

# Absolute Return Bond Strategies

Investing in a low interest rate environment

**Standard Life**  
Investments

**June 2016**

This document is for investment professionals only and should not be distributed to or relied upon by retail clients. It is only intended for use in jurisdictions where the relevant funds are authorised for distribution or where no such authorisation is required.

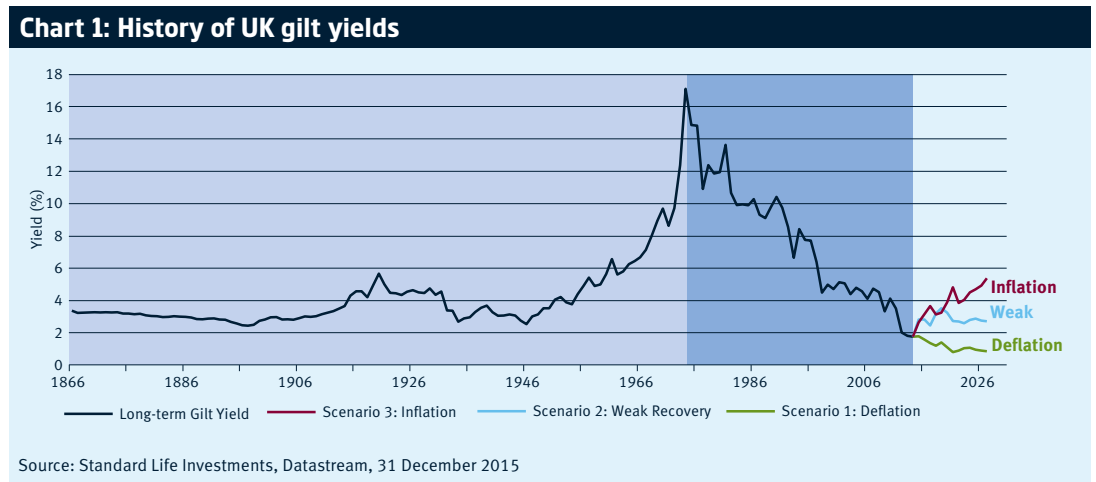
# Introduction

The market environment of the last few years has created new challenges for fixed income investors; yields on most bonds have fallen to historical lows. This situation has forced many market participants to re-think their approach to investing in fixed income and consider more innovative bond investment products. An effective solution for navigating current investment conditions is an absolute return bond strategy and this approach is gaining wide popularity as a result. In this paper, we examine the case for absolute return fixed income investing and the key attributes of these investment solutions.

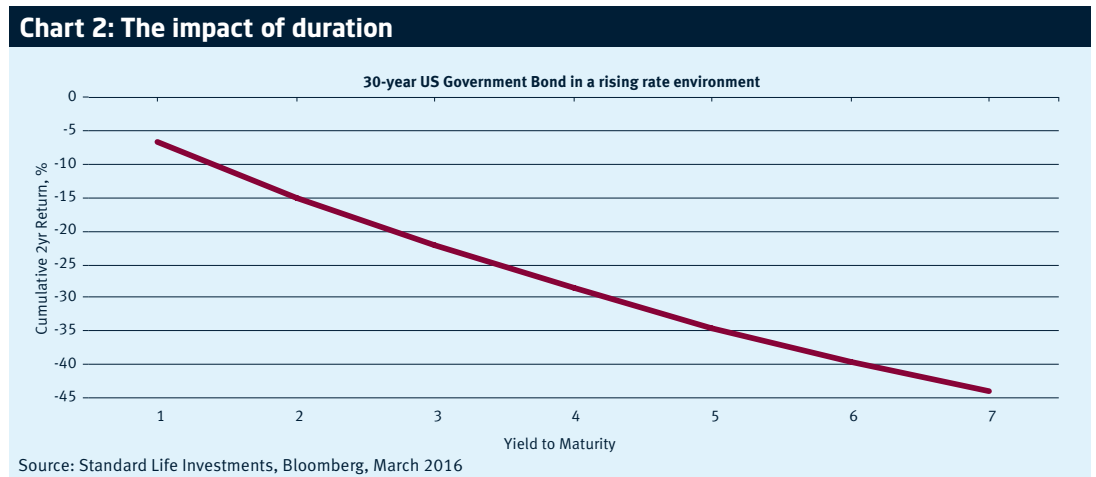
# Investing for today's environment

For a long time, fixed income has played a key role in investors' portfolios, providing both return and balance. Historically, the traditional benefits of owning fixed income within the context of a diversified portfolio included safety and provision of income. In today's environment, however, both of these propositions have become increasingly challenged.

