



STAYING FIXED

Unlocking opportunities in global fixed income.

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The range of opportunities within the fixed income asset class has broadened significantly in recent years, providing compelling solutions for plan sponsors seeking to increase returns and achieve

a better duration match between assets and liabilities. This paper briefly summarizes the challenges faced by institutional investors in achieving higher returns and in asset-liability duration matching. It then highlights the expanding fixed income opportunity set available to plan sponsors to build portfolios with better risk-reward profiles.

In recent years, institutional investors have pursued higher returns through greater allocations to equities versus bonds and, within fixed income, by favouring lower-rated, higher-yielding bonds. In addition, they have shifted a greater portion of their assets into alternative investment strategies. Some of these decisions have led to greater exposure to systematic risk and exacerbated the mismatch in the duration of assets versus liabilities.

Many plan sponsors have turned to longer-duration bonds in an effort to better match the duration of their assets with that of their liabilities. The problem has been that the global supply of longer bonds is limited relative to demand. Moreover, supply tends to be concentrated in narrow sub-sectors of the market. Today's global fixed income markets offer plan sponsors compelling solutions to the dual challenges posed by the need for higher rates of return and for a better asset-liability duration match. This can be achieved through higher yields, more balance among term structure decisions, and additional opportunities for incremental returns through sector allocation and security selection. Using a range of strategies across global fixed income sectors, it is possible to increase returns per unit of risk or earn the same return with less risk.

Opportunities abound

Macro strategies, variances in currency values, economic growth rates, and monetary and fiscal policies across

Europe, Japan and the U.S. still offer alpha-generating possibilities. Strategies that take advantage of differences in the steepness or flatness of yield curves can also be productive.

Structured products are increasingly attractive to sophisticated plan sponsors because they offer the added advantages of collateralization and diversification.

Mortgage-backed securities (MBS) are the largest sub-sector within the securitized market. Asset-backed securities (ABS) and commercial mortgage-backed securities (CMBS), which are more sensitive to credit risk than prepayment risk, have expanded the range of opportunities within the securitized debt sector. Structured credit products such as collateralized debt obligations (CDOs), collateralized loan obligations (CLOs), and collateralized bond obligations (CBOs), are the newest frontier.

Credit sectors continue to appeal to institutional investors. Global corporate high-yield bonds and emerging market debt are particularly noteworthy. Global high-yield corporate bonds have weathered several market cycles and measure nearly US\$1 trillion in size. Over the past 15 years, emerging market debt has evolved from a tactical allocation to a strategic asset class in the eyes of many sophisticated institutional investors. Indeed, many are surprised to learn that it has been the best performing asset class since 1990.

Of course, meeting the challenges faced by investors is not just about opportunities embedded in these global bond sectors. It also involves creatively combining strategies within and across these markets. A diversified set of strategies reduces the dependence on one particular market or economic environment and increases the probability of achieving return targets over the long term with the optimal risk-return balance. Whichever route one chooses, sophisticated risk management systems are required to understand risk within each of these sub-sectors as well as inter-related risks across sectors. ■