereign and corporate bonds in fixed income portfolios.

ABS offer exposure to underlying collateral pools of residential mortgages, consumer loans, credit cards, commercial mortgages and corporate loans and provide meaningful diversification at the security and sector level. The asset class is broadly under represented, if not virtually absent, in our database of independent financial advisor (IFA) model portfolios as asset backed securities require niche knowledge and expertise by the fund manager and can vary widely by yield, duration and credit quality.

Figure 1: inefficient frontier – asset backed securities



Yield cushion, defined as a security's yield divided by its duration, is a common approach that looks beyond yields as a cushion protecting bond investors from the potential negative effects of duration risk. The yield cushion potentially helps mitigate losses from falling bond prices if yields were to rise.

In figure 1 the highest yield cushion would be found in securities furthest to the left and closest to the top.

Source: Bloomberg, Morningstar, as at 30 November 2021.

Notes: yield cushion is defined as yield-to-worst (YTW) divided by duration. Yield-to-worst and effective duration of ICE BofA Sterling Corporate AAA-A Index, ICE BofA Sterling Corporate AAA 1-3 Years Index, Bloomberg Sterling ABS FRN AAA Index, Bloomberg Gilt 1-3 Year Index, Bloomberg Gilt All Durations Index, ABS funds in the Morningstar EAA Other Bond Category (light orange). **Past Performance is not indicative of future returns.** Yields may vary and are not guaranteed.

Given the unique characteristics of the ABS asset class and its broad under representation in model portfolios, the correlation between ABS and government bonds has historically been negative while the correlation to corporate bonds and riskier asset classes has typically been low as well (figure 2). This is specifically important during periods of stress, as ABS offer the potential for a differentiated source of returns. During the initial COVID-19 crisis, the broad sterling ABS floating rate note index showed comparable performance numbers as to short-term government bonds and short-term corporates, and with a similar low standard deviation over the past five years (figure 3).

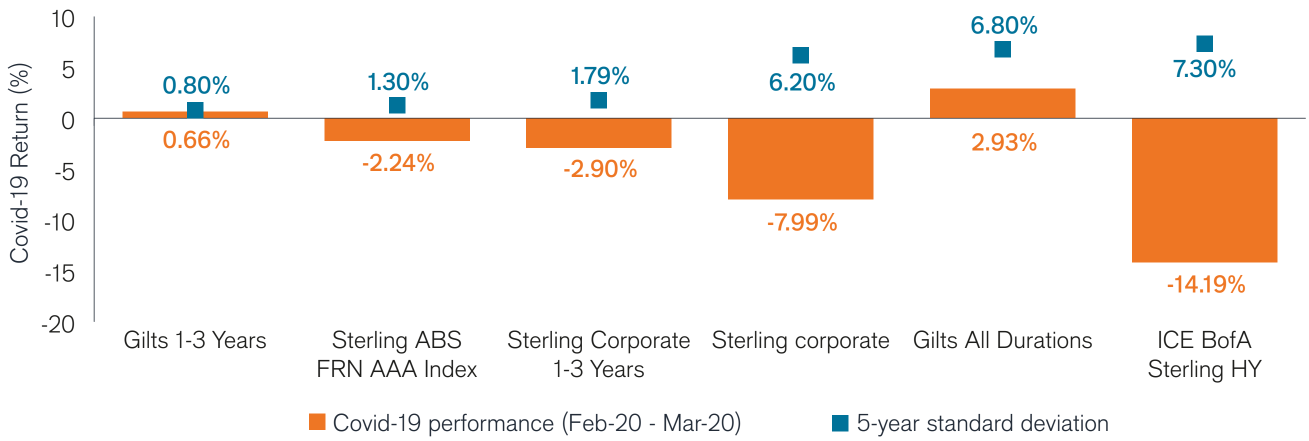
Figure 2: correlation between Sterling FRN AAA Index and other asset classes

	Sterling ABS FRN AAA Index	Gilts 1-3 years	Gilts all durations	Sterling corporate 1-3 years	Sterling corporate	ICE BofA Sterling HY Index	FTSE All-Share Index
Sterling ABS FRN AAA Index							
Gilts 1-3 years	-0.17						
Gilts all durations	-0.09	0.65					
Sterling corporate 1-3 years	0.30	0.18	0.16				
Sterling corporate	0.18	0.32	0.60	0.84			
ICE BofA Sterling HY Index	0.39	-0.16	-0.08	0.92	0.71		
FTSE all-share Index	0.22	-0.09	-0.10	0.61	0.50	0.71	

Source: Portfolio Construction and Strategy Team, Bloomberg, as at 30 November 2021.

