

Unlocking Relative Value: Optimizing Team Structure for Multisector Fixed Income Investing

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Executive Summary

- Some “core” bond strategies are failing to meet investors’ return expectations and that has forced clients to search for alternative solutions. Multisector strategies emerged as one solution to meet the growing need for increased diversification and higher expected returns.
- The structure of traditional managers creates artificial boundaries to a successful multisector investment process. Consequently, relative value opportunities can be overlooked.
- Flexibly structured teams that require individuals to have cross-asset expertise may better discern relative value opportunities in the fixed income market that are overlooked by traditionally structured managers.

Introduction

Given the rise of passive strategies in both equity and fixed income markets, today's investors often hold actively managed strategies to a higher standard of performance than they have in the past. The failure of some "core bond" strategies to meet investor expectations has prompted them to search for alternative solutions. Multisector strategies emerged as one solution to meet the growing need for income and capital appreciation. Actively managed multisector strategies are typically less constrained by a benchmark and free to exercise judgment through high-conviction security selection and a long-term view. However, these attributes of a multisector approach are frequently at odds with the way traditional asset managers are structured.

The Traditional Team Structure Can Be Rigidly Siloed

Most types of multisector fixed income approaches were developed in the wake of the 2008 Global Financial Crisis. They generally attempt to provide higher returns in a low-yield world while also trying to avoid the pitfalls of being overly risk-averse in a potentially rising rate environment. Yet many multisector managers have failed to deliver. Why is that? A traditional fixed income investment team designed along rigid sectors and segments has difficulty executing a multisector strategy due to two structural factors:

1. Instead of desired investment outcomes defining the starting point, benchmarks dominate the construction of strategies and investment teams.
2. Fundamentals and valuation have traditionally been two separate parts of the decision-making process instead of being intrinsically linked from concept through execution to derive compelling relative value opportunities.

The traditional role for a fixed income manager was to provide index-like

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market exposure (beta), while applying an active component to generate alpha, net of fees. The requirements of the client generally meant an "active" manager was afforded little freedom to deviate from the benchmark for fear of creating excess tracking error.

Given these constraints, traditional asset managers generally worked to create excess return through two main channels. First, a top-down process to express overweights or underweights relative to broad factor exposures, such as duration, geography, quality and market sectors. And second, through a bottom-up process utilizing credit analysts to pick securities in each segment of the index to reflect the top-down allocation decisions. These top-down and bottom-up processes were then combined into a portfolio, and the result often looked much like a benchmark, though it was supposed to outperform across market cycles.

Valuation and Fundamental Siloes

The valuation component (e.g., is duration cheap or expensive?) is often decided at the firm level through an investment committee or chief investment officer. Fundamental analysis (e.g., is car manufacturer "A" better than car manufacturer "B"?) is decided at the analyst level. The inherent challenge to this process is that an attractive investment always aligns valuations and fundamentals. This challenge is hard to overcome if the process itself is compartmentalized.

For the traditionally structured asset manager, the potential disconnect between valuations and fundamentals is often a moot point because as the portfolio looks similar to the benchmark, it can still be positioned to provide alpha relative to the benchmark. However, for a portfolio that is generally unconstrained by a benchmark, the concept of relative value across sectors becomes tremendously important.

Team Design: Critical to Delivering Outcomes Expected by Clients

Asset managers historically built fixed income investment teams based on broad asset classes represented in a benchmark.

Generally, first came analysts focused on U.S. Treasuries and agencies, then came additional support around agency mortgage-backed securities, followed by investment-grade credit, and finally high-yield corporates and other riskier "core plus" sectors. In theory, this team structure enables the bottom-up selection of best-in-class securities within narrow siloes that are then pushed up to a portfolio manager for inclusion in top-down allocation decisions for a core benchmark-like portfolio. Part and parcel of this structure is the notion that a sector analyst focused solely on a single industry, say U.S. automobiles, is best equipped to pick the best opportunity within that industry. That could be Ford one month, and GM the next. Whatever the case, the auto analyst is the team expert on U.S. auto manufacturers. But

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what if neither is particularly compelling compared to other sectors or fixed income sub-asset class credits? Should a place in the portfolio necessarily be maintained for U.S. auto sector exposure?

Once investment strategies began crossing boundaries, like multisector strategies, mixing discrete segments of investment grade, high yield, emerging market debt, etc., and drilling down into even more granular industry segments within each, things became complicated. Traditional core bond team structures have largely remained dual top-down, bottom-up processes, limiting flexibility. If clients are seeking a different outcome from their active managers with a multisector approach, it may make more sense for the asset manager to be structured more flexibly.

The Importance of a Flexible Team Approach

Consider the challenge facing a traditional fixed income portfolio manager charged with running a multisector strategy within the confines of defined sector teams. Say the manager has a bullish view on a particular macro theme and asks two credit specialists to each produce a recommendation.

Both credit specialists, in response, highlight two bonds assessed to have the strongest fundamentals relative to the broad investment theme. One may be a better value than the other, but both bonds are deemed the best opportunities in their segments. The manager could take one or both bonds, and nonetheless miss many others with similarly strong fundamentals, similar leverage to the macro theme, but better relative valuations than seen through the rigid lens of these specific credit sectors. For example, why should a manager be limited to a specialist's recommendation

of a Hilton corporate bond if a hotel commercial mortgage-backed security exhibits similar fundamentals but better relative value at the time?