The relative safety of fixed income is one of the main benefits of the asset class and means investors have a very high certainty (at least for highly rated investment grade bonds) that, in addition to receiving some form of return, their invested capital will be repaid over a predetermined period of time. Moreover, investors would normally expect positive returns even over the short-to-medium term. Indeed, over the last 30-plus years this asset class produced good stable returns, propelled by steadily declining government bond yields (see Chart 1).



Today, however, with developed government bond yields hovering around all-time lows, fixed income markets might now display an asymmetric risk profile. Further market upside is naturally limited – rates are already extremely low and in a growing number of countries have reached negative territory. At the same time, once interest rates start rising, the downside for bond investors could be substantial. A bond's duration – one of the key properties of any fixed income security – measures its sensitivity to changes in interest rates and presents a rough approximation of how much a bond investor is set to lose if rates rise by 100 basis points (bps), or gain if rates fall. For example, a bond with duration of eight years will incur a capital loss of approximately 8% if rates spike up by 100 bps (1%). The longer dated the bond, the greater those price changes are for a given change in yield. Chart 2 below illustrates the expected two-year return on a 30-year government bond under a variety of changes in yield.



Low interest rates do not only result in an elevated and asymmetrical interest rate risk profile, they also make the provision of income (another key property of fixed income) more difficult as well. Many investors, whether institutional pension funds or individual retirees, take advantage of the regular stream of payments generated by fixed income assets and use it to cover spending needs. As rates have moved lower, yield-hungry investors have been forced into the riskier part of the credit spectrum in the search for extra income. Today, large parts of major government bond markets actually have negative yields (as at end-February 2016). The markets appear to believe that return of capital is at least as important as return on capital.

Despite these challenges, we do not believe that the current situation is calamitous for fixed income investors. It is important to acknowledge, however, that at this juncture investors need to reassess their approach to the asset class and look for some new, innovative solutions which can help navigate this environment with more certainty. In our view, an absolute return global bond strategy can provide a strong response to the challenges of the current environment (as outlined in Table 1).

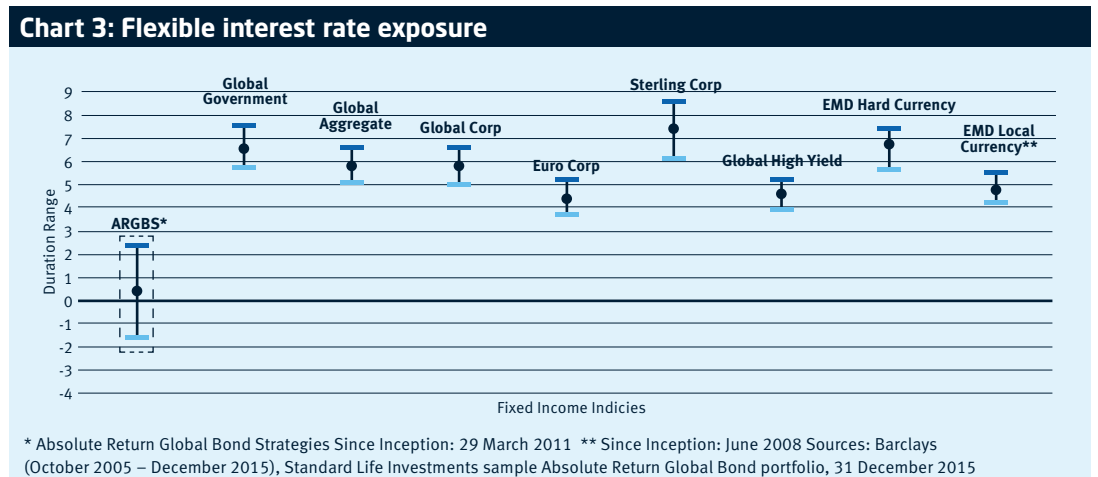
<b>Table 1</b>		
<b>Historical benefit of fixed income</b>	<b>Current challenge</b>	<b>How absolute return bond strategies can help</b>
Downside protection	Rising rates => potential negative returns	Positive returns in different macro environments
Provision of income	Low yields	Unconstrained opportunity set and advanced investment techniques
Diversification within a broad portfolio	Higher correlations across asset classes	Provide returns in an uncorrelated way

