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Stay unconstrained in fixed income markets

Key takeaways

An unconstrained fixed income strategy that incorporates diversified sources of return offers performance potential for an environment of normalizing interest rates.

As the Federal Reserve begins to raise interest rates, it may be an opportune time for investors to incorporate an unconstrained bond strategy into their portfolios.

It's important to differentiate unconstrained strategies, since many focus on either macro-oriented or corporate-credit risks, while a few are more diversified.

In today's atypical environment, we believe the ideal way to structure an unconstrained bond strategy is to include sub-sectors of the mortgage market, *in addition to* macro-oriented and corporate-credit strategies.

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With the Fed entering "liftoff," timing may be right for unconstrained bond strategies.

In the first quarter of 2016, investor interest in non-traditional fixed-income strategies — often referred to as "unconstrained" bond strategies — waned. This took place after these strategies garnered significant positive attention in 2013 and 2014, particularly as interest rates moved dramatically higher during the "taper tantrum" of mid-2013, when the Federal Reserve began to cut back on its bond-purchasing program, known as "quantitative easing."

Some of the slowdown in activity during the past couple of years has been interest-rate driven. Investors have felt more comfortable staying with benchmark-oriented fixed income strategies, as the feared rate hikes from the Federal Open Market Committee (FOMC) were delayed, and interest rates actually declined throughout 2014 and into 2015. After speaking with both consultants and plan sponsors, we believe that unconstrained strategies have not performed up to most investors' expectations.

Yet giving up on unconstrained bonds at this particular time might not be well advised. In fact, it might a be an excellent time to consider moving forward with — or enhancing — such a strategy given that we are finally entering a time when the Fed will be seeking to "normalize" interest rates, albeit with a large degree of uncertainty as to how the process will play out.

In addition, spreads for most fixed income securities have approached their widest levels in the post-crisis period due to a host of macro-related issues that overhang the markets.

Unconstrained strategies are unique

It has been said that non-traditional fixed income strategies are like snowflakes — each one is different. Even the nomenclature referring to these strategies contains differences: "unconstrained bonds," "absolute return," "strategic income/alpha," "opportunistic fixed income," and "total return" are used to name fixed income strategies with similar objectives. What's more, each strategy seems to fall into different categories among those investment managers who attempt to put them into a particular style box.

Unconstrained fixed income strategies are generally not benchmarked to broad fixed income indexes, such as the Barclays U.S. Aggregate or Barclays Global Aggregate. (Note that in the institutional marketplace, Putnam refers to these strategies as Fixed Income Global Alpha.) They also have much wider mandates regarding both duration positioning and sectors allowed for investment within the fixed income universe. This type of mandate is often managed to a cash- or LIBOR-based benchmark, which has a duration of roughly zero.

Duration targets across different managers' strategies also tend to be highly variable, ranging from very tight (0 years, plus or minus 2) to very wide (0 to 10 years, -2 to 5 years, or -3 to 8 years).

Regarding eligible investments, most strategies invest in both domestic and international bonds, with the ability to utilize both of those sectors included in the traditional broad investment-grade benchmarks, as well as those that are considered the traditional "Plus" sectors of a Core Plus mandate. Plus sectors include high yield, bank loans, and emerging market (EM) debt.

Many managers also use various types of mortgage-backed securities that may fall outside traditional benchmarks, such as U.S. non-agency residential mortgage-backed securities (RMBS), lower-rated commercial mortgage-backed securities (CMBS), and collateralized mortgage obligations (CMOs). A handful of managers use convertible securities and equities, to a limited extent, to potentially enhance returns.

> "It might be an excellent time to move forward with — or enhance — an unconstrained strategy."

Institutional investors implement unconstrained fixed income strategies in many different ways. The strategies can be used as yield/return enhancers, as vehicles intended to help reduce interest-rate risk, as a complement to a U.S.- or Global Aggregate-based strategy, or as an overlay to a liability-driven investment solution. Many institutional investors have implemented unconstrained strategies to either reduce interest-rate exposure and/or complement a Core or Core Plus fixed income allocation.