More attractive relative valuation is often missed if specialists don't adequately assess both fundamentals and relative value of securities both inside and outside their specialties. A wide range matters because many fixed income opportunities lie outside standard specialized credit desks. Failing to examine the fundamentals and relative value of securities across asset classes can lead to suboptimal outcomes. Keeping the bottom-up (fundamental) and valuation (top-down) considerations separated only exacerbates the issue.

Focus Research across Sectors while Incorporating Quantity, Timing and Probability

Because analyzing risk and reward is essential to fixed income investing, one could assume that its implementation would be relatively consistent across the discipline. Siloed approaches in traditional team structures prevent this from happening. However, a consistent lens can be applied by framing every investment in terms of quantity, timing and probability of cash flows, irrespective of asset class or industry classification. Distilling every opportunity into an examination of quantity, timing and probability of cash flow allows for a relative-value discussion, comparing risk and return across opportunity sets. Good bonds can be found in out-of-favor industries, and bad bonds often result from favored macro views due to high valuations.

Using this consistent lens, multisector investment teams should work dynamically across sectors, segments and investment structures to more effectively

analyze individual risk/reward tradeoffs in pursuit of superior results. While traditional team architecture creates reasonable probabilities for success when hewing to a benchmark with pre-defined and narrowly circumscribed allocations, it is not necessarily a smooth transition to apply that same structure and internal incentive system to a multisector strategy.

To effectively pursue this relative-value approach, an investment team needs individuals to have analytical expertise across sectors as well as an understanding of the tradeoffs between various choices. Thus, an investment professional steeped in asset-backed security (ABS) analysis must also be aware of the value, or lack thereof, across the corporate landscape when analyzing a credit driven by the same factors as the given ABS. Only then can an informed discussion occur across a collaborative investment team that compares the relative attractiveness, apples to oranges. In addition to cross-asset and cross-sector expertise, individuals should also have the expertise and the power to share both valuation and fundamental views on securities, so the team can vet a wide opportunity set with a multi-dimensional debate.

An Example of a Flexible Team Structure at Work

If a benchmark agnostic assessment of risk/reward is the key to multisector fixed income investing, investment teams should be built in this image. Ideas ought to be compared versus the broad universe of available investments from the first part of the analytical process, not merely as a last step performed by the portfolio manager. Without the context of relative value outside of one's principal area of coverage, it is impossible to regularly and accurately determine the merits of a potential investment outside its narrow peer group.

Thornburg's global fixed income team was built from the ground up to embody a flexible perspective that seeks the most compelling relative value opportunities. To begin with, all portfolio managers are also analysts, building bottom-up investment theses while incorporating a macroeconomic judgment. Additionally,

all portfolio managers and analysts are required to maintain an awareness of relative value across the broader fixed income landscape, so their insight is not limited to their main area of coverage. This ensures that risk/reward is debated in an informed manner by all members of the team for every opportunity.

Ultimately, investors should consider

team structures when conducting due diligence on multisector strategies.

Different team structures may increase fixed income opportunities for investors as well. Because siloed structures may overlook relative value opportunities, they create valuation inefficiencies in the marketplace from which asset managers with flexible team structures can gain.

Bear in mind that a flexible team structure that is effective is not created overnight. Due diligence on multisector strategies should also ask whether the fixed income manager's flexible team structure has successfully served investors over the long term. ■

Important Information

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Alpha – A measure of the difference between a portfolio's actual returns and its expected performance, given its level of risk as measured by beta. A positive alpha figure indicates the portfolio performed better than its beta would predict. In contrast, a negative alpha indicates under-performance, given the expectations established by the beta.

Beta – A measure of market-related risk. Less than one means the portfolio is less volatile than the index, while greater than one indicates more volatility than the index.

Duration – A bond's sensitivity to interest rates. Bonds with longer durations experience greater price volatility than bonds with shorter durations.

Tracking Error – A measure of how closely a portfolio follows its benchmark. Typically, it's the standard deviation of the difference in returns between a portfolio and the benchmark. Actively managed portfolios tend to have a higher tracking error compared to passively managed investments.

Asset-backed Security (ABS) – A security whose value and income payments are derived from and collateralized (or "backed") by a specified pool of underlying assets. The pool of assets is typically a group of small and illiquid assets that are unable to be sold individually. Pooling the assets into financial instruments allows them to be sold to general investors, a process called securitization, and allows the risk of investing in the underlying assets to be diversified because each security will represent a fraction of the total value of the diverse pool of underlying assets.

Mortgage-backed Security (MBS) – A type of asset-backed security that is secured by a mortgage or collection of mortgages. These securities must be grouped in one of the top two ratings as determined by an accredited credit rating agency and usually pay periodic payments that are similar to coupon payments. The mortgage must have originated from a regulated and authorized financial institution.

Investments carry risks, including possible loss of principal. Portfolios investing in bonds have the same interest rate, inflation, and credit risks that are associated with the underlying bonds. The value of bonds will fluctuate relative to changes in interest rates, decreasing when interest rates rise. Unlike bonds, bond funds have ongoing fees and expenses. Investments in mortgage backed securities (MBS) may bear additional risk. Investments in the Funds are not FDIC insured, nor are they bank deposits or guaranteed by a bank or any other entity.

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