The ways in which absolute return bond strategies help solve the current fixed income conundrum reflect the unique properties of these solutions. They provide the key to understanding the concept of absolute return bond investing and differentiating it from other types of fixed income products. With this in mind, it is worth discussing its features in more detail.

### 1. Seeking positive returns in different macro environments

As the word ‘absolute’ suggests, absolute return global bond strategies aim to deliver positive returns in various market environments. In conventional bond funds, active managers usually target outperformance relative to a benchmark index. The overall return is a combination of alpha (active outperformance) and beta (benchmark returns), where the manager is responsible for the alpha component only. By contrast, the performance of an absolute return global bond strategy is dominated by the manager’s alpha and can therefore be defined as ‘skill-driven’ (as opposed to more conventional ‘benchmark-driven’ products). Taking responsibility for the overall performance of a portfolio is a challenging task for a manager. For fixed income absolute return products, it means that positive returns can potentially be delivered regardless of market direction.

An absolute return bond strategy should be expected to avoid persistent duration or credit bias, i.e. be managed without systematic rate or credit exposure. All of the traditional fixed income indices (rates, credit, emerging market debt, etc) have substantial duration exposure, leaving investors with significant interest rate risk (see Chart 3). An absolute return bond strategy can take both positive and negative duration views, implementation being subject to the manager’s conviction. It is important, however, that over the long term the average (or median) duration position of the portfolio moves as close to zero as possible, underlining the lack of directional bias.



The same logic is applicable to credit – while the absolute return global bond strategy should be able to explore credit as one of the sources of return, it should not be overly reliant on it. Credit plays an important role for fixed income investors, but its returns over the long term are usually subject to cyclical and widening credit spreads can lead to significant negative returns. Absolute return global bond strategies need to demonstrate more predictable and stable returns, hence carefully managed, risk-aware exposure to credit is one of their key properties. That naturally leads to the idea of diversification, which we discuss later on in the paper.

The overall level of returns from the strategy should be largely consistent with returns from traditional fixed income indices, but delivered in a more stable and uncorrelated way.

## 2. Pursuit of yield – unconstrained opportunity set and advanced investment techniques

The low-yield environment we are experiencing makes it difficult to generate a good level of income. Skilled managers must seek the most compelling investment opportunities in the market. That naturally leads to the idea of broadening the opportunity set, expanding it both geographically and across the types of eligible instruments the manager can invest in. Employing an unconstrained fixed income universe truly empowers managers, enabling them to select only the highest conviction ideas and build a diversified portfolio.