Part of the frustration over the lackluster performance, however, stems from the fact that interest rates have not materially moved higher over the past few years, despite expectations that the Fed would begin unwinding its accommodative monetary policy stance.

A period of underperformance as yields declined

Since the end of 2013, yields have generally drifted lower as the Fed continued to push out the timing of its first rate hike, until finally moving rates up 0.25% following the FOMC meeting held in mid-December 2015. Because the direction of rates has been flat to slightly lower over the past three years, the Barclays U.S. Aggregate Index has generally performed quite well, to the surprise of those concerned about rising interest rates. Over the past three years, the Barclays U.S. Aggregate has generated an annualized return of nearly 1.50%. This is relatively low by historical standards, but far better than many had feared if rates had moved higher. The Barclays Global Aggregate Index in the same three-year period ending December 31, 2015, posted an annualized return of -1.74% due to weakness in emerging markets, hinting that the more attractive areas for an unconstrained strategy were in U.S. sectors.

Unconstrained bond strategies are generally designed to pursue an alpha target of cash plus a 3% return. If portfolio managers had achieved that target over the past three years, investors likely would have been pleased with the performance — beating the traditional U.S. benchmark by more than 1.50% and the global proxy by nearly 5%. The reality, however, is that very few of the dozen or so competing strategies in this space have, in fact, returned more than 3% during this time.

In addition, many strategies have struggled even to produce the 1.50% annualized return of the Barclays U.S. Aggregate Index over the past three years. Importantly, many high-profile, fixed income managers with established reputations in the Core and Core Plus spaces have been among the poorest performers and, in some cases, posted negative annualized returns.

Why managers have failed to deliver returns

Investment philosophies play a big role in this disappointing performance result. In analyzing the competitive universe in the unconstrained bond space, we have found that managers tend to fall into two investment styles:

- **Macro-oriented:** The first category is macro-oriented — with primary alpha drivers being interest rates and currency. (At Putnam, we refer to these drivers as "term structure" risk.)
- **Credit risk-focused:** The second category de-emphasizes interest-rate risk, concentrating instead on credit risk, particularly corporate credit risk.

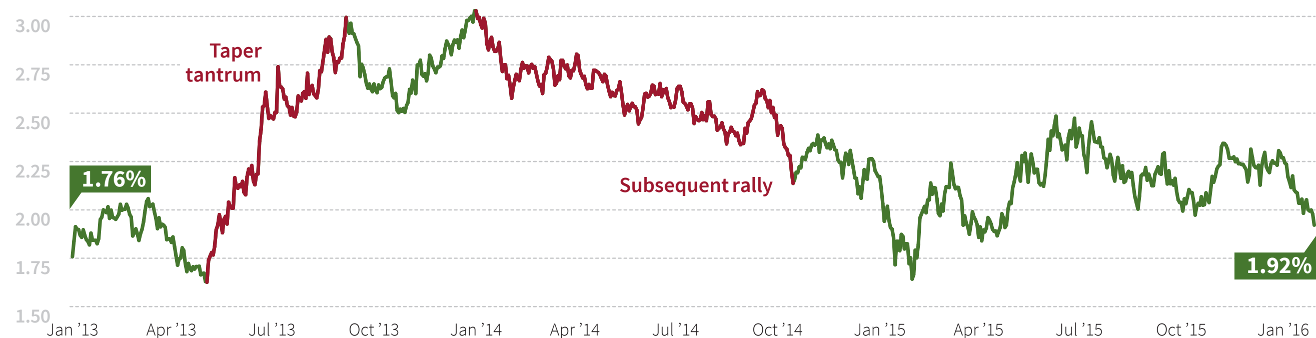
Due to the volatility and unpredictability of the fixed income markets, it has been challenging to generate consistent alpha over the past three years using either style. For macro-oriented managers who focus on duration, many were caught by surprise when rates sold off during the taper tantrum. Subsequently, they positioned themselves for short duration going into 2014 in anticipation of rates continuing to move higher. However, interest rates fell in 2014 as the Fed continued to keep the federal funds rate near zero, while central banks in other regions continued to remain generally accommodative. Therefore, having a negative duration stance ended up being a drag on performance.