Notes: correlation over past five years. HY = high yield corporate bonds. FRN = floating rate notes. **Past Performance is not indicative of future returns.**

Figure 3: 5-year standard deviation and performance – Covid-19 Crisis (Feb-Mar 2020)



Source: Portfolio Construction and Strategy Team, Bloomberg, as at 30 September 2021. **Past Performance is not indicative of future returns.**

ABS typically provide many essential features of traditional core fixed income such as low volatility, low correlation to traditional equities and high quality, if composed of investment grade securities. However, when comparing the key risk and return characteristics of ABS funds, there is a large dispersion in the outcomes (eg, the wide spread of dots plotted in figure 1), clearly creating the need for a skilled manager with the ability to understand and analyse the risks in a securitisation transaction, as well as robust due diligence process.

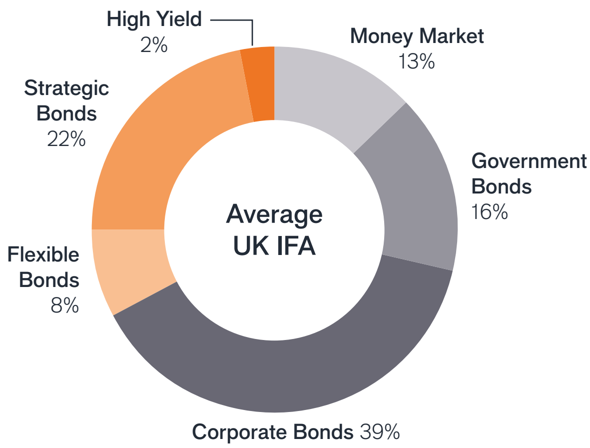
2 Investor persona 2: reaching for yield, responsibly

"I want to increase yield, but I worry about high yield spread levels."

Opportunity: redefine high yield

Analysis of hundreds of client portfolios in the UK PCS proprietary database shows that IFAs on average allocate 22% of their fixed income allocation to strategic bond funds. This is higher than the advisors' average allocation to government bonds and by far higher than their allocation to income generating, riskier fixed income assets like high yield or emerging markets debt.

Figure 4: UK IFA fixed income allocation patterns



Source: Portfolio Construction and Strategy Team, as at 30 September 2021.

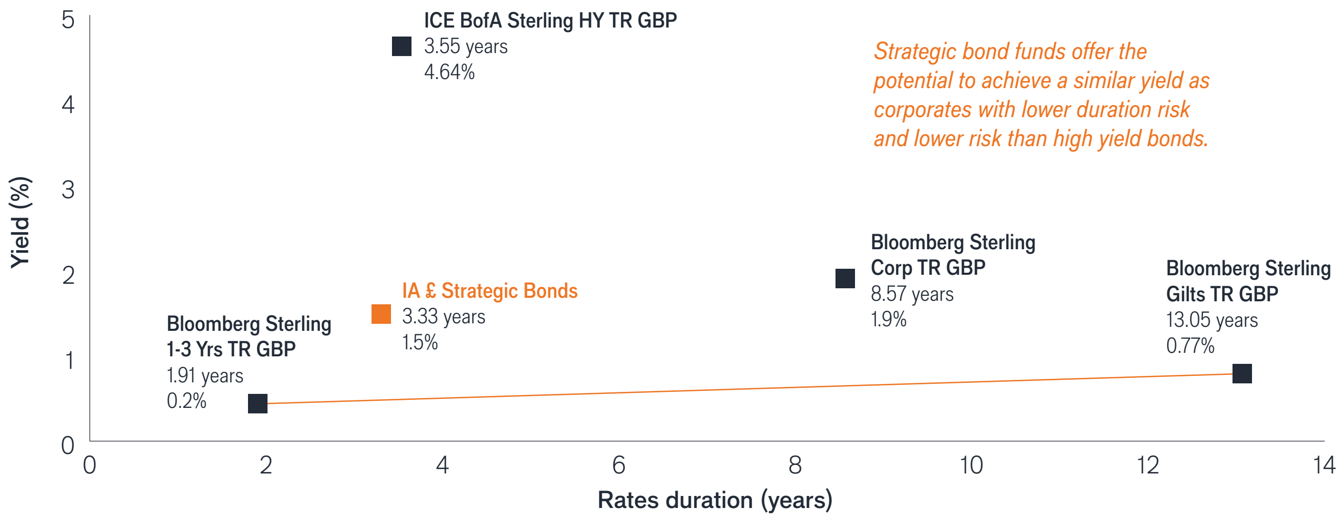
The average reliance on strategic bond funds instead of high yield makes sense, with credit spreads currently below 10-year averages and the high yield asset class having much less upside than it did in March 2020 when spreads were near all-time highs.

