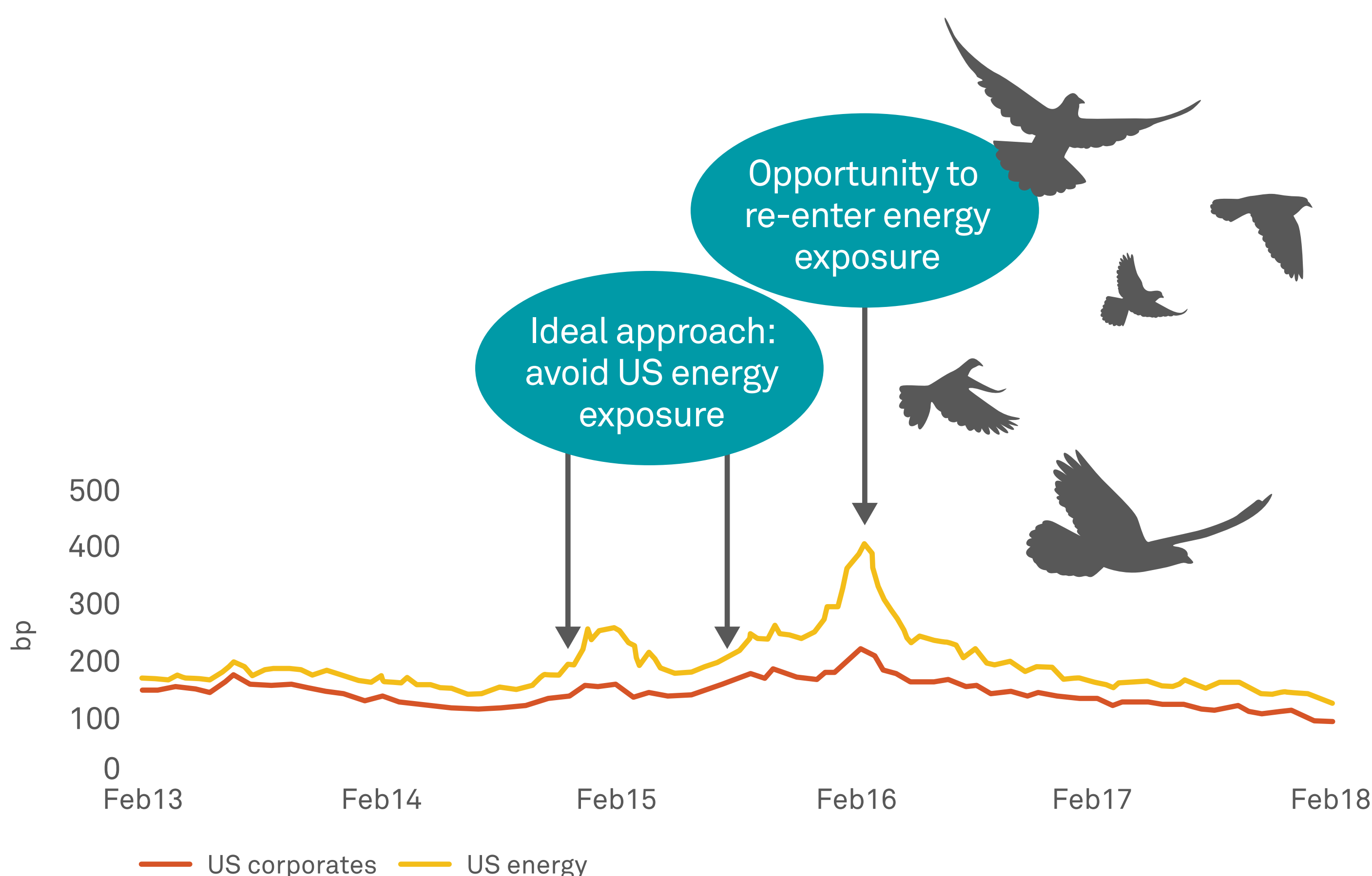
Uncaging fixed income opportunities

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

Missed opportunities

- Investment grade corporate
- Agg commercial mortgage-backed securities
- Agg asset-backed securities
- EM USD
- Leveraged loans
- High Yield
- Agency Mortgage-backed securities
- Gov related
- Treasuries
- Asset-backed securities
- Commercial mortgage-backed securities
- Collateralised loan obligations

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



Source: Bank of America Merrill Lynch, 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.

Gautam Khanna and James DiChiaro, senior portfolio managers. Insight Investment – a BNY Mellon Company

[1] Source: Portfolio Selection, Harry Markowitz, The Journal of Finance, 1952. 3 Bloomberg, Bank of America Merrill Lynch, Insight, as at June 2018

All investments involve risk, including the possible loss of principal. Asset allocation and diversification cannot assure a profit or protect against loss.

*** 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.

Investing in foreign denominated and/or domiciled securities involves special risks, including changes in currency exchange rates, political, economic, and social instability, limited company information, differing auditing and legal standards, and less market liquidity. These risks generally are greater with emerging market countries.

Investors cannot invest directly in an index. Indices are unmanaged and have no fees.

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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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