What is scientific fixed income investing and why should investors embrace it?

BlueCove was founded in 2018 to research and develop state-of-the-art scientific investment processes applicable to fixed income

Real innovation in the fixed income industry is rare. So much so that it is hard to name more than a handful of examples: the advent of the Eurobond market in the 1960s, of the high yield bond market in the 1970s, of passive fixed income funds in the 1980s, of credit default swaps in the 1990s, and of the global credit market in the early 2000s. We believe that scientific fixed income investing is poised to be the industry's next such innovation and, like its predecessors, to bring meaningful benefits to investors.

What is scientific fixed income investing?

At BlueCove, scientific fixed income investing involves re-engineering the traditional discretionary investment model in order to eliminate its weaknesses. This is done by breaking the investment process down into its component parts (universe definition, data sourcing, alpha sourcing, portfolio construction, trade execution) and reassembling it - with people and technology assigned their optimal roles. Human discretion is directed away from fields in which it is weak (such as subjective forecasting) and towards those in which it is strong (such as objective analysis)[1]. Technology is assigned the tasks it does best, knowledge management is retained at the firm level, and an asset class-siloed investment process dependent upon human discretion at every stage is replaced by one in which discretion is focused on process design and improvement[2].

What is it not?

Scientific fixed income investing is not opaque; when operated properly it is rigorously transparent in its decision and performance attribution. It does not dispense with human discretion; it redirects it towards the design, construction, and monitoring of the investment process. It is not auto-execution; deep asset class expertise underpins implementation and multiple components of the process, including alpha insights, risk, transaction cost and liquidity modelling. It is not rigid; manual intervention by asset class experts occurs when, for instance, corporate actions or liquidity considerations require[3]. From an investor standpoint, it is also not a homogenous discipline; each firm will take its own evidence-based approach to the investment process, with some focusing on top-down market factor and style driven approaches and others on bottom-up insights.

Why has it taken so long to arrive?

Investors often query why it has taken scientific fixed income investing so long to arrive. After all, the scientific method has been at the forefront of successfully solving hard problems for over four hundred years[4]; the complexity of fixed income makes it an excellent prima facie candidate for the application of science; and (to take an example) an early version of scientific fixed income investing was being practiced at Barclays Global Investors as long ago as 2005. The reason is that, until recently, fixed income as an asset class lacked the data, market structure, market breadth and depth of research that are the necessary preconditions for modern scientific fixed income investing. Rapid growth in all these metrics in the last few years, however - driven by a huge expansion in the size of the asset class post the Great Financial Crisis - has changed all this and created the conditions for the discipline to flourish.

How do investors stand to benefit?

Most actively managed institutional fixed income portfolios today are dominated by discretionary managers. While the best are excellent, the majority are not, as evidenced by 69% of actively managed investment grade funds and 99% of actively managed high yield funds underperforming their benchmark between 2005 and 2019[5]. We believe this is due, inter alia, to a prevalence of cognitive and emotional bias, a lack of portfolio breadth caused by the suboptimal use of technology, and a lack of decision-making transparency throughout the investment process: all weaknesses a well-run scientific process is designed to correct. Transitioning from a portfolio composed of discretionary managers to one combining the best of discretionary and scientific (whose returns tend to have a low to negative correlation to one another[6]) has the potential significantly to improve investor returns.
Investors should also stand to benefit from the fact that a relatively small number of scientific fixed income managers look likely to have the field to themselves for some time to come. This is because on the one hand the bona fide scientific fixed income business model is an expensive and difficult one to build (creating high barriers for new entrants), and on the other because it is a hard one for incumbent discretionary managers to retrofit without doing themselves significant cultural and commercial collateral damage. With new entrants largely excluded and incumbents strongly incentivised to settle for a 'quantamental' compromise, the medium-term alpha opportunity available to investors via a relatively small number of scientific managers operating in an uncrowded space should be meaningful.

Where from here?

At BlueCove, we expect that the diversification and alpha generation benefits described above - alongside the natural ability of a scientific firm to create bespoke investment solutions for clients (given the generally modular nature of research streams) - should allow well-run scientific fixed income managers to add real value to institutional investors' portfolios in the years to come. We look forward to playing our part in this exciting new phase of industry innovation.

About

LUMYNA

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Lumyna is part of the Generali Investments multi-boutique offering

Lumyna is a market leading Alternative UCITS platform. It brings best-of-breed hedge fund managers to the European market via regulated, liquid and transparent UCITS vehicles. Lumyna is partnering with BlueCove to launch a UCITS version of BlueCove's scientific fixed income strategy. Adding to Lumyna's existing accolades, most recently the platform was recognised as the 'Best UCITS platform' by HFM European Services Awards.

FOOTNOTES

1 As discussed in publications such as Daniel Kahneman's, 'Thinking, Fast and Slow'. See also 'Superforecasting' by Philip Tetlock and Dan Gardner, 2015.
2 Van Gelderen, Eduard & Monk, Ashby H. B., 'Knowledge Management in Asset Management', August 11th, 2015.
3 Manual intervention is conducted scientifically and aids model improvement and design. All interventions are catalogued and marked for this purpose.
4 David Siegel, 'Quant's Best Strategy Is From The 17th Century', Wall Street Journal, May 26th 2017.
5 Source: S&P Dow Jones Indices Research: SPIVA US Scorecard, Year End 2019.
6 AQR, 'Alternative Thinking', Q3 2017, BlueCove internal research.

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