Interest rates most likely had a relatively small impact on most managers' strategies in 2015. Despite a fairly high level of volatility in the market, rates ended the year relatively close to where they began, at least in the 5- to 10-year portion of the yield curve.

Another type of strategy we see relies less heavily on macro-oriented strategies, but instead carries higher credit risk, particularly high yield, bank loans, and EM debt. The high yield market, in particular, had difficulty in late 2014 and again in 2015, as spreads widened dramatically due to falling oil prices and concerns about a slowdown in global growth, led by a cooling Chinese economy.

Many macro-oriented managers were surprised by interest-rate moves over the past three years

Yield on the U.S. 10-year Treasury Note (2013 through January 2016)



Source: Bloomberg.

The high yield market, as measured by the JPMorgan Chase Developed High Yield Index, returned -4.53% in 2015, with certain sub-sectors of the market — energy, metals and mining, and CCC-rated debt — posting double-digit losses. Bank loans fared somewhat better, as did U.S. dollar-denominated EM debt, but local currency EM debt also suffered dramatically as these currencies fell versus the U.S. dollar.

Over the past three years, due to the increased volatility in global markets, none of these sectors has posted what would be considered outstanding returns. While several have outperformed the Barclays Global Aggregate Index, the Barclays U.S. Aggregate Index has been a more formidable competitor. Depending on the exposure to these three sectors within an unconstrained strategy, it is likely that any manager would have struggled to achieve his or her alpha target, or even outperform a more traditional benchmark.

Performance in an atypical, rising-rate environment

What kind of performance should an unconstrained bond investor expect in an environment in which the Fed is hiking interest rates?

The first and most difficult part of attempting to answer this question remains in trying to determine both how much and how quickly the Fed will move in today's economically atypical environment. In the past, the Fed typically began to hike interest rates in order to head off an undesired uptick in inflation resulting from GDP increasing too rapidly.

In the current environment, GDP has been running well below the economy's long-term 2%–2.5% range, while inflation remains below the Fed's 2% longer-run target rate, and is expected to remain there for the foreseeable future, according to the Fed's forecasts. Thus, during this hiking cycle, we find ourselves in uncharted waters regarding what a likely scenario might be for the path of the federal funds rate.

The FOMC stated in its March 16, 2015 press release that the pace of increases will be "gradual" and that the federal funds rate is "likely to remain, for some time, below levels that are expected to prevail in the longer run." The FOMC's economic projections, released following its March meeting, show a median estimated federal funds rate of 0.9% by the end of 2016, over half a percentage point above today's level. This implies approximately two rate hikes of 0.25% each.

With this outlook for the possible path of increases, we can turn to these key questions:

- How will interest rates perform in the U.S. Treasury market?
- How will other sectors of the fixed income markets perform as rates move higher?

Again, given today's atypical environment, it may be difficult to glean from past experience just how fixed income markets may react.

Historically, when the Fed has raised rates, U.S. Treasury rates also moved higher, with market rates often leading the way as the pace of the Fed's future moves were priced in advance. The U.S. Treasury yield curve has also typically flattened (although not always), as short-term rates tend to be more sensitive to the Fed's overnight rate.

