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Unconstrained Bond Investing: Too Good To Be True?

Examining the risks of non-traditional fixed-income approaches

Market dislocations and record-low interest rates have spawned interest in unconstrained bond funds amid investors' ongoing quest to boost income and protect capital. Despite its popularity, this non-traditional approach remains mired in complexity. Ironically, it also carries risks that may offset the very risk-reducing benefits investors seek and dilute the role of fixed income as a portfolio's primary risk-mitigating component.

While interest rates are expected to rise in 2015, many believe the increases will be slow and deliberate.

Unconstrained Bond Funds May Create New Risks:

- Complexity makes evaluation difficult
- Increased credit risk
- May negate the role of fixed income as a portfolio's primary diversifier

Mediocre returns, often with high fees:

- More traditional mandates may offer a better option to unconstrained strategies

In this article, we explore the factors driving demand for unconstrained approaches and investigate their associated risks, featuring insights from Tim Doyle, CFA, Brandes Fixed Income Portfolio Manager, and Eric Jacobson, Morningstar Senior Analyst/Co-Head of Fixed Income for North America.

Fear Driving Demand

Also known as multi-sector, absolute return, strategic income and opportunistic fixed income, unconstrained strategies may own "…global bonds, currencies, high-yield bonds, structured bonds, and even equities. Many use leverage, derivatives, and swaps, taking short positions as well as long ones."[1] They seek to enhance returns and protect capital if, for example, interest rates rise [2]. They have attracted more than $460.0 billion in assets as of year-end 2014, according to eVestment. See Exhibit 1.

According to Doyle, "The category is set up for an Armageddon interest-rate move, with portfolio durations running at near zero or even negative." However, some analysts don't expect a sharp spike upward when rates rise, prompting Doyle to ask, "What are the chances that we'll get that Armageddon move in rates? And even if we do, then what? What do non-traditional bond strategies solve for afterwards?"

He added, "In 2013, we saw one of the largest moves up in the 10-year Treasury and the Barclays U.S. Aggregate Bond Index was down only 2.0%." And while interest rates are expected to rise in 2015, many believe the increases will be slow and deliberate.

[1] Kidd, Deborah. "Shedding Light on Unconstrained Bond Funds." CFA Institute's "Investment Risk and Performance Feature Articles." 10/27/14. http://www.cfapubs.org/doi/abs/10.2469/irpn.v2014.n1.8

[2] De Aenlle, Conrad. "When Bond Funds Think Outside the Box." The New York Times. April 4, 2014. http://www.nytimes.com/2014/04/06/business/mutfund/when-bond-funds-think-outside-the-box.html?_r=0

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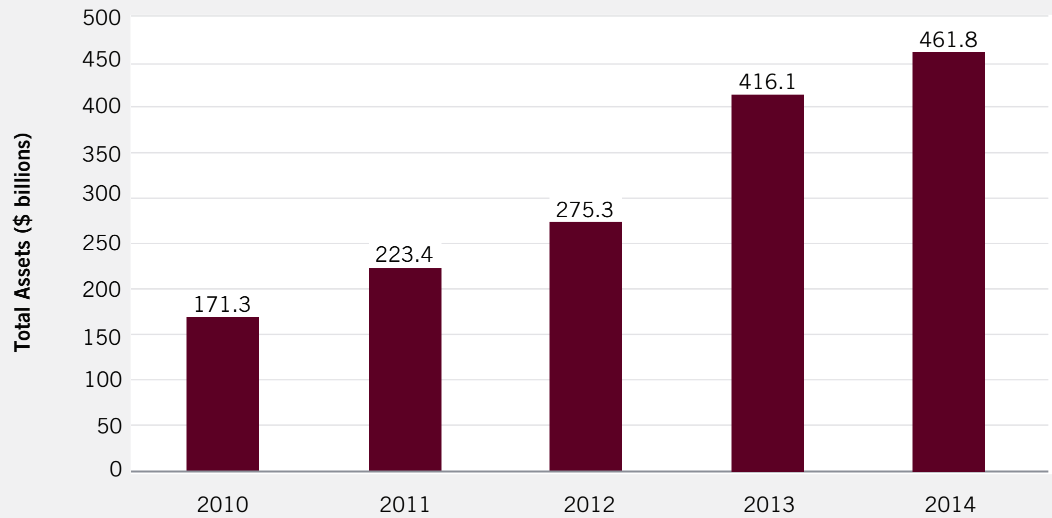
"This overt reach for yield could be a warning sign that investors are willing to take on more risk without adequate compensation for the underlying credit fundamentals."

