Uncaging fixed income opportunities

US fixed income aggregate indices can be heavily concentrated and can exclude a large part of the credit universe...

...while more flexibility could allow investors to navigate sell-offs

Ideal approach: avoid US energy exposure

Source: Bloomberg, Bank of America Merrill Lynch, Insight, as at June 2018, for illustrative purposes only.

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Market cap-weighted benchmarks rose to prominence in the decades following the 1950s, when the concept of market ‘beta’ (representing the ‘fully diversified market portfolio’) was developed as part of modern portfolio theory [1]. Benchmarks are now the common proxy for beta. Originally, these benchmarks were used as a guide to help measure a manager’s performance. However, over time, market participants became fixated with analyzing every difference between a portfolio and its benchmark, potentially tying investors closer to them and away from their core objectives.

With the rise of benchmark-aware investing, either explicitly (through passive mandates) or implicitly (via ‘closet’ indexing active portfolios) much of the industry has appeared to lose sight of this income-oriented objective, focusing instead on price moves in a market where the instruments redeem at par.

In our view in the credit markets, this obsession with benchmarks raises four key problems: indices are structurally-biased towards the most indebted issuers, market weights can lead to concentration risks, passive funds are prone to forced selling and ‘closet’ indexing can tie active funds to flawed benchmarks.

In our view, being more benchmark-agnostic, through looking for the most compelling credit opportunities, maximizes the potential to capture beta and alpha more efficiently. In turn, we believe flexible strategies can help investors exploit the artificial barriers created by benchmarks.

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* Bonds are subject to interest rate, credit, liquidity, call and market risks, to varying degrees. Generally, all other factors being equal, bond prices are inversely related to interest-rate changes and rate increases can cause price declines. Municipal income may be subject to state and local taxes. Some income may be subject to the federal alternative minimum tax for certain investors. Capital gains, if any, are taxable. High yield bonds involve increased credit and liquidity risk than higher rated bonds and are considered speculative in terms of the issuer's ability to pay interest and repay principal on a timely basis.

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**Beta** is a measure of the volatility, or systematic risk, of a security or a portfolio in comparison to the entire market or a benchmark.

**Modern Portfolio Theory** is an investment theory based on the idea that risk-adverse investors can construct portfolios to optimize or maximize expected return based on a given level of market risk, emphasizing that risk is an inherent part of higher reward.

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