Struggling to outperform when global markets turned volatile

Fixed income asset class returns by year (2013–2015)

	2013	2014	2015	Annualized
Barclays U.S. Aggregate Index	-2.02%	5.97%	0.55%	1.44%
Barclays Global Aggregate Index	-2.60%	0.59%	-3.15%	-1.74%
JP Morgan Developed High Yield Index	8.42%	2.13%	-4.53%	1.87%
Barclays U.S. High Yield Loan Index	5.39%	1.54%	-0.82%	2.00%
JP Morgan EMBI Global Diversified	-5.25%	7.43%	1.18%	0.99%

Sources: Barclays, JPMorgan. Indexes are unmanaged and do not incur expenses. You cannot invest directly in an index.

Based on history, expect lackluster U.S. bond returns as rates rise

Historical performance of the Barclays U.S. Aggregate Index during Fed hiking regimes

	Fed funds rate start to end of hiking cycle	Barclays U.S. Aggregate Index annualized return	Barclays Global Aggregate Index
Feb. 1994–Feb. 1995	3.00%–6.00%	0.01%	3.34%
June 1999–May 2000	4.75%–6.50%	2.11%	-2.38%
Feb. 2005–June 2006	2.25%–5.25%	0.74%	-0.89%

Sources: Bloomberg, Barclays. Indexes are unmanaged and do not incur expenses. You cannot invest directly in an index.

Likewise, spreads for other sectors of the fixed income markets (MBS, investment grade, high yield corporate debt, etc.) have generally tightened during Fed hiking regimes as a reflection of stronger economic fundamentals, although, again, this has not always been the case.

If the past is a useful indicator of what to expect in the future — the higher rates and flattening yield curve of past FOMC hiking cycles — one might expect the Barclays U.S. Aggregate Index to generate relatively lackluster returns during this time. One historical example is when the FOMC hiked rates six times in 1994, taking the federal funds rate from 3% to 6%. In that context, the Barclays U.S. Aggregate Index returned -2.92%. In fact, 1994 was the last calendar year the U.S. Aggregate posted a negative return prior to 2013.

The other point to consider as we enter "liftoff" is that yields in the fixed income market are significantly lower than they were during any of the previous hiking regimes. Coupled with the fact that the duration of the bond market is also longer than it has been historically, this leaves many bond portfolios more exposed to a potential increase in interest rates than ever before.

> "Many bond portfolios are more exposed to a potential increase in interest rates than ever before."

What type of performance might investors expect in this environment?

If we assume that the typical unconstrained bond strategy is targeting a return of cash plus 3% — and managers are able to deliver a return consistent with their target — then one might expect that this type of strategy could outperform one that is benchmarked to a traditional broad fixed income index. In particular, this will be the case if rates rise, and the manager's duration positioning is close to zero (i.e., the duration of "cash") or short (i.e., negative duration).

It is more difficult to predict how other risks within an unconstrained strategy might perform in a rising-rate environment. Corporate credit spreads tend to be inversely correlated with interest-rate moves, as higher rates often indicate a strengthening economy that creates a positive environment for corporate credit as long as inflation remains under control.

This relationship is not constant because there are often many other forces at work, such as supply/demand imbalances, market liquidity, or idiosyncratic issues that may occur at the issuer or sector level. For 2016, a further drop in oil prices — and commodity prices in general — is an example of an idiosyncratic event that could weigh on the corporate credit sector. For those managers using EM debt as a potential source of alpha in an unconstrained strategy, similar idiosyncratic issues could affect their strategies at either the macro or country level.

Mortgage exposure may help to diversify risk

As mentioned in previous white papers (see "Revisiting 'Thinking Outside the Index,'" September 2015), we believe the ideal way to structure a non-benchmark-oriented fixed income strategy is to utilize those subsectors of the mortgage market that introduce other less-correlated risks — in addition to macro-oriented and corporate-credit-related strategies.

In particular, we believe that adding mortgage credit risk (in the form of both non-agency residential MBS and commercial MBS) as well as prepayment risk (in the form of various types of CMO structures, including IOs and other IO-like securities) allows investors to build better balanced and more diversified portfolios from a risk perspective, without sacrificing yield or expected return.

