Unlocking Relative Value: Optimizing Team Structure for Multi-Sector Fixed Income Investing

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Executive Summary

- The frequent failure of "core" bond strategies to meet investors' return expectations has forced many clients to search for alternative solutions. Multi-sector strategies emerged as one solution to meet the growing need for income and capital appreciation.

- Multi-sector's approach necessitates that managers combine discrete asset classes in ways not captured by a traditional benchmark.

- The structure of traditional managers creates artificial boundaries to a successful multi-sector investment process.

- Flexible, cross-asset-oriented teams are needed to discern relative values and bridge the gap between valuations and fundamentals and can provide a durable solution with potential for superior risk-adjusted returns.

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Given the rise of passive strategies in both equity and fixed income markets, today's investors often demand that active managers serve a different role than in years past. As clients increasingly incorporate both active and passive approaches, they should consider hiring active managers with broad mandates to provide a solution to specific problems and generate alpha. This is certainly the case with the rise of the multi-sector fixed income asset class, in which active managers are typically less constrained by a benchmark and free to exercise judgement through high-conviction security selection and a long-term view. However, this orientation toward a solution and the resultant freedom to pursue it are frequently at odds with the way traditional asset managers are structured.

Most types of multi-sector fixed income investing developed in the wake of the 2008 Global Financial Crisis. They generally attempt to provide higher returns in a low-yield world while also trying to avoid the pitfalls of significant risk-free rate exposure in a potentially rising rate environment. Yet many multi-sector managers have failed to deliver. A traditional fixed income investment team designed along rigid sectors and segments has difficulty executing a multi-sector strategy due to two structural factors:

1. Instead of solutions defining the starting point, benchmarks dominate the construction of strategies and investment teams.
2. Fundamentals and valuation have traditionally been two separate parts of the decision-making process instead of being intrinsically linked from concept through execution to derive relative value successfully.

The traditional role for a fixed income manager was to provide index-like market exposure (beta), while applying an active component to generate alpha, net of fees. The requirements of the client generally meant an "active" manager was afforded little freedom to deviate from the benchmark for fear of creating excess tracking error. Given these constraints, traditional asset managers generally worked to create excess return through two main channels. First, a top-down process to express minor overweights or underweights relative to broad factor exposures, such as duration, geography, quality, and market sectors. And second, through a bottom-up process utilizing credit analysts to pick securities in each segment of the index to fill out the top-down allocation decisions. These top-down and bottom-up processes were then combined into a portfolio, the end result of which often looked much like a benchmark, though it was supposed to outperform across market cycles.

The top-down process often focuses on valuations, while the bottom-up process frequently focuses on fundamentals. The valuation component (e.g., is duration cheap or expensive?) is often decided at the firm level through an investment committee or chief investment officer. Fundamental analysis (e.g., is car manufacturer A better than car manufacturer B?) is decided at the analyst level. The inherent challenge to this process is that an attractive investment always aligns valuations and fundamentals. This challenge is hard to overcome if the process itself is compartmentalized.

For the traditionally structured asset manager, the potential disconnect between valuations and fundamentals is often a moot point because so long as the portfolio looks similar to the benchmark, it can theoretically still be positioned to provide alpha relative to the benchmark. However, for a solution-oriented portfolio that is generally unconstrained by a benchmark, the concept of relative value across sectors becomes tremendously important.

Team Design: Critical to Building Successful Outcomes/Solutions

Asset managers historically built fixed income investment teams based on broad asset classes represented in a benchmark. Generally, first came analysts focused on U.S. Treasuries and agencies, then perhaps additional support was added around agency mortgage-backed securities, followed by investment-grade credit, and finally high-yield corporates and other riskier "plus" sectors. In theory, this team structure enables the bottom-up selection of best-in-class securities within a narrow silo that are then pushed up to a portfolio manager for inclusion in top-down allocation decisions for a core benchmark-like portfolio. Part and parcel of this structure is the notion that a sector analyst focused solely on a single industry, say U.S. automobiles, is best equipped to pick the best opportunity within that industry. That could be Ford one month, and GM the next. Whatever the case, the auto analyst is the team expert on U.S. auto manufacturers. But what if neither is particularly compelling compared to other sectors or fixed income sub-asset class credits? Should a place in the portfolio necessarily be maintained for U.S. auto sector exposure?

Once investment strategies began crossing boundaries, mixing discrete segments of investment grade, high yield, emerging market debt, etc., and drilling down into even more granular industry segments within each, things became complicated. Traditional core bond team structures have largely remained dual top-down, bottom-up processes, limiting flexibility. If clients are seeking a different outcome from their active managers with a multi-sector approach, it may make more sense for the asset manager to be structured more flexibly.

Consider the challenge facing a traditional fixed income portfolio manager charged with running a multi-sector strategy within the confines of defined sector teams. Say the manager has a bullish view on a particular macro theme and asks two credit specialists to each produce a recommendation.

Both, in response, highlight two bonds assessed to have the strongest fundamentals relative to the broad investment theme. One may be a better value than the other, but they're both the best assessed in their segmented classes based on their respective fundamentals. The manager could take one or both bonds, and nonetheless miss many others with similarly strong fundamentals, similar leverage to the macro theme, and better relative valuations than both analysts' recommendations. For example, why should a manager be limited to a specialist's recommendation of a Hilton corporate bond if a hotel commercial mortgage-backed security exhibits similar fundamentals but better relative value at the time?

More attractive relative valuation is often missed if specialists don't adequately assess both fundamentals and relative value of securities both inside and outside their specialties, constraining the manager's choices. Ideally, fundamentals and valuation align in analyzing a wide range of securities that may have similar drivers but very different relative valuations. A wide range matters because many fixed income opportunities lie outside standard specialized credit desks. Failing to examine the fundamentals and relative value of securities across asset classes can lead to sub-optimal outcomes.