— Tim Doyle, CFA

Exhibit 1: Unconstrained Bond Funds Have Attracted Increasing Assets



Source: eVestment, as of 12/31/14
The data in this chart includes institutional global and U.S. unconstrained bond mandates drawn from the eVestment database. It includes 104 products. 2014 data includes 6 products for which year-end 2014 data was not available; we used year-end 2013 data for those products.

Beware of the Risks

Beyond capital protection, investors also expect unconstrained bond strategies to provide higher yields. But investors often don't ask how, resulting in a number of risks embedded in non-traditional strategies, including credit risk, complexity on what constitutes an unconstrained bond portfolio and a lack of transparency.

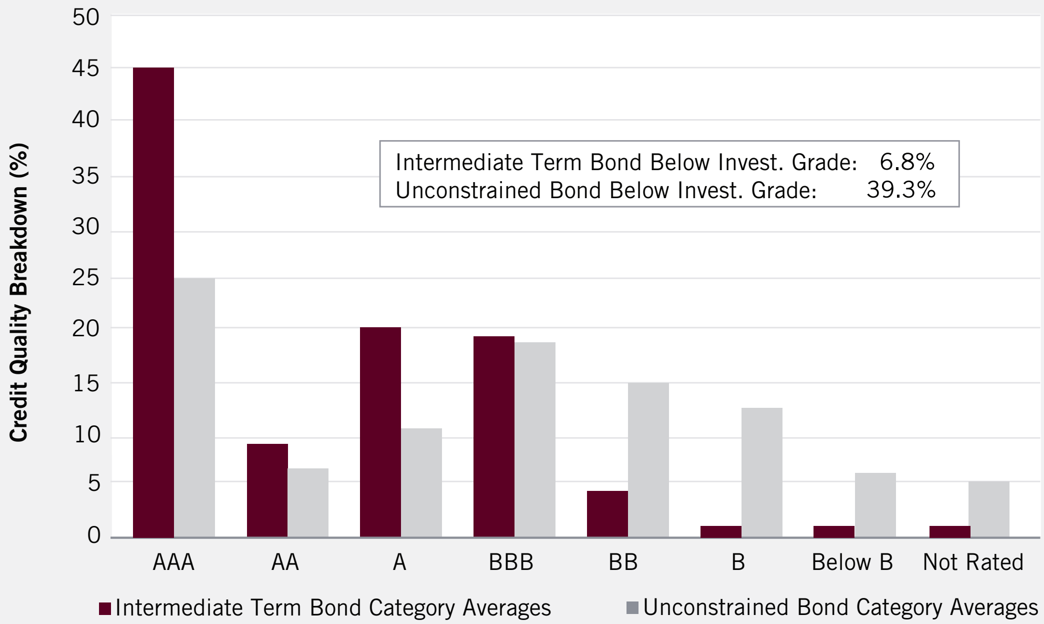
"This overt reach for yield could be a warning sign that investors are willing to take on more risk without adequate compensation for the underlying credit fundamentals. In other words, investors appear to be overpaying for yield because it's so scarce," said Doyle. "And with unconstrained bond (strategies), it's unclear that investors will get the protection they seek, especially if a big chunk of these strategies are in high-yield bonds."

Exhibit 2 on the next page, shows the weighting of Morningstar's non-traditional (or unconstrained) bond category averages, which have higher allocations to below-investment-grade bonds (below BBB) than intermediate-term bond category averages. "One of the biggest concerns out there is the mismatch between what investors understand vs. reality," Doyle added.

Amid the popularity of unconstrained approaches, Jacobson wrote, "Morningstar's latest data show that the average fund in the category has a whopping 40% exposure to investments rated below investment grade (or that don't have ratings). That compares with only 13.5% for the average intermediate-term bond fund, and there aren't any such exposures in the Barclays U.S. Aggregate Bond Index." He added that promotional materials for these funds don't tend to focus on ". . . how they're going to make up for the loss of return potential of a longer-duration portfolio. The information is there to see if you even scratch the surface of a fund's portfolio statistics, though, and what you find may leave some investors feeling a little queasy."[3] That queasiness may be exacerbated in the event of a market downturn.

[3] Jacobson, Eric. "5 Things Your Fund Company Won't Tell You About Non-Traditional-Bond Funds: Sins of Omission Are Still Sins." 7/3/14. http://news.morningstar.com/articlenet/article.aspx?id=654637 Jacobson was referencing mid-year 2014 data in his comments. On 12/31/14, the unconstrained bond funds still had exposure to below-investment-grade bonds near 40% (actually 39.6%), while the intermediate-term bond funds' exposure to below-investment-grade issues had fallen to 6.8%, according to Morningstar.

