Ramblings about unconstrained debt funds (work in progress)

Michael Furey | Delta Research and Advisory | 02 September 2014

I've recently returned from a 10-day research trip to the UK with a dozen senior fund research analysts, during which we visited a variety of strategies offered by a variety of managers and, fortunately for me, met some of the leading thinkers and researchers in the advice industry (hat tip D&G... and I don't mean Dolce and Gabbana). Several of the nine managers we visited spoke to their "unconstrained debt" strategies. Amongst our group of research analysts, it was largely agreed that these strategies are flavour of the month. But, there was differing opinion about whether and how to use them in investment portfolios.

DEFINITION

First, it's appropriate to define what an unconstrained bond fund is. The key is obviously in the definition of unconstrained. Typically, such funds are managed to an absolute return-like objective (for example, cash plus 3% per annum over rolling three year periods) and therefore, independently of traditional bond benchmarks like the Barclays Global Aggregate. As a result, there is the ability to execute virtually any debt-like strategy or instrument whether it be long or short duration, credit/high yield, government, CDOs, ABS, swaps, etc... hence the "unconstrained" moniker.

These basic characteristics don't suggest managers are accepting significant risk, particularly given there is often a secondary objective more akin to a Sharpe ratio (which may be excess return over cash divided by volatility). So, there's a risk-adjusted benchmark which should make the punters happy with respect to risk-based objectives.

There may be other characteristics and, sometimes, certain constraints that are common sense with respect to objectives (e.g. minimum liquidity). But, in my opinion, these are the core characteristics. The bottom line is that managers of these strategies have numerous levers to pull to gain and protect depending on their view of the investment world.

FLAVOUR OF THE MONTH

There are several factors that suggest these funds are likely to be very popular amongst investors today, with the main ones being:

- **Potential for gain in rising interest rate market** - It appears current market consensus is that interest rates around the world can't stay near these historic lows and there is

only one way to go... up. This means the return expectations for traditional conservative bond funds are very low and investors are looking for an alternative.

- **Flexibility to avoid being caught in another credit crunch** – Credit spreads have been tightening since the start of 2009 and downside risk is also increasing, so exposure to a strategy nimble enough to get out of high yield can be quite handy. Let's face it – high yield bond funds had equity-like negative returns during the GFC and no one wants to experience that again. So why not give a manager the chance to exercise their discretion? Well, perhaps there are a few reasons, but I digress.
- **Many believe bond benchmarks are flawed and should not be managed to** – Rightly or wrongly, there is a wide-held belief that debt benchmarks are poorly constructed as they give the highest weights to the most indebted companies and/or governments, so benchmark risks are high. Managing to an absolute return outcome that is independent of debt benchmarks may be attractive.

These unconstrained strategies are not "beta" or market-related strategies. They are very much pure "alpha" strategies and heavily reliant upon the pure security selection and/or market timing skill of the portfolio manager. Their performance has been short term and experienced a tightening of credit spreads combined with declining interest rates, so irrespective of the portfolio position, many bond funds have a reasonable track record if set up post GFC – and that does appear to be the case. This relates to one of the major risks of these unconstrained bond funds and why it may be risky to fall in love with these strategies. They are yet to be truly stress tested by the markets.

PORTFOLIO CONSTRUCTION

There was a lot of debate amongst the group of research analysts around where these funds should be allocated in a portfolio. The agreed options were quite obvious – either the debt (or bond/fixed income) or alternatives allocation.

The argument in favour of using them in the debt allocation centred on the fact that the returns come from that particular asset class. The argument for allocating them to alternatives was pretty much centred on the strategies' complexity and non-benchmark investment approach.

My personal belief is that they should sit in the alternatives allocation. But, either way, current portfolio construction methodology in the financial advice world is led by the asset allocation decision which is primarily a beta (or market-related) decision. These funds, with their non-benchmark objectives, have the potential of ruining the intentions of any recommended asset allocation. If the beta decision of the asset allocation is less of an issue then the question of where to allocate unconstrained debt strategies is possibly a question of investment philosophy and how these funds are likely to satisfy associated investment beliefs. In other words, irrespective of strategy, a key question to answer is "What is the role

of the debt investment in the broader portfolio?" As a diversifier to reduce portfolio risk? As a pure income focus irrespective of correlations with other asset classes? Or some combination?

