ADVISOR PERSPECTIVES

To Manage Rising Rates, Consider Benching Your Benchmark

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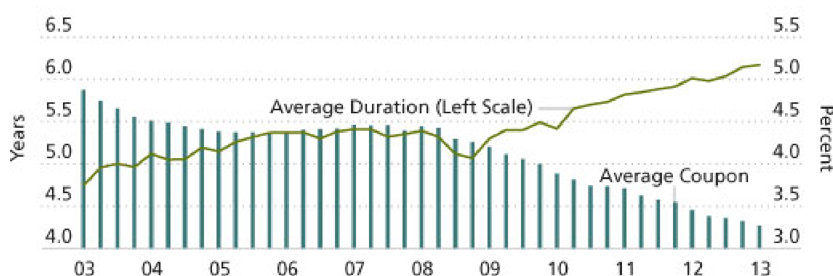
As we enter a period of rising rates, many bond investors are growing more aware of the risks of benchmark-oriented bond portfolios. It may be time to sit the benchmark down and consider more flexible, unconstrained approaches to fixed income.

Benchmarked investing worked well enough when interest rates were declining, providing a major tailwind to bond returns. But bond indices were never good model portfolios, and their flaws can pose a major risk. One challenge is rising durations—the duration of the Barclays Global Aggregate Index has risen from 4.8 to 6.2 years in the past decade (Display), and US bond indices have seen a similar climb. That's a big jump in interest-rate sensitivity, which may not be a good fit for bearish investors.



Through June 30, 2013
Modified adjusted duration and average coupon of Barclay's Global Aggregate Bond Index measured quarterly
Source: Barclays

Bond Market Duration Is Climbing While Coupon Declines

Another issue is that bond indices are weighted by market capitalization: if an issuer churns out more debt, it becomes a bigger part of the index. Benchmarked investors are obligated to buy more debt of an issuer that they should arguably be avoiding. Compounding these problems, many indices are bloated with government bonds, which have some of the lowest yields in the market.

Unconstrained Investing: Getting More Players in the Lineup

Not surprisingly, many bond investors are moving to an unconstrained approach, which seeks to provide a positive return in a wide range of market conditions. Here are a few ways that unconstrained portfolios can go where benchmarked-driven investing can't:

Toning Down Interest-Rate Risk: Benchmark-based portfolios generally aren't very aggressive in managing duration to control interest-rate risk. This was clear in the recent bond sell-off. From May through July, the Barclays US Aggregate Index returned (3.2)%. Over the same period, only 26% of intermediate-term investment-grade managers beat that index. Of course, intermediate-term bonds have historically gone on to rebound from rising rates, but unconstrained portfolios offer a different path that doesn't track an index. This can mean more room to manage duration risk. As a result, 83% of unconstrained bond managers beat the US Aggregate during this challenging period. (The categories measured were the Lipper Intermediate Investment-Grade Bond peer universe and members of the Lipper Absolute Return peer universe that contain the words "Unconstrained Bond" in their names.)

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Improving Flexibility: Benchmark-based investors can be limited in their ability to underweight certain investments, because the lowest they can go is zero. Take countries, for example. If a country has a large enough weighting, the ability to go to zero can make a difference. But for countries with small weights, it may not be enough to move the needle.

Unconstrained strategies with a strong negative view on a small country can take a short position (sell a bond the portfolio does not own), which would benefit when the country's bonds do poorly. This flexibility is important: 15 of the 22 local bond markets in the Barclay's Global Aggregate(as categorized by currency of issuance) comprise less than 1% of the index each. Shorting securities has risks if the price rises, of course, but the upward price movement of bonds has been somewhat bounded because of their structure.

Unlocking Value in a Low-Value World: Making a call on the direction of interest rates is only one aspect of bond investing —and it's challenging to get it right. But what if you could express a strong view without adding duration to a portfolio? Suppose the price relationship between two countries becomes skewed. Unconstrained portfolios can exploit these discrepancies by buying one country and selling another at the same time—called a long/short trade. This has the potential to add value without bumping up interest-rate risk. This idea can be extended to sector and yield-curve opportunities, too.

There are many other strategies in unconstrained bond investing, but the common themes are flexibility and the effort to add value rather than look like a benchmark. However, unconstrained investing should still have responsible limits for managing portfolio risk. Among these are issuer concentration rules, limits on low-quality bonds and volatility targets.

With so many strikes against benchmarking, it's easy to see why investors are seeking more creative ways to invest in bonds. With the long-running bull market for bonds likely over and indices showing their flaws, it may be time to consider asking benchmarked investing to take a seat.

The views expressed herein do not constitute research, investment advice or trade recommendations and do not necessarily represent the views of all AllianceBernstein portfolio-management teams.

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