ABSOLUTE RETURN FIXED INCOME:

WHERE DOES IT FIT IN?

Alex Johnson,
Head of Absolute Return Fixed Income, BNP Paribas Investment Partners

We define absolute return as a style of investing focused on alpha strategies with returns coming from beta largely excluded. While beta is usually positive, it may not always be.

Absolute return fixed income can be used to deliver fixed income returns uncorrelated with market direction. It is a diversifier, narrowly to a fixed income allocation, and more broadly to a whole portfolio. It is also a source of discrete alpha, allowing ready identification of alpha, and access to less traditional portfolio construction methodologies.

Absolute return has a variety of applications for investors. The first and arguably most obvious is that freeing a portfolio return from an underlying beta is particularly relevant if the investor is concerned that the market beta will be anemic, or negative.

FIXED INCOME RETURNS UNCORRELATED TO MARKET DIRECTION

Fixed income investors know that as the yield falls, the price rises: the inverse relationship of price to yield. What may be less intuitive for some is that duration rises as yields fall. This creates a pernicious but mathematically inevitable situation that as yields fall, price sensitivity – risk, in other words – rises, so even as running yields fall, the risk of capital loss increases. 2015 has seen the returns per unit of risk reach their all-time low in US Treasury notes. This fact may have been partially obscured because the increase in capital values – prices – has flattered fixed income total returns. In many cases, investors have also benefitted from large secular foreign exchange moves contributing significantly to fixed income portfolios. Both of these effects are transient. Fixed income as an asset class is delivering very little in the way of income, and with interest rates so low, there is little room for further price appreciation.

That is not to say that there are not opportunities: there are many, all the more so for managers able to express views in both long and short markets and sectors. Absolute return enables investors to benefit from these opportunities, without at the same time committing to the risk of a negative market beta.

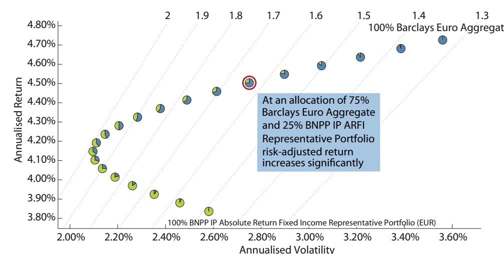
This is a powerful reason to look at absolute return, because many investors need to maintain a fixed income exposure in their portfolios. Typically, it is used to diversify other exposures, such as equities. As the name implies, it is the portfolio allocation generating income, essential for pension funds to provide for current retirees and to cover operating expenses for many others. It is also that part of the portfolio aiming to provide stability. Simply not owning fixed income at all achieves none of these portfolio goals. Absolute return fixed income provides that diversification. By nature of the fixed income instruments in the portfolio, it should be able to deliver income. Most importantly, it may be able to achieve both of these things without also importing a high degree of risk of capital loss.

FIXED INCOME RETURNS AS A DIVERSIFIER

An absolute return portfolio uncorrelated with market direction offers an additional benefit beyond avoidance of negative outcomes such as a bond bear market.

The graph shows an efficient frontier, taking the Barclays Euro Aggregate index as a proxy for a given fixed income allocation. An interesting point is found at an allocation of 75% Barclays Aggregate, 25% BNP Paribas Investment Partners' absolute return fixed income representative portfolio - risk falls considerably more than return is sacrificed, so risk-adjusted return increases significantly. Another way of expressing this is that adding an uncorrelated asset to an existing portfolio will increase its risk-adjusted return, all things being equal.

Figure 1: Absolute Return Fixed Income as a Diversifier



Source: BNP Paribas Investment Partners /FFTW (Prism); Bloomberg. Data shows risk adjusted returns of combinations 31 October 2006 – 30 June 2015

ABSOLUTE RETURN AS AN ALTERNATIVE

To expand on this theme, we have focused on the fixed income side of absolute return fixed income. To be sure, the classic asset allocation might be a 60/40 split between equities and fixed income, with some variation to take into account factors such as conviction, market outlook, or the duration of liabilities. However, many asset allocators also make provision for alternatives.

This can mean an asset class that is neither fixed income nor equity. Examples include property, commodities, or so-called exotic betas. What these allocations tend to be targeting is not difference in itself, but rather an uncorrelated return stream. Absolute return can offer exactly the same benefits. If the returns are generated from alpha, it should be the case that there is no necessary linkage between these returns and those of the underlying market. In addition to an allocation to alternatives on its own merits, investors with fixed liabilities may find this particularly interesting. Insurance companies with matched portfolios operating under a Basel III regime may be looking for a return-seeking portfolio, of which absolute return may be an ideal complement. Here, an offering in a fund is likely to be of interest in most jurisdictions given tax treatment of derivatives, though investors should ensure that fund rules meet their own requirements on issues such as ratings in particular.

The same logic applies to liability-driven defined benefit matched pension plans, where a split is made between a matching portfolio and a return portfolio. The return portfolio will be aiming to generate returns uncorrelated with moving the matching portfolio, and clearly alternatives are likely to do this well.

ABSOLUTE RETURN AS DISCRETE ALPHA

The final use for absolute return fixed income concentrates on commoditised beta. If beta is cheap some investors may feel that paying a manger on the basis of skill to deliver returns that can be sourced from an ETF or total-return swap is inefficient.

The problem is arguably worse than over-paying for generic skill. The problem lies in identifying the alpha, and separating it from beta. In other words, how does an investor readily identify that the manager is actually delivering alpha, rather than simply leveraging beta? Absolute return investing aims to isolate that manager skill, and does not blend it with a market return. What remains is a measure of manager skill, and one which can be added to an asset allocation either as an alternative or as the alpha engine when paired with a beta.

A portfolio comprising discrete alpha returns and a matching beta should offer qualitatively the same experience as a portfolio blending alpha and beta, but where the investor can identify the source of returns precisely, and equally identify that which is skill, and that which is index replication.

To conclude, absolute return fixed income aims to offer investors a style of investing focused on alpha strategies with returns coming from beta largely excluded. Indeed, the uncorrelated alpha may allow better identification of what alpha and beta actually are, and taken further, may allow a true liquid alternative, or with portable alpha strategies, different ways to construct asset allocations of alpha against a range of betas. Ultimately, discrete alpha, transparency, superior risk control, in a package offering diversification and liquidity are likely to be of interest to most asset allocators and investors.

The value of investments and the income they generate may go down as well as up and it is possible that investors will not recover their initial investment. This document is directed only at person(s) who have professional experience in matters relating to investment. Opinions included in this article constitute the judgment of the author at the time and may be subject to change without notice.

BNP PARIBAS
INVESTMENT PARTNERS