If these current valuations in traditional high yield cause concern, but investors are still attracted to its potential to drive relatively high portfolio yield with relatively low duration contribution, strategic bond funds may be a solution for investors to consider. This category provides an investor with the ability to allocate to high yield on an opportunistic basis while also diversifying into other fixed income sectors that can add value over traditional core/core plus strategies (Source: Morningstar, as at 30 November 2021).

Some additional 'plus' sectors, or sectors that can often be below investment grade, but offer compelling risk/return relative to the rate sensitive part of the market include sectors like bank loans. Many of these sectors are excluded from the traditional fixed income benchmarks and are often under represented in portfolios.

Possibly because of their greater latitude to allocate to these diversified sectors and in a more tactical fashion, the funds in the strategic bond category can potentially serve as an opportunistic middle ground between the intermediate core and high yield space.

Figure 5: inefficient frontier – strategic bond funds

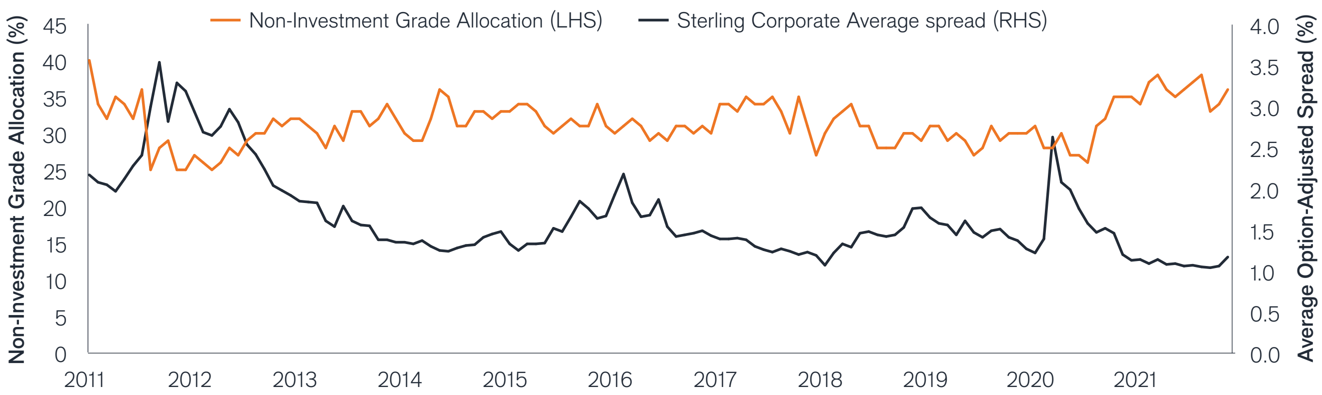


Source: Morningstar, Bloomberg, as at 30 November 2021. **Past Performance is not indicative of future returns.** Yields may vary and are not guaranteed.

As shown in figure 5, long duration and low yields in UK gilts are just the beginning of the story. Strategic bond funds share, along with corporate bonds, the benefits of higher yield (relative to government bonds) and lower volatility and losses during equity sell-offs (than high yield), while at the same time experiencing significantly lower sensitivity to rising rates.