Exhibit 2: Warning Signs? Unconstrained Bond Funds' Credit Risk, as of 12/31/14
Exposure to Below Investment Grade More Than 5 Times that of Intermediate-Term Bond Funds



Source: Morningstar, as of 12/31/14

Credit and Equity Sensitivity

In a presentation to financial advisors at the Brandes Investment Partners Global Due Diligence Symposium in November 2014, Jacobson said unconstrained bonds are credit and equity sensitive, with high correlations to high-yield bonds, leveraged loans, as well as U.S. and emerging market equities, as shown in Exhibit 3.

In studying the performance history of most unconstrained strategies, the Investments & Wealth Monitor reported, "A significant portion of the universe maintains high and persistent exposures to credit and generates return streams that mimic those of high-yield and bank-loan strategies."[4]

Exhibit 3: Unconstrained Bond Funds Have Offered Little Diversification Benefit, 1/1/10 to 12/31/14
High Correlations to Other Asset Classes Can Change Portfolio Complexion

		1	2	3	4	5	6	7	8	9	10
1	US Open End Nontraditional Bond	1.00									
2	Barclays US Agg. Bond	0.20	1.00								
3	S&P 500	0.58	-0.28	1.00							
4	BofA/ML US HY Master II	0.86	0.17	0.74	1.00						
5	S&P/LSTA Leveraged Loan	0.79	-0.07	0.64	0.80	1.00					
6	Barclays US Corp IG	0.56	0.85	0.07	0.57	0.31	1.00				
7	JPM EMBI Global	0.71	0.49	0.45	0.70	0.36	0.66	1.00			
8	Barclays US Treasury	-0.16	0.90	-0.56	-0.20	-0.37	0.59	0.18	1.00		
9	Barclays US MBS	0.13	0.89	-0.23	0.11	-0.12	0.65	0.44	0.77	1.00	
10	Barclays US Treasury TIPS	0.38	0.80	-0.05	0.38	0.19	0.76	0.58	0.63	0.71	1.00

Source: Morningstar, as of 12/31/14.

[4] Cohen, Adam I. and Jingwei Lei. "Unconstrained Fixed Income, Really?" Investments & Wealth Monitor. Investment Management Consultants Association. Sept./Oct. 2014.

Unconstrained bond strategies' high correlation with various asset classes may negate fixed income's role as a portfolio's primary diversifier to equity volatility. Historically, when equity holdings have declined, the fixed-income component has helped cushion the impact on overall portfolio performance. Investors may wish to reevaluate the role their fixed income allocation is designed to play in overall portfolio construction—and assess whether unconstrained bond strategies align with those objectives.

Case Study: Credit Selloff Example

There are other risks embedded in non-traditional bond strategies. Jacobson cited the "insurance" that fixed income holdings provide within a diversified portfolio during market downturns and noted some investors may be sacrificing that benefit in the chase for returns. ". . . If you strip out all the rate sensitivity by getting rid of your intermediate-term bond funds or government funds, at that point, you've taken away an insurance policy," he said. "If you go back and look at the third quarter 2011, go back and look at 2008, the only thing that did well in those periods were U.S. Treasuries."[5]

"If you're thinking, I need to get rid of this because I'm afraid it's going (to) sell off, think again…."

— Eric Jacobson

He added, "(If) you're thinking, I need to get rid of this because I'm afraid it's going (to) sell off, think again, because you don't want to be predicting interest rates. You don't want to be doing that in your portfolio, and the one time that you are really going to need it, if it's not there, everything is going to go down at the same time."[5]

Jacobson mentioned 2011 to illustrate his point; that year provides a good case study. Non-traditional bond funds declined 1.29% in 2011, when credit spreads widened as a result of the euro zone debt crisis and the decline in U.S. Treasury yields amid a flight to quality. In contrast, intermediate-term bond funds advanced 5.86% in the same year.[6] Similarly, investors today seeking to protect themselves against one risk (such as rising rates) may unintentionally expose themselves to other risks (such as credit risk).

Unconstrained and Mired in Complexity Makes Evaluation Potentially "Treacherous"

Unlike traditional bond strategies, unconstrained bond approaches can invest anywhere—although it may not always be clear exactly where. While there are various unconstrained approaches available, finding a true multi-sector approach can be difficult. "In reality there are a number of variations of unconstrained fixed-income investing, making an uninformed investment decision in this space potentially treacherous," according to *Investments & Wealth Monitor*.[7]

In the same article, the authors sought to compare and contrast various unconstrained bond funds, but noted, "Unfortunately, we found the performance histories of most strategies too limited and manager-reported data too intermittent and inconsistent, making this evaluation particularly difficult."

Pressure to Stretch Risk Boundaries—But at What Cost?

Beyond the difficulties evaluating unconstrained bond strategies and the risk of taking on new risks while trying to hedge others, there remains another important consideration: fees. "Investors are paying almost double the fees for non-traditional funds," Doyle said of the unconstrained category. "If you combine high costs with low rates along with the tight fixed-income spreads in the market now, there's the risk of increased pressure to stretch risk boundaries to generate returns," Doyle added.

