Coping with a crisis-era mentality

Multi-sector bond strategies may offer relief in a yield-constrained environment

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- In an era of near-zero rates, investors face a conundrum: How can you generate a competitive, sustainable yield without compromising the other characteristics that have long made fixed-income assets attractive?
- Multi-sector bond portfolios may offer a solution. By widening their opportunity set to include more esoteric areas of the credit markets, managers in this space can focus less on the movement of interest rates as a primary source of both risk and return and more on their own insights.
- In our view, today's extremely challenging macroeconomic environment means investors should consider adding multi-sector strategies as a companion alongside a more traditional fixed-income allocation.

Fixed-income assets have long been viewed as a relatively calm corner of the market that allows you to earn a reasonable rate of return, avoid massive market gyrations and generally sleep soundly at night. That idea has been reinforced by a 40-year bull market for bonds that has sent rates consistently lower and provided a steady and powerful tailwind for fixed-income investors that has lasted decades.

But recent developments may be causing investors to rethink the role fixed-income assets play in their portfolios. A series of global crises, beginning with the Great Financial Crisis of 2008-09 and ending with the COVID-19 pandemic, has placed global monetary authorities almost perpetually on crisis footing and left global rates pegged at or near zero for an extended period of time, threatening to end — or at least alter — the way fixed-income assets perform within a diversified asset allocation. Now, with the tailwind of falling rates all but exhausted, investors are facing a conundrum: How can you generate a sustainable, competitive yield without compromising the safety and security fixed-income assets typically provide? Asked another way, is the decades-long bull market in bonds over?

Of course, the answer to that question is a resounding "no." While traditional fixed-income sectors — especially higher-quality sectors such as government bonds, agency securities and investment-grade corporates — may be range-bound by persistently low rates for at least a while longer, we believe opportunities to generate competitive yields without necessarily sacrificing some of the other attractive characteristics fixed-income assets provide still exist. You just have to look a little harder to find them.

Moving beyond core-satellite

Many have relied on intermediate core bond funds for the bulk of their fixed-income allocations, and for good reason: Funds in this category provide a simple and easy-to-understand way to access much of what the world of fixed income has to offer. Indeed, at Empower Retirement, these funds still compose nearly two-thirds of retirement savers' total fixed-income allocations — a powerful endorsement of the leading role these funds can (and perhaps still should) play in an investor's asset allocation.

It goes without saying that the long bull market in rates is one key factor that enabled these strategies to succeed. But if, as argued above, that tailwind is slowing (or even reversing) as a result of macroeconomic factors, it's only natural to begin to consider exploring other options to enhance this portion of an investor's fixed-income allocation.

Another, perhaps less well-understood, implication of the current low-rate environment is also worth mentioning here: a slow but steady increase in portfolio duration. (Duration, according to its simplest definition, measures the sensitivity of a bond portfolio to interest rates.) Because many core bond fund managers are required to keep portfolio duration pegged fairly close to that of their benchmark, they now face a dilemma. They continue to bear all the interest rate risk associated with the steady rise in portfolio duration, but the persistent decline in yields means they are suddenly being compensated far less for bearing such risk. That's not a situation any investor wants to find themselves in.

Ample compensation?
Portfolio duration and interest rate risk have risen while yields are like cash.

Source: Bloomberg.

In any case, the current low-yield environment has focused attention on a trend that has quietly been developing for years: namely, an incremental shift away from the core-satellite approach to fixed income and toward a more nuanced approach that makes full use of the full range of fixed-income sectors currently on offer. In our view, this is a positive development, because the issue at hand isn't so much that the opportunity set in fixed income has been exhausted in an era of falling rates, but rather that the full range of asset types hasn't yet been fully utilized — except by the most sophisticated investors. And that's beginning to change.[1]

Multi-sector bond portfolios: A potential solution

Multi-sector bond portfolios blend expertise across a range of fixed-income sectors to deliver a portfolio designed to take advantage of the many levers at their disposal. In an ideal case, managers in this space can focus less on the movement of interest rates as a primary source of both risk and return and more on their own insights, which are in turn informed by clues provided by borrowers and their fellow investors as the credit cycle evolves.

Naturally, strategies in the category often emphasize so-called "spread sectors," which often carry higher yields and greater risk than other, more familiar sectors of the bond market — but also tend to frequently fall in and out of favor over the course of a full market cycle. This can clearly be seen in the table on the next page, which demonstrates in full, living color the tendency of different sectors of the fixed-income market to perform quite differently across time.

Utilizing knowledge of industry-specific, borrower-specific and broad macroeconomic themes, multi-sector bond teams tend to move quickly to capitalize by actively shifting portfolio assets across securities, categories and even broad market sectors when they identify significantly mispriced assets. And, there is evidence to suggest that successful managers in the space may have the instincts necessary to take full advantage of this flexibility.

As the table on the next page suggests, allocating to the high-yield sector at opportune times (and, perhaps even more importantly, getting out of the way when credit spreads spike) is one way to be successful as a multi-sector income manager. It's perhaps no coincidence, then, that the median multi-sector bond portfolio saw its most pronounced overweight to high-yield relative to history in 2016 (when high-yield bonds sat atop the league table) and its most pronounced underweight in 2008, when U.S. high yield was near the bottom. But while this flexibility can be extraordinarily valuable in a yield-constrained environment, it also comes at a cost: Many funds in the category can invest more than half their assets in below-investment-grade securities and can take meaningful positions in emerging market debt, securitized assets and even more esoteric segments like collateralized loan obligations and leveraged loans. For that reason alone, choosing a multi-sector bond manager requires thorough due diligence and careful monitoring thereafter. It's also a key reason that it's difficult for us to imagine multi-sector bonds ever representing the sole exposure in an investor's fixed-income allocation, but it's also an area we are confident investors should explore as a companion to core bonds as they wrestle with the challenges presented by today's low-yield environment.