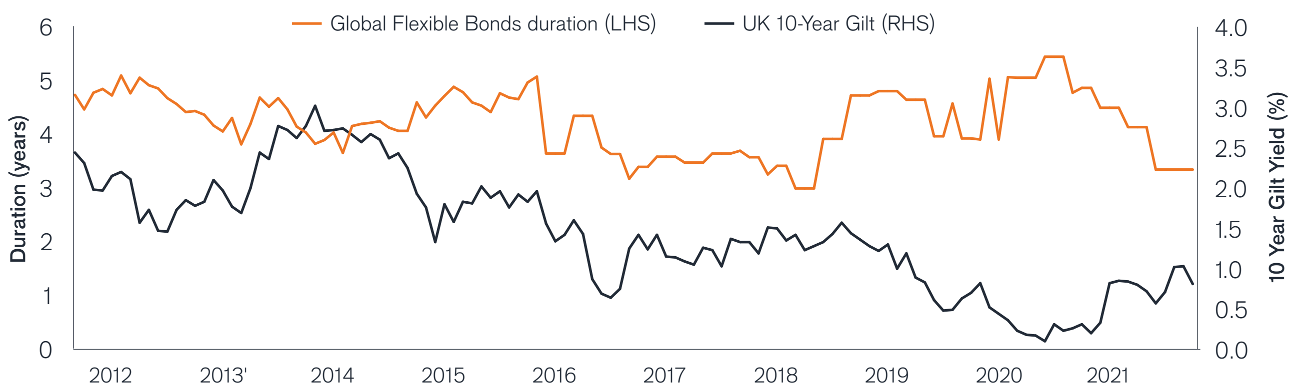
Figure 6: strategic bond funds – flexibility in credit and duration management

Figure 6a: flexibility in credit management



Source: Portfolio Construction and Strategy Team, Bloomberg, Morningstar, as at update 30 November 2021. Notes: average allocation to non-investment grade bonds in the IA £ Strategic Bond Category. Average option-adjusted spread of Sterling corporate. **Past Performance is not indicative of future returns.**

Figure 6b: flexibility in duration management



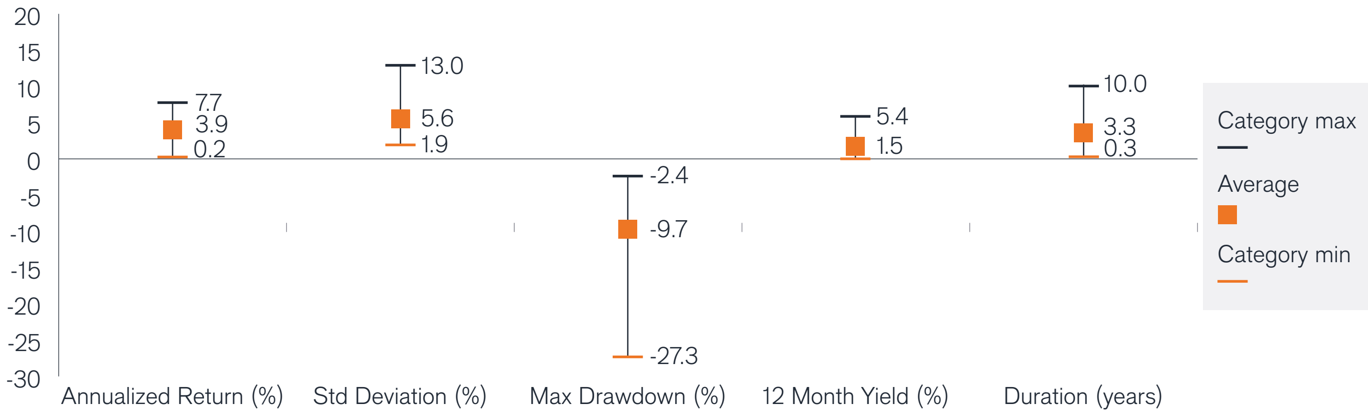
Source: Portfolio Construction & Strategy Team, Bloomberg, Morningstar, as at 30 November 2021.

Notes: Morningstar Global Flexible Bonds (GBP hedged) Category average effective duration. 10-Year UK Gilt Index Yield. **Past Performance is not indicative of future returns.** Yields may vary and are not guaranteed.

