ACTIVE MULTI-FACTOR INTEREST RATE MANAGEMENT

Quantitative alpha strategies in interest rate markets have repeatedly been questioned over recent years. Regular interventions by central banks – often running contrary to fundamental trends – were a challenge for the forecasting quality of numerous approaches. Yet it is possible to generate robust outperformance, even in difficult market conditions, by applying a diversified multi-factor rates overlay.

The pricing of assets on the capital markets is usually driven by the relationship between supply and demand: all prevailing interest rates cannot escape this market mechanism over the long term. Yet in recent years, there has been increasing evidence of a decoupling, in the wake of the global financial markets crisis and the subsequent euro crisis. Numerous cases of coordinated political and central bank interventions have pushed sovereign bond yields to levels which were not always justified by fundamentals, and which were impossible to forecast using conventional (factor) approaches. An innovative interest rate overlay, which delivers robust and reliable outperformance in spite of these influences, is not only based on fundamental duration strategies, but employs a multi-factor approach combining various interest rate risk premia.

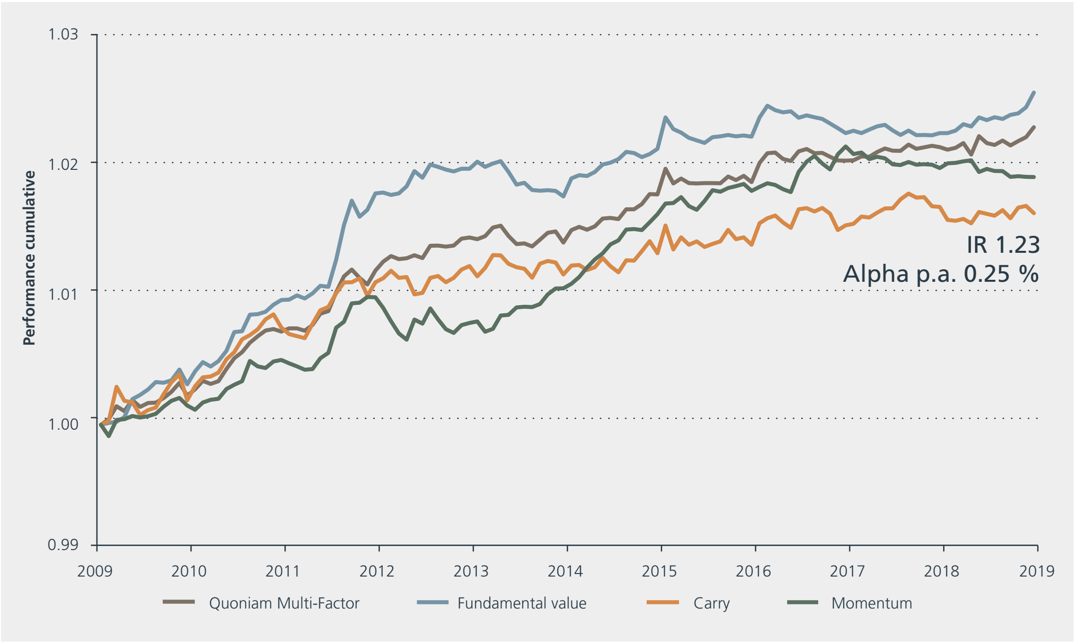
What are the mechanics of robust fixed-income overlay strategies?

In spite of extensive politically motivated intervention in the bond markets, as with other asset classes global fixed-income futures offer value, carry and momentum risk premia which can be generated systematically. The highest risk-adjusted returns are

> A combination of cyclical and anti-cyclical interest rate strategies generates robust returns, independent of market phases.

provided by a combination of fundamental value approaches, trend-following models which do not rely on any forecasts, and carry strategies. In the context of fundamental pro-cyclical strategies, which build on and expand the value premium concept, Quoniam applies 'nowcasting' techniques in order to forecast changes in interest rates using a variety of real-time macroeconomic indicators. The trend-following model, in contrast, is signal-based, combining short-term and long-term trends in the time-series and cross-section domain in order to capture the momentum premium. Lastly, the duration-neutral carry approach exploits interest rate differentials both between identical maturities of different countries and between different maturities within a given yield curve.

Performance development of Quoniam's interest rate overlay strategy



Performance of Quoniam's multi-factor interest rate overlay over the past ten years (Jan 2009 – Dec 2018), with an average implemented annualised volatility of 0.20%. The values shown are the result of a model calculation which approximates implementation as closely as possible.
Sources: Quoniam, Datastream, Bloomberg

Consistent outperformance through combination of strategies

Quoniam's quantitative multi-factor approach systematically combines the building blocks mentioned to create a successful and robust fixed-income futures strategy that is used as an overlay for numerous bond portfolios. The global universe comprises highly liquid bond and interest rate futures, whereby the overall risk and return characteristics of the strategy can be adapted as required. A typical strategy implemented by Quoniam exhibits an average volatility of approximately 0.20% p.a. The chart shows the overall performance of Quoniam's multi-factor interest rate strategy in comparison to single risk premia over the past ten years from 2009 until 2018. The combination of the various strategies smooths out 'troughs' experienced by individual risk premia, thus achieving consistent outperformance overall.

Whilst all sub-strategies individually generated positive performance throughout the entire observation period, the combined strategy delivered the highest alpha of approximately 0.25% p.a., together with the highest information ratio of 1.23.

During the period until 2012, the fundamental strategy outperformed all other risk premia. However, given the significant interest rate reductions following ECB President Mario Draghi's "whatever it takes" speech in 2012, the momentum strategy clearly outperformed until 2015. The carry strategy generated also very good performance due to the fact that in spite of the rally in bond markets, structural carry differences have remained unchanged over long periods of time. Yet compared to the individual sub-strategies, the multi-factor strategy delivered the best performance over the entire ten-year period and remained very stable. Despite numerous monetary policy interventions in the bond market, a balanced mix – of a fundamental value approach, a trend-following, and a carry strategy – allows the generation of robust outperformance for investors.

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