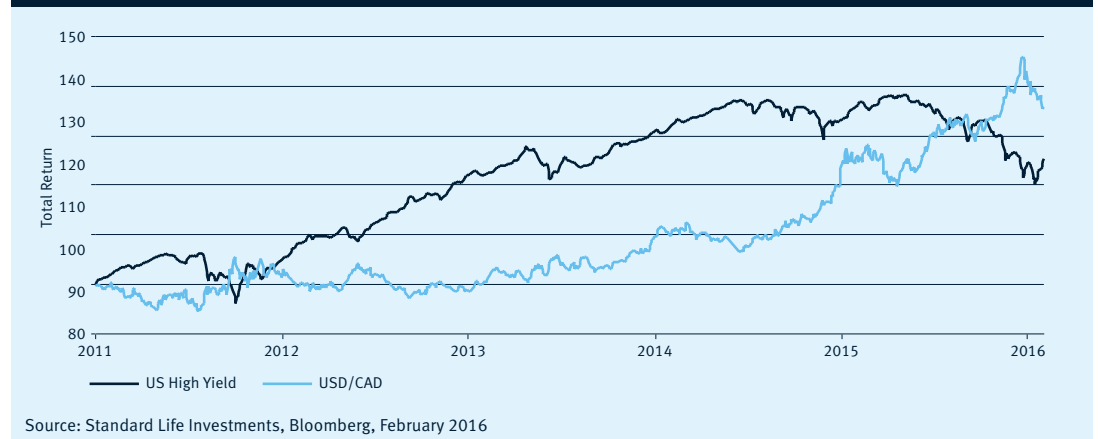
As discussed above, avoiding systematic duration and credit biases is one of the key objectives of an absolute return global bond strategy. This means the manager cannot rely solely on interest rate term premia or credit spread premia, but has to be more instrumental in pursuit of positive returns. With that, we believe that an absolute return global bond strategy can employ the following seven main sources of return.

- ▶ **Credit** – strategies providing exposure to the bonds which offer yield in excess of risk-free government bonds (corporate, securitised or sovereign credits, including their derivatives).
- ▶ **Duration** – strategies providing directional exposure to government bonds or interest rates or their derivatives.
- ▶ **Cross-market** – strategies aiming to explore changes in relative value between duration-equivalent government bonds of different countries.
- ▶ **Yield curve** – strategies aiming to explore changes in the yield differential between government bonds of the same country in various maturities.
- ▶ **Inflation** – strategies aiming to benefit from change in inflation expectations in either a single country or relative between two countries.
- ▶ **Foreign exchange** – strategies aiming to benefit from the change in FX rate between developed or emerging currencies.
- ▶ **Volatility** – strategies exploiting changes in expected volatility of interest rates through swaptions or similar instruments.

The most effective implementation of these strategies can be achieved within the global opportunity set, taking advantage of the disparity in economic growth between certain parts of the developed world (US versus EU for example) or between the developed world and emerging markets.

Bringing together different types of risk position has important diversification benefits, ultimately providing more resilient and stable performance. We can see evidence of this if we look at the relationship of just two positions: high yield corporate bonds (credit) and long US dollar (USD) versus short Canadian dollar (CAD). It is quite clear that during credit market sell-offs, such as those experienced in late-2011, mid-2013 and late-2014, the USD/CAD position performed particularly well and provided a positive contribution which offset the negative return from credit (see Chart 4). While this example highlights two positions, in a portfolio which includes 20-30 positions a manager can build an enhanced level of diversification that can be resilient across various market environments. Importantly, in the example given, both positions delivered strong performance over the medium and long term. This illustrates the approach to selecting positions and constructing the portfolio; every single position is expected to add value over time; no position should get into the portfolio solely because of its diversification benefits.

**Chart 4: The benefits of true diversification**



While some of these positions may be implemented with physical holdings, there are also strategies which necessitate the use of derivatives. Specific benefits of using derivatives within the context of absolute return are that it offers:

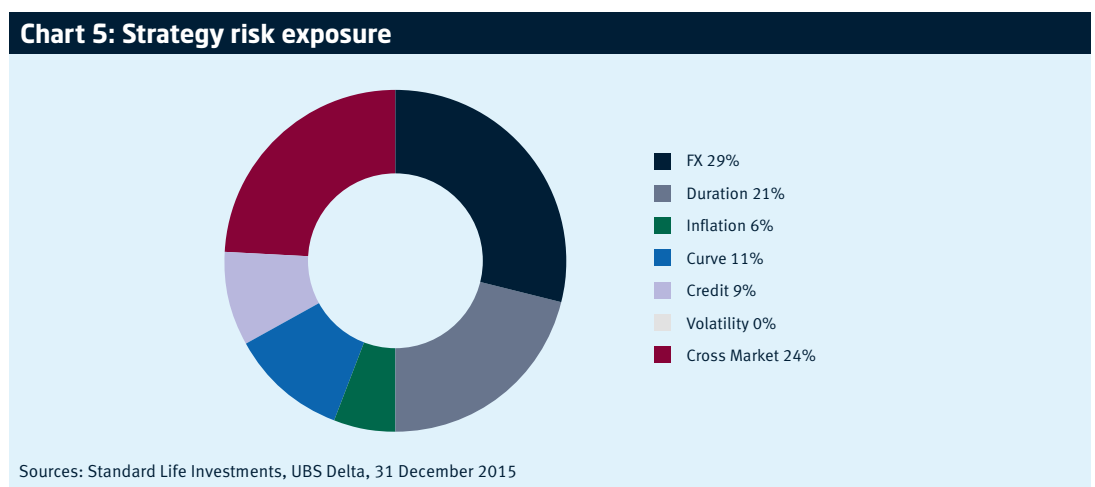
- ▶ efficient management of investment risks
- ▶ a broader range of available investment strategies
- ▶ enhanced portfolio liquidity
- ▶ reduced transaction costs.