Thus, the strategic bond category demonstrates flexibility in actively managing duration and credit exposures (figure 6). Another key benefit of the broader global opportunity set is the possibility of smoothing the volatility of a bond portfolio's returns by identifying countries that may be either just beginning to price in an economic recovery or – at the other extreme, may have nearly completed it. Less duration exposure could be taken in the former (countries just starting to price a recovery) than the latter (countries which may have largely priced in a recovery).

However, the large amount of flexibility in this category can be a detriment to returns given the very diverse set of outcomes among managers – not all strategic bond funds are created equal (figure 7). For example, during the COVID-19 crisis in March 2020, the maximum drawdown of strategic bond funds ranged between -27.3% and -2.4%. This highlights the importance of choosing the right active manager to avoid negative surprises.

Figure 7: nuance and dispersion in strategic bonds sector



Source: Portfolio Construction & Strategy Team, Morningstar. as at 30 November 2021.

Notes: calculations for the average of funds in the IA £ Strategic Bond Sector from September 2016-21. **Past Performance is not indicative of future returns.** Yields may vary and are not guaranteed.

3 Investor persona #3: diversifying away from both bonds and stocks

"I want to diversify from duration and credit altogether, but I'm not comfortable moving to equities given the valuations and risk involved"

Opportunity: redefine your alternative selection

If investors still are not satisfied with any solution presented above, it is often because they want to lower their allocation to bonds altogether; which begs the question of where to put the money withdrawn from bonds.

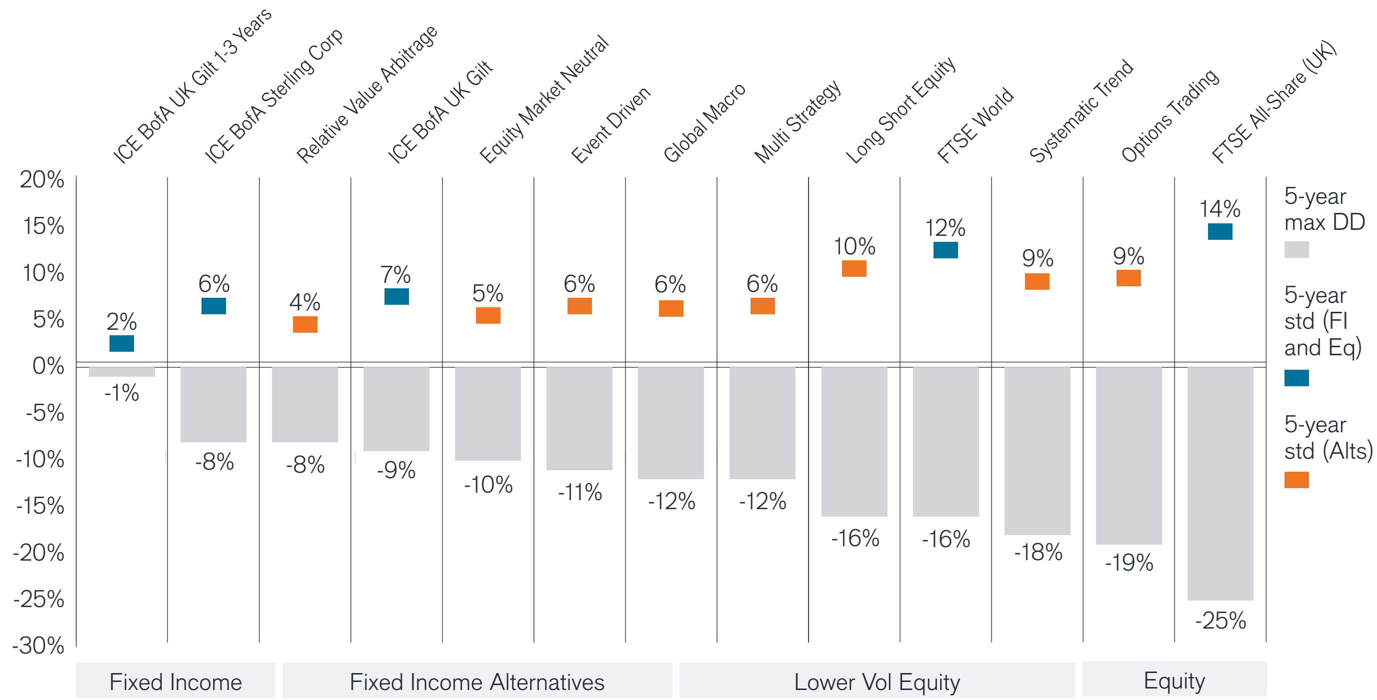
Instead of simply moving that money into equities, investors are increasingly looking to alternatives as a way to sidestep both equity and fixed income risks.