[5] Benz, Christine and Eric Jacobson. "Why Dumping Your Core Bond Fund Could Cost You." Morningstar Video Reports. 8/4/14. http://www.morningstar.com/cover/videocenter.aspx?id=659744

[6] Jacobson, Eric, quoting Morningstar data, from his presentation "Nontraditional Bond Fund Investing," given November 13, 2014 at Brandes Investment Partners Global Due Diligence Symposium in San Diego.

[7] Cohen, Adam I. and Jingwei Lei. "Unconstrained Fixed Income, Really?" Investments & Wealth Monitor. Investment Management Consultants Association. Sept./Oct. 2014.

What About Performance?

So how richly have investors been rewarded for unconstrained bond funds' ability to go anywhere? While performance history is short, not very well thus far. In fact, traditional intermediate term bond fund mandates have fared better (with lower standard deviation) based on three- and five-year average annualized returns. See Exhibit 4.

Exhibit 4: Unconstrained Strategies Have Trailed More Traditional Fixed Income, as of 12/31/14

Morningstar Category	Total Returns (3-Yr Annualized)	Total Returns (5-Yr Annualized)	Std Dev. (3-Yr)
Unconstrained Bond Funds	3.28%	3.38%	3.06%
Intermediate Term Bond Funds	3.38%	4.78%	2.85%

Source: Morningstar, as of 12/31/14. Past performance is not a guarantee of future results.

Traditional core plus mandates have fared better based on three- and five-year average annualized returns.

Conclusion

After examining the merits and risks of unconstrained bond investing, two key takeaways stand out:

1. **Investors should be aware of the risks embedded in these and other complex strategies and carefully evaluate if the rewards can offset those risks.**
2. **There are benefits to maintaining exposure to more traditional fixed income strategies—or those with greater transparency that enable fixed income to be the portfolio's primary diversifier.**

Jacobson stressed that investors should be wary of the benefits touted by some unconstrained bond fund managers. Such benefits, he noted, are "…almost by definition, impossible to provide all in the same package. Ultimately, anything that sounds that good to be true should probably be making the hair on the back of your neck stand up."[8]

[8] Jacobson, Eric. "5 Things Your Fund Company Won't Tell You About Non-Traditional-Bond Funds: Sins of Omission Are Still Sins." 7/3/14. http://news.morningstar.com/articlenet/article.aspx?id=654637

The Barclays U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. This index is a total return index which reflects the price changes and interest of each bond in the index.

The S&P 500 Index with gross dividends measures equity performance of 500 leading companies in industries of the U.S. economy.

The BofA Merrill Lynch U.S. High Yield Master II Index tracks the performance of U.S. dollar-denominated below-investment-grade rated corporate debt publically issued in the U.S. domestic market.

The S&P/LSTA (Loan Syndications and Trading Association) Leveraged Loan Index covers more than 1,100 loan facilities and reflects the market-value-weighted performance of U.S. dollar-denominated institutional leveraged loans.

The Barclays U.S. Corporate Index measures the investment grade, U.S. dollar-denominated, fixed-rate, taxable corporate bond market.

The J.P. Morgan Emerging Markets Bond Index Global tracks total returns for traded external debt instruments in the emerging markets. It includes US dollar-denominated Brady bonds, loans, and Eurobonds with an outstanding face value of at least $500 million.

The Barclays U.S. Treasury Index is an unmanaged index consisting of U.S. dollar-denominated, fixed-rate, publicly issued bonds. The index is a total return index which reflects the price changes and interest of each bond in the index.

The Barclays U.S. Mortgage-Backed Securities Index is an unmanaged index consisting of fixed-rate, mortgage-backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). The index is a total return index which reflects the price changes and interest of each bond in the index.

The Barclays Capital US Government Inflation-Linked Bond Index measures the performance of the US Treasury Inflation Protected Securities (TIPS) market.

Correlation is a measure of how a security's (or a portfolio's) price moves relative to another; it is expressed as a correlation coefficient with a range between 1.0 and -1.0. A correlation coefficient of 1.0 suggests prices move in lockstep; -1.0 suggests moves that are completely opposite. Zero suggests no relationship.

Duration, at its simplest, measures the price sensitivity of an asset (often a bond) to changes in interest rates. Longer duration securities tend to exhibit greater price fluctuation when interest rates rise or fall.

Standard deviation (in the context of investing) measures the historical range of price fluctuations for a security or portfolio around a mean. Higher standard deviation reflects higher, historical price volatility.

Yield measures the income generated by a security or investment. It is often expressed as a percentage of income or dividends received annually divided by the price paid for that security, its current value or face value.

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