Core Is at Our Core

IS IT STILL AT YOURS?

Long seen as a building block of investor portfolios, "core" fixed income funds play a crucial, stabilizing role. But as the U.S. interest-rate environment normalizes, now may be a good time to assess whether your core allocation continues to live up to its name.

The "stretch for yield" has been a common turn of phrase since the financial crisis, describing investors' migration up the risk curve in pursuit of income.

Gautam Khanna, lead portfolio manager of BNY Mellon Insight Core Plus Fund, explains: "When rates were at or near zero globally, investors were earning very little yield in quality fixed income assets. Yet on the liabilities side, the need for income had not changed. Naturally, there was a tendency to go up the risk spectrum in search of higher yields."

He says now the U.S. Federal Reserve is firmly in a rate-hiking cycle, the impetus behind this "stretch for yield" should be weaker, and yet the risk "migration" is still to unwind. As a result, we believe allocations to higher-yielding (and in many cases higher risk) assets remain elevated.

Outside the U.S., other developed economies are further behind in their recoveries, with monetary regimes that are still unrecognizable compared with pre-crisis norms. In Europe, particularly, the extrication from years of experimental monetary policy is only just beginning.

As a result, Khanna believes investors' allocations are yet to catch up with the current market environment: "The 10-year U.S. Treasury is currently yielding around 3% and investment-grade corporates offer a spread of around 100 basis points on top of that. If you add in elements of higher-yielding fixed income assets around the edges, you can now aim to achieve 4% to 5% within a core fixed income strategy. This is a much more compelling level of yield when inflation is hovering around 2%."

Globally, within the developed markets, the U.S. Interest-rate curve looks more compelling. As an illustration, he says, 10-year U.S. Treasuries and 10-year Italian sovereign debt currently yield around the same level. "Given the current backdrop in Italy, which would you rather own?"

U.S. Treasuries versus other Developed Market Sovereign Bonds

	10-year Yield (%)
U.S.	3.05
UK	1.44
Germany	0.47
Japan	0.13
France	0.82
Italy	3.15
Australia	2.67

Source: Bloomberg, September 30, 2018

STYLE DRIFT IS PERVASIVE

Retail investors have not been the only ones guilty of risk migration over the past 10 years: Professional investors have also moved into higher-yielding assets to try and satisfy outcomes promised to their clients, while pension funds concerned with unfavorable liability ratios have behaved similarly.

This move up the risk spectrum has largely worked for pension funds: In 2008, the funded ratio for pension plans was down to 79.1% compared with 105.8% in 2007. In August 2018, the latest funding ratio release showed plans to be 93.5% funded.[1]

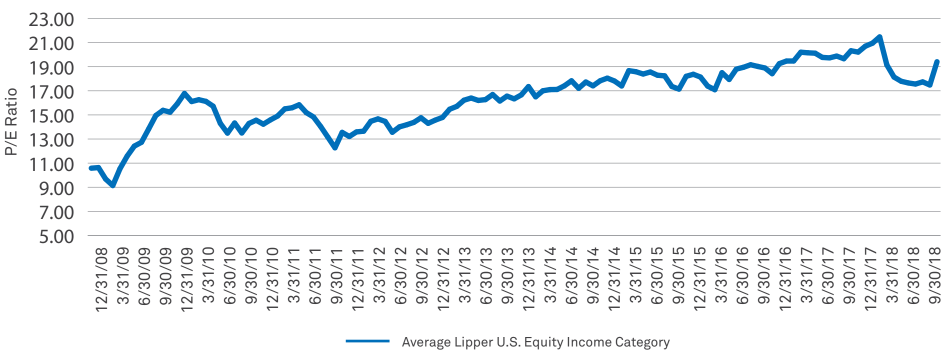
"This improvement in funding ratios has in part been achieved via the shift into higher-yielding, riskier asset classes, such as dividend-paying stocks," says Khanna.

In relatively benign market conditions, this move may have seemed unproblematic. But now, nine years into an equity bull market, and with PE ratios of dividend-paying stocks at 19.41, concerns about a correction have started to surface.

Khanna does not believe the end of the cycle is upon us but still cautions around taking undue risk: "We do not think we are overly close to the end of the cycle but we think it is a good time to rebalance slightly towards assets that provide some ballast in trickier market conditions. The good news is, with the

[1] Historic data is from the Milliman White Paper: Corporate Pension Funding Study, April 2018 and covers fiscal years. Recent data is from the Milliman 100 Pension Funding Index, as of August 2018.

Average Lipper U.S. Equity Income Category



Source: Lipper as of 9/30/2018.

Fed moving towards what could be considered 'neutral' interest rates, higher quality credit and sovereign bonds are yielding at more viable levels."

FAVORABLE FOR FIXED INCOME?

Another factor he believes to be presenting a structural tailwind for fixed income assets is the demographic story in Western economies. "Aging populations and fewer citizens of working age mean there is little sign that income will fall down the pecking order in terms of investor priorities." In the U.S., for example, the Baby Boomer generation (aged 52-70 in 2016) remains the largest generation, with 74 million individuals now falling into this category.

As these Baby Boomers retire, the need for income and effective drawdown will become more important than ever for a growing number of investors. Khanna says this is a prime reason to be alert for potential mission creep from portfolio managers.

He continues: "As a team, we do not shy away from taking risk where it is appropriate. We do, however, try to build as robust a portfolio as possible by allocating to investments that offer a greater margin of safety for a given level of risk. We strive to avoid generic market beta in favor of deeply researched idiosyncratic opportunities that we believe offer a better risk and reward equation."

It is this approach that Khanna relies on to provide a core fixed income portfolio in the true sense of the word.

"We think this is the optimal way to structure such a portfolio in order to provide a balance of income and ballast, or downside protection. We are constantly working to avoid style drift: Investors look to our strategy for specific 'core' characteristics and it is crucial that we fulfill them."

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