Breadth is both one of the biggest opportunities and one of the biggest challenges, when allocating to liquid alternatives. While potentially serving to diversify a portfolio, there are a wide range of characteristics among them, both across categories and within. When looking for a liquid alternative to replace a fixed income allocation one may start by identifying the alternative categories that have a similar risk profile to the fixed income that is being replaced.

As you can see in the chart in figure 8, based on trailing 5-year standard deviation, the closest comparisons to core fixed income are what we label as 'Fixed Income Alternatives':

- Relative Value Arbitrage
- Event Driven
- Equity Market Neutral
- Multi Strategy
- Global Macro

Figure 8: 5-year risk characteristics of fixed income, equities and their alternatives



Source: Portfolio Construction & Strategy Team, Morningstar.as at 30 November 2021.

Notes: ICE BofA UK Gilt 1-3 Years TR GBP, Bloomberg Gilt All Durations GBP Index, ICE BofA Sterling Corporate GBP, FTSE World TR GBP, FTSE All-Share (UK) Index TR GBP, averages of the Morningstar EAA alternative categories. **Past Performance is not indicative of future performance**

Once an investor has identified the relevant category(ies) to consider, it is most important to look under the hood and understand a strategy's characteristics.

As shown in figure 9, there is a wide divergence of fund level risk within each Morningstar category. While the Event Driven category had an overall average risk that was in line with the Sterling Corporate Bond Index's 6.2% standard deviation (figure 8), you can see that certain managers in the Event Driven category have produced a 5-year standard deviation that's far higher than the FTSE All-Share Index (UK equities) 13.8%. If the purpose of adding alternatives is to replace fixed income duration, this risk dynamic needs to be assessed carefully.

Figure 9: 5-year standard deviation of Morningstar alternative categories

Source: Portfolio Construction & Strategy Team, Morningstar, as at 30 November 2021.

Notes: Morningstar Category averages/min/max: EAA Systematic Trend, EAA Relative Value Arbitrage, EAA Event Driven, EAA Equity Market Neutral, EAA Multi Strategy, EAA Global Macro, EAA Options Trading, Bloomberg UK Gilts all duration Index, FTSE All-Share (UK) Index. **Past performance is not a guide to future performance.**

Are there no (good) one-size-fits-all solutions?

Every investor has different goals, time horizons and risk tolerances. However, for investors that want a balanced portfolio that will perform (that is, generate a reasonable risk-adjusted return) across different environments, 'core' allocations to bonds have generally delivered.

Even as interest rates declined towards – and in some cases through – zero, core bond benchmarks like the Bloomberg Global Aggregate Index proved they could help mitigate downside risks when equities sold off. We do not believe the current environment is so fundamentally different that this history should be ignored. Equity markets are (at the time of writing) at all-time highs, and the risks of unknown or unexpected events are as prevalent as ever.

However, with treasury yields expected to rise, it makes sense for many investors to consider having less exposure to them than they did when rates fell. The timing of that decision, however, has proved impossible to perfect, and we believe the instinct to lower overall duration needs to be questioned through a customised portfolio consultation.

Ultimately, we believe that navigating these decisions requires a thoughtful, forward looking asset allocation process implemented with a hands-on approach from experienced bond managers.

A successful allocation can use all the techniques and instruments that we have described to dynamically adjust exposures as conditions evolve, while maintaining a focus on finding the appropriate balance of risk and reward to meet investors' goals. However, inevitable as it may seem that bond yields may rise, we believe bond portfolios have a core role to play in diversified portfolios.

About the Portfolio Construction and Strategy team

The PCS team performs customised analyses on investment portfolios, providing differentiated, data-driven diagnostics. From a diverse universe of thousands of models emerge trends, themes and potential opportunities in portfolio construction that the team believes will be interesting and beneficial to any investor.

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