Look familiar?

Different sectors of the fixed-income market have performed differently across time.

Best performing ↑ / Worst performing ↓

2006	2007	2008	2009	2010	2011	2012	2013
EMKT (High-Yield) 12.69%	U.S. Aggregate 6.97%	U.S. MBS 8.34%	U.S. High Yield 58.12%	Non-Agency CMBS 20.81%	EMKT (Inv. Grade) 8.36%	EMKT (High-Yield) 23.78%	U.S. High Yield 7.44%
U.S. High Yield 11.85%	U.S. MBS 6.90%	U.S. Aggregate 5.24%	Leveraged Loans 44.87%	EMKT (High-Yield) 15.30%	U.S. Aggregate 7.84%	U.S. High Yield 15.81%	Leveraged Loans 6.15%
Leveraged Loans 7.33%	EMKT (Inv. Grade) 5.67%	EMKT (Inv. Grade) -9.11%	EMKT (High-Yield) 43.67%	U.S. High Yield 15.12%	Non-Agency CMBS 6.47%	EMKT (Inv. Grade) 14.73%	Non-Agency CMBS 0.18%
EMKT (Inv. Grade) 5.60%	EMKT (High-Yield) 4.83%	ABS -12.72%	Non-Agency CMBS 28.14%	EMKT (Inv. Grade) 10.91%	U.S. MBS 6.23%	Non-Agency CMBS 10.04%	ABS -0.27%
U.S. MBS 5.22%	Non-Agency CMBS 4.60%	EMKT (High-Yield) -20.69%	EMKT (Inv. Grade) 26.42%	Leveraged Loans 9.97%	ABS 5.14%	Leveraged Loans 9.43%	EMKT (High-Yield) -1.33%
Non-Agency CMBS 4.91%	ABS 2.21%	Non-Agency CMBS -22.72%	ABS 24.71%	U.S. Aggregate 6.54%	EMKT (High-Yield) 5.07%	U.S. Aggregate 4.22%	U.S. MBS -1.41%
ABS 4.70%	Leveraged Loans 1.88%	U.S. High Yield -26.16%	U.S. Aggregate 5.93%	ABS 5.85%	U.S. High Yield 4.98%	ABS 3.66%	U.S. Aggregate -2.02%
U.S. Aggregate 4.33%	U.S. High Yield 1.87%	Leveraged Loans -28.75%	U.S. MBS 5.89%	U.S. MBS 5.37%	Leveraged Loans 1.82%	U.S. MBS 2.59%	EMKT (Inv. Grade) -5.33%

2014	2015	2016	2017	2018	2019	2020
EMKT (Inv. Grade) 6.94%	EMKT (High-Yield) 6.92%	U.S. High Yield 17.13%	EMKT (High-Yield) 9.54%	ABS 1.77%	U.S. High Yield 14.32%	U.S. Aggregate 7.51%
U.S. MBS 6.08%	U.S. MBS 1.51%	EMKT (High-Yield) 15.89%	U.S. High Yield 7.50%	Leveraged Loans 1.14%	EMKT (Inv. Grade) 13.99%	EMKT (Inv. Grade) 7.51%
U.S. Aggregate 5.97%	ABS 1.25%	Leveraged Loans 9.88%	EMKT (Inv. Grade) 7.28%	U.S. MBS 0.99%	EMKT (High-Yield) 11.48%	U.S. High Yield 7.11%
Non-Agency CMBS 4.15%	Non-Agency CMBS 0.57%	EMKT (Inv. Grade) 6.47%	Leveraged Loans 4.25%	Non-Agency CMBS 0.98%	Non-Agency CMBS 8.76%	Non-Agency CMBS 6.89%
U.S. High Yield 2.45%	U.S. Aggregate 0.55%	Non-Agency CMBS 4.00%	Non-Agency CMBS 3.86%	U.S. Aggregate 0.01%	U.S. Aggregate 8.72%	ABS 4.52%
Leveraged Loans 2.06%	Leveraged Loans 0.38%	U.S. Aggregate 2.65%	U.S. Aggregate 3.54%	EMKT (Inv. Grade) -1.10%	Leveraged Loans 8.17%	EMKT (High-Yield) 4.25%
ABS 1.88%	EMKT (Inv. Grade) -1.25%	ABS 2.02%	U.S. MBS 2.47%	U.S. High Yield -2.08%	U.S. MBS 6.35%	U.S. MBS 3.87%
EMKT (High-Yield) -1.40%	U.S. High Yield -4.47%	U.S. MBS 1.67%	ABS 01.55%	EMKT (High-Yield) -4.73%	ABS 4.53%	Leveraged Loans 2.78%

Source: Bloomberg.

Past performance is not a guarantee of future results.

1 This can be seen clearly in product development data: The number of products available in areas such as emerging market bonds, bank loans, non-traditional bonds and multi-sector funds have mushroomed over the last decade while the number of intermediate core and core-plus bond funds has actually declined. (GWI calculations based on Morningstar data, February 2021.)

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