DEBT INVESTMENT PHILOSOPHY

Traditionally, the debt asset class has a defensive role in portfolios and equities takes the more aggressive/return driving role. An unconstrained debt portfolio may significantly vary between traditional defensive and aggressive assets over time and the return success is therefore highly reliant upon the market timing and security selection skills of the manager – which is a risk in itself. This paradox is the first major challenge to assigning unconstrained debt funds to the debt allocation. That is, it potentially compromises debt's intended defensive role.

As already mentioned, there is a widely held belief that interest rates are more likely to increase than decrease in the coming years and, therefore, the belief that holding conservative bonds is a risky position. Hence, unconstrained debt strategies may actually reduce risk given an assumed improved return expectation in a rising interest rate market.

Unfortunately, there is one significant problem with this belief – it is purely a return driven one and ignores broader portfolio risk. In other words, there is little or no consideration of the correlation with the other asset classes and we should expect higher correlation to equities will increase portfolio risk significantly more than high correlation to bond indices. Certainly, the possibility of low correlation in poor performing equity markets exists. But, it requires the unconstrained bond manager to have that position as opposed to being a natural hedge like conservative bonds often are in times of stress.

The GFC was a wonderful exercise in understanding what true diversification is, as certain debt investments (i.e. higher yielding) turned out to be highly correlated with equity markets and declined in value at the same time as equities – providing little to no diversification whatsoever.

PORTFOLIO CONSTRUCTION FLAW

As mentioned, the current investment approach particularly in the retail advice world, is a two-step process. The first step is to assign an asset allocation based on an investor's needs and risk tolerances. The second step is to assign investments to the asset allocation. Model portfolios aside, the flaw in this process in the retail advice world is that these two steps are separate and therefore the asset allocation decision, which is a beta or market-related decision, is often ruined by the investment allocations. Using unconstrained debt funds is a case in point, unless the asset allocation decision specifically provides for this type of strategy (and, if it does, there is bound to be some arbitrary quality to the allocation as opposed to an objective return and risk focus).

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For example, if the Strategic or Dynamic or Tactical asset allocation suggests a 30% allocation to debt strategies and the benchmarks for this allocation are the UBS Composite (in the case of Australian debt) and Barclays Global Aggregate (for Global debt), then allocating to an unconstrained debt fund will potentially reduce the required exposure to these asset classes. Certainly, the strategies we looked at had little to no correlation to these indices – hence they would change the desired asset allocation. This is the main reason why allocating unconstrained debt funds to the debt asset class is inappropriate more often than not.

ALTERNATIVES ALLOCATION

What we are left with is to allocate unconstrained debt strategies to the alternatives asset class. However, this too creates some problems.

The first relates to the definition and objective of the alternatives asset class.

For most investors, the alternatives asset class is the non-traditional asset class. It comprises anything that has little to no relationship with traditional debt and equity investments – for example, hard and soft commodities, illiquid assets like private equity, direct property and direct infrastructure, complex hedge fund strategies like global macro, arbitrage, short selling, managed futures, and exotic derivatives like structured products. Given their complexity and perceived lack of relationship over time with traditional markets, unconstrained debt strategies appear to sit neatly amongst the complexity of hedge fund strategies.

However, an arbitrary allocation to alternatives should never occur. Arbitrary allocation will obviously increase unnecessary risks as it is possible to create both a low risk alternatives portfolio and a high risk alternatives portfolio. So constructing according to objectives is a must.

The design of the alternatives portfolio is part of the broader portfolio design so careful consideration should be given to potential correlations not just with other alternative investments but also traditional asset classes – and particularly in times of stress.

The second issue is how the unconstrained debt strategy is likely to contribute to the desired return and risk of the alternative allocation and overall portfolio.

CORRECTING THE PORTFOLIO CONSTRUCTION FLAW

The approach of considering an individual investment at the same time as the broader portfolio's return and risk objectives should not just occur within the alternatives asset class but also at the overall portfolio level as well. Separating the beta decision from the alpha decision is an inefficient approach to portfolio construction. The decisions should be made together with portfolio return and risk objectives top of mind at all times.

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This approach removes the two step approach to investing that the Australian retail advice industry has embraced, moving instead towards an integrated asset class and investment selection approach. The asset class allocation then becomes the output instead of the input.

Of course, all of this is easier said than done and it may produce other unstated risks and may require tools or skills that are not available. But, an integrated asset class and investment approach should increase the alignment with return and risk objectives compared to the current approach in which the investment decision often ruins the recommended asset allocation.

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