In the first two months of 2016, the high yield market has experienced a dramatic widening in spreads. Therefore, it could be argued that this sector is attractive in terms of relative value. We agree that the high yield sector is attractively valued, with the caveat that investors should be aware that pricing volatility will remain high and defaults could increase from current levels, particularly if oil prices were to fall back to recent lows.

Spreads in other fixed income sectors have recently widened as well. This is, to some degree, in sympathy with what has occurred in the high yield market and as part of a general risk-reduction mentality that has existed in the marketplace since the latter part of 2015. Other factors, such as increased issuance in both the investment-grade corporate and CMBS markets or a dip in the 30-year

Sector spreads have widened as interest rates have fallen

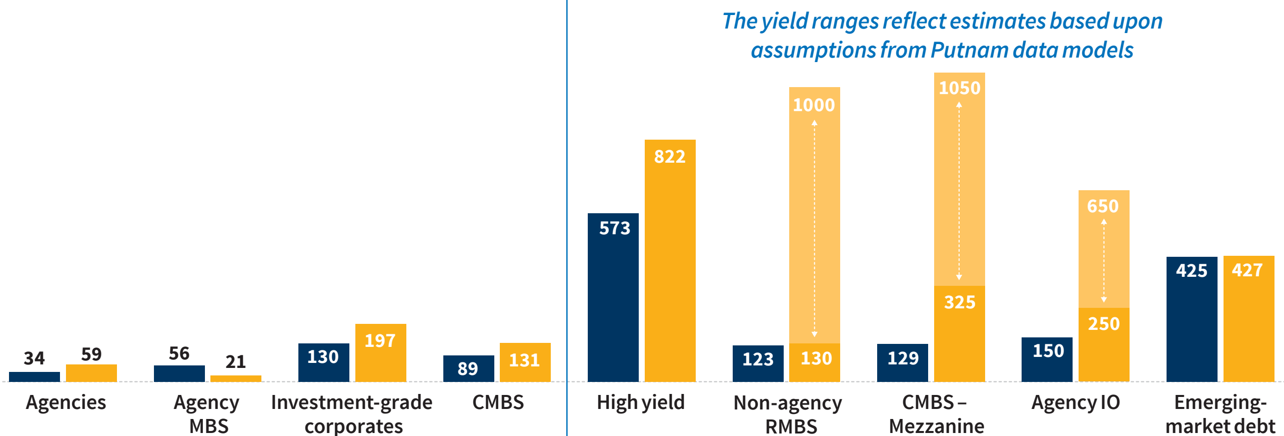
■ Average excess yield over Treasuries (OAS, 1/1/98–12/31/07) ■ Current excess yield over Treasuries (OAS as of 2/29/16)

A limited opportunity

Opportunities in the heavily traded benchmark sectors remain scarce.

Greater growth potential

Non-benchmark strategies may offer better returns in today's environment.



Sources: Barclays, Bloomberg, Putnam, as of 2/29/16. Data is provided for informational use only. Past performance is no guarantee of future results. All spreads are in basis points and measure option-adjusted yield spread relative to comparable maturity U.S. Treasuries with the exception of non-agency RMBS and mezzanine CMBS, which are loss-adjusted spreads to swaps calculated using Putnam's projected assumptions on defaults and severities, and agency IO, which is calculated using assumptions derived from Putnam's proprietary prepayment model. Agencies are represented by Barclays U.S. Agency Index. Agency MBS are represented by Barclays U.S. Mortgage Backed Securities Index. Investment-grade corporates are represented by Barclays U.S. Corporate Index. High yield is represented by JPMorgan Developed High Yield Index. CMBS is represented by both agency and non-agency CMBS that are eligible for inclusion in the Barclays U.S. Aggregate Bond Index; CMBS-Mezzanine pre-2007 spreads are represented by the same index using the AA, A, and BBB components. Average OAS for Mezzanine CMBS is only available for the 2000–2007 and is therefore only displayed for that time period. Emerging market debt is represented by the Barclays EM Hard Currency Aggregate Index. Non-agency RMBS is estimated using average market level of a sample of below-investment-grade securities backed by various types of non-agency mortgage collateral (excluding prime securities). Current OAS for mezzanine CMBS is estimated from an average spread among baskets of Putnam-monitored new issue and seasoned mezzanine securities, as well as a synthetic (CMBX) index. Agency IO is estimated from a basket of Putnam-monitored interest-only (IO) and inverse IO securities. Option-adjusted spread (OAS) measures the yield over duration equivalent Treasuries for securities with different embedded options.