Using derivatives requires skill and diligence on the manager's part. In particular, they must be fully aware of the counterparty exposure and required level of collateral. However, when used properly, derivatives can substantially enrich the manager's toolkit, helping generate stable performance with a moderate level of risk.

#### 4. Providing returns in an uncorrelated way

While achieving overall positive performance is the key objective of absolute return strategies, investors may also benefit from returns that are generated in an uncorrelated way – demonstrating low correlation with conventional bond indices and other asset classes outside fixed income.

In order to achieve that, strategies have to be constructed with an enhanced level of diversification. Each type of market exposure has to provide a substantial contribution to overall risk, with none of them dominating the portfolio profile. It is helpful to establish formal limits (for example, 40% of the overall risk) which can be allocated to a single risk type. Chart 5 shows an example of how the market exposures of an absolute return bond strategy can be diversified across various types of risk. Each sector of the chart represents the relative contribution to overall portfolio risk (volatility).



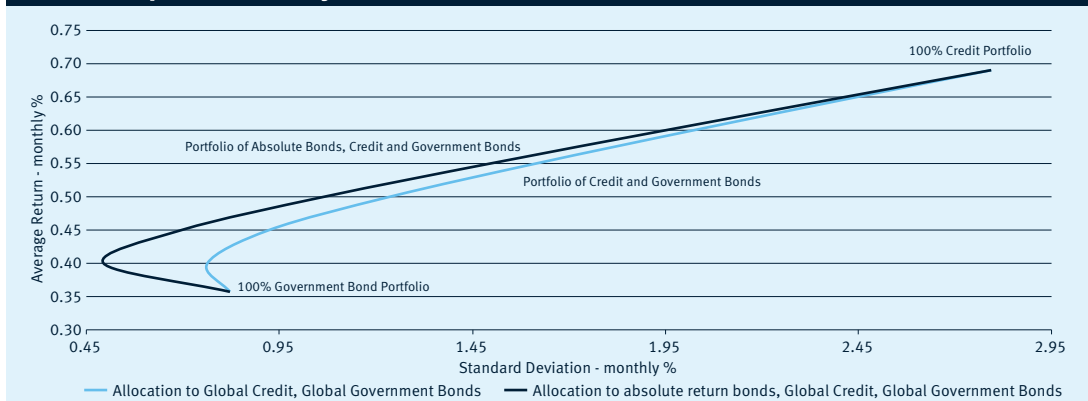
Such an enhanced level of diversification is an indication that the portfolio is not overly dependent on any single type of market return, but instead draws its performance from a broad palette of market exposures. If, for example, credit returns are negative over a certain period of time, it is fair to expect positive and offsetting contributions from duration, curve and relative value trades. That, in turn, can help the absolute return bond strategy achieve its key objective – producing stable positive returns across various market environments.