A Common Ground Framework: Quantity, Timing, and Probability

Given that analyzing risk and reward is germane to fixed income investing, one could assume that its implementation would be relatively consistent across the profession. In practice, segmentation of professionals and responsibilities can hamstring execution. An agency mortgage analyst focuses on an entirely different set of risks than does a high yield corporate analyst. Yet both potentially have a place in a multi-asset product with a specific solution as the desired outcome. A different lens should be applied when investing across a broader palette. Every investment can be framed in terms of quantity, timing, and probability of cash flows irrespective of asset class or industry classification. Good bonds can be found in out-of-favor industries, and bad bonds often result from favored macro views due to high valuations. The traditional specialist approach in fixed income may be prone to miss the alignment of valuations and fundamentals.

Rather than confining the research and resulting allocation process to personnel structures designed for a different product set, multi-sector investment teams should work dynamically across sectors, segments, and structures to more effectively analyze individual risk/reward tradeoffs in pursuit of superior results. While traditional team architecture creates reasonable probabilities for success when hewing to a benchmark with pre-defined and narrowly circumscribed allocations, it is not necessarily a smooth transition to apply that same structure and internal incentive system to a solutions-oriented strategy. Rather, teams built from the ground up according to a solution; e.g., robust returns over many macro outcomes through comprehensive analysis of relative value across sectors, in our judgement comes from a better philosophical starting point.

We think analysis should start with relative risk/reward comparisons across categories of opportunity, with a desired solution as the basis for assessment of relative value. Distilling every opportunity into an examination of quantity, timing, and probability of cash flow allows for a relative-value discussion, comparing risk and return across opportunity sets. To effectively pursue this relative-value approach, an investment team needs analytical expertise across sectors as well as an understanding of the tradeoffs between various choices. Thus, an investment professional steeped in asset-backed security (ABS) analysis must also be aware of the value, or lack thereof, across the corporate bullet landscape when analyzing a bond driven by the same factors as the given ABS. Only then can an informed discussion occur across a collaborative investment team to compare the relative attractiveness of apples to oranges.

Flexible Perspective: A Multi-Sector Structure for a Multi-Sector Strategy

If the appropriate assessment of risk/reward irrespective of a benchmark is the key to multi-sector fixed income investing, investment teams should be built in this image. Ideas ought to be compared versus the broad universe of available investments from the first part of the analytical process, not merely as a last step performed by the portfolio manager. Without the context of relative value outside of one's principal area of coverage, it is impossible to regularly and accurately determine the merits of a potential investment outside its narrow peer group.

Thornburg's global fixed income team was built from the ground up to embody a flexible perspective. To begin with, all portfolio managers are also analysts, building bottom-up investment theses while incorporating a macroeconomic judgment. Additionally, all portfolio managers and analysts are required to maintain an awareness of relative value across the broader fixed income landscape, such that their focus does not become myopic with respect to their main area of coverage. This ensures that risk/reward is debated in an informed manner by all members of the team for every opportunity.

Our investment team conducts fundamental security analysis to compare the risk/return characteristics of each security across sector, segment, and structure from the inception of each idea. Our consistent process of evaluating a security in relation to both those in the portfolio and sundry others outside it, selecting the optimal investment on its own merits and in relation to the rest of the portfolio, should keep

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portfolio positioning from leaning toward a particular macroeconomic belief. While our top-down viewpoint drives our broad risk/reward framework at the macroeconomic level, all decisions are analyzed at the individual security level, effectively helping us avoid large macroeconomic bets. We believe this approach to investing provides us the opportunity to generate robust, risk-adjusted total return across many macroeconomic outcomes. ■

Important Information

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Alpha – A measure of the difference between a portfolio's actual returns and its expected performance, given its level of risk as measured by beta. A positive alpha figure indicates the portfolio performed better than its beta would predict. In contrast, a negative alpha indicates under-performance, given the expectations established by the beta.

Beta – A measure of market-related risk. Less than one means the portfolio is less volatile than the index, while greater than one indicates more volatility than the index.

Duration – A bond's sensitivity to interest rates. Bonds with longer durations experience greater price volatility than bonds with shorter durations.

Tracking Error – A measure of how closely a portfolio follows its benchmark. Typically, it's the standard deviation of the difference in returns between a portfolio and the benchmark. Actively managed portfolios tend to have a higher tracking error compared to passively managed investments.

Asset-backed Security (ABS) – A security whose value and income payments are derived from and collateralized (or "backed") by a specified pool of underlying assets. The pool of assets is typically a group of small and illiquid assets that are unable to be sold individually. Pooling the assets into financial instruments allows them to be sold to general investors, a process called securitization, and allows the risk of investing in the underlying assets to be diversified because each security will represent a fraction of the total value of the diverse pool of underlying assets.

Riskless (or risk-free) Interest Rate – The theoretical rate of return of an investment with zero risk. The risk-free rate represents the interest that an investor would expect from an absolutely risk-free investment over a given period of time. Though a truly risk-free asset exists only in theory, in practice most professionals and academics use short-dated government bonds, such as a three-month U.S. Treasury bill.

Investments carry risks, including possible loss of principal. Portfolios investing in bonds have the same interest rate, inflation, and credit risks that are associated with the underlying bonds. The value of bonds will fluctuate relative to changes in interest rates, decreasing when interest rates rise. Unlike bonds, bond funds have ongoing fees and expenses. Investments in mortgage backed securities (MBS) may bear additional risk. Investments in the Funds are not FDIC insured, nor are they bank deposits or guaranteed by a bank or any other entity.

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