Adding mortgage-related securities can help diversify risk

Correlation of monthly hedged excess returns since 2009

Higher correlation Lower correlation

	IG	HY	Loans	EM USD	S&P	NA RMBS	Agency IO	CMBS	Agency MBS
IG	1.00								
HY	0.90	1.00							
Loans	0.84	0.89	1.00						
EM USD	0.85	0.90	0.75	1.00					
S&P	0.51	0.63	0.39	0.64	1.00				
NA RMBS	0.41	0.30	0.30	0.31	0.12	1.00			
Agency IO	0.37	0.46	0.49	0.41	0.26	0.19	1.00		
CMBS	0.57	0.45	0.46	0.38	0.21	0.33	(0.06)	1.00	
Agency MBS	0.24	0.25	0.26	0.29	0.03	0.20	0.17	0.28	1.00

Sources: Barclays, Putnam. For illustrative purposes only. Indexes used in the above calculation include the Barclays U.S. Corporate Index, Barclays U.S. High Yield Index, Barclays U.S. High-Yield Loans Index, and the Barclays EM USD Sovereign indexes. Where there is no available representative index, data is based on a universe of securities selected by Putnam that are representative of various fixed income sectors and subsectors within the mortgage market.

mortgage rate (potentially increasing prepayment speeds for IOs), have helped push spreads wider. In addition, the impact of financial regulation in the capital markets appears to have increased the liquidity risk premium that is embedded in the valuation of various types of fixed income securities. Putnam's overall fundamental views regarding the direction of the U.S. economy have not changed. Thus, we see this spread-widening as a buying opportunity across most sectors of the fixed income markets.

We believe potentially large diversification benefits may be achieved by adding various types of mortgage-related securities to a portfolio. Non-agency RMBS, CMBS, and various prepayment strategies that are available in the agency CMO market have proven over time to have a low correlation to both corporate credit-related securities (investment grade and high yield) and EM debt, as well as equities. Unlike the various subsectors of the credit markets that have been shown to have a relatively high correlation to equities (i.e., 0.40 to 0.70), the subsectors of the mortgage market have much lower correlations (i.e., 0.00 to 0.25).

Moreover, these different types of mortgage strategies (RMBS, CMBS, and IOs) all have low correlations to each other (i.e., 0.30 or less). This indicates that investors may benefit by including all three mortgage-backed security types as part of a broad fixed-income portfolio.

We continue to favor fixed income portfolios that include a broad mix of risks: term structure (macro), corporate credit, mortgage credit (RMBS and CMBS), and prepayment. We believe the risks in these sectors look attractive not only from a relative value perspective, but also for building a more diversified portfolio intended to exhibit lower correlation to the equity-related portion of a portfolio.

Although the past few years have been challenging for unconstrained bond funds, we believe that today's environment presents opportunities for these strategies as the Fed embarks on raising interest rates, while most central banks in other regions remain more accommodative. That said, it is important for investors to understand the full range of unconstrained bond strategies available — and what role they can play in their portfolios. Among these types of strategies, some employ only macro-oriented and term-structure strategies, while others invest primarily in high yield corporate debt, both of which underperformed in 2014 and 2015.

At Putnam, we believe that investors should consider the advantages of a broadly diversified, unconstrained bond strategy that includes securitized mortgages, in addition to macro-oriented, term-structure, and corporate-credit risks.

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