In order to properly ascertain the level of diversification in an absolute return bond strategy and the quality of performance, investors can calculate the correlation of the returns to those of a number of popular bond indices (aggregate, corporate, emerging markets, etc). They can gauge the degree to which the returns of the overall strategy were reliant on this sector's performance. The normal level of correlation to any of these indices is below 0.3-0.4, which is a sign of a genuine diversification within the strategy. At the same time, a correlation of over 0.8 to any of the bond indices can be an alarming sign, indicating a serious sector bias. This can be particularly troubling in the case of a high correlation with credit, which means that the manager of the strategy has relied primarily on spread premium without really exploring other market sectors for return contribution. This can mean the future performance of such a strategy in more volatile credit market conditions would be less certain.



A low correlation to conventional bond indices, demonstrated by an absolute return bond strategy, is not only the indicator of the high quality of its potential performance but also a benefit within the context of a diversified fixed income allocation. The combination of more reliable performance, low volatility and low correlation to the other parts of the portfolio makes an absolute return bond strategy a useful performance enhancer and markedly improves expected risk-adjusted returns on the overall fixed income allocation (see Chart 6).

**Chart 6: Improved risk-adjusted returns**



Source: Standard Life Investments, Barclays Live, 31 March 2016

## Summary

In summary, we believe that absolute return bond strategies can help investors navigate this difficult environment and hence deserve a place within portfolios. In this paper, we looked at the key benefits of absolute return global bond strategies, many of which are particularly pronounced against the current market backdrop. A fixed income approach that displays no persistent bias to any market variable over time will enhance investors' returns and diversification, while exploiting the best opportunities available in the markets.





## Important Information

This material is for informational purposes only. This should not be relied upon as a forecast, research or investment advice. It does not constitute an offer, or solicitation of an offer, to sell or buy any securities or an endorsement with respect to any investment vehicle. The opinions expressed are those of Standard Life Investments and are subject to change at any time due to changes in market or economic conditions.

Any data contained herein which is attributed to a third party (“Third Party Data”) is the property of (a) third party supplier(s) (the “Owner”) and is licensed for use by Standard Life\*\*. Third Party Data may not be copied or distributed. Third Party Data is provided “as is” and is not warranted to be accurate, complete or timely. To the extent permitted by applicable law, none of the Owner, Standard Life\*\* or any other third party (including any third party involved in providing and/or compiling Third Party Data) shall have any liability for Third Party Data or for any use made of Third Party Data. Past performance is no guarantee of future results. Neither the Owner nor any other third party sponsors, endorses or promotes the fund or product to which Third Party Data relates.

\*\*Standard Life means the relevant member of the Standard Life group, being Standard Life plc together with its subsidiaries, subsidiary undertakings and associated companies (whether direct or indirect) from time to time.”

## standardlifeinvestments.com

Standard Life Investments Limited is registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL. Standard Life Investments Limited is authorised and regulated in the UK by the Financial Conduct Authority.

Standard Life Investments (Hong Kong) Limited is licensed with and regulated by the Securities and Futures Commission in Hong Kong and is a wholly-owned subsidiary of Standard Life Investments Limited.

Standard Life Investments Limited (ABN 36 142 665 227) is incorporated in Scotland (No. SC123321) and is exempt from the requirement to hold an Australian financial services licence under paragraph 911A(2)(l) of the Corporations Act 2001 (Cth) (the ‘Act’) in respect of the provision of financial services as defined in Schedule A of the relief instrument no.10/0264 dated 9 April 2010 issued to Standard Life Investments Limited by the Australian Securities and Investments Commission. These financial services are provided only to wholesale clients as defined in subsection 761G(7) of the Act. Standard Life Investments Limited is authorised and regulated in the United Kingdom by the Financial Conduct Authority under the laws of the United Kingdom, which differ from Australian laws.

Standard Life Investments Limited, a company registered in Ireland (904256) 90 St Stephen’s Green Dublin 2 and is authorised and regulated in the UK by the Financial Conduct Authority.

Standard Life Investments (USA) Limited is registered as an Exempt Market Dealer with the Ontario Securities Commission and as an Investment Adviser with the US Securities and Exchange Commission. Standard Life Investments (Corporate Funds) Limited is registered as an Investment Adviser with the US Securities and Exchange Commission.

Calls may be monitored and/or recorded to protect both you and us and help with our training.  
www.standardlifeinvestments.com © 2016 Standard Life, images reproduced under licence