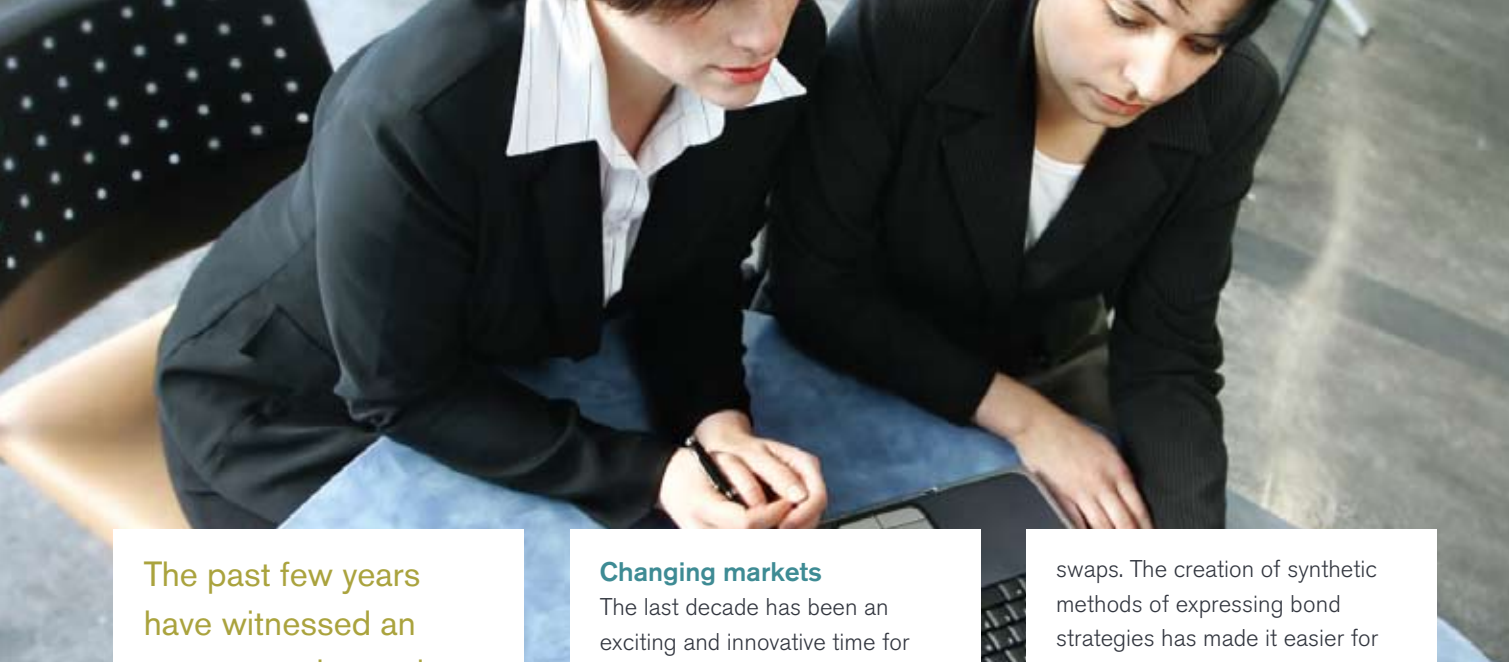


# Getting the most out of your bond portfolio





The past few years have witnessed an enormous change in the way in which bond portfolios are managed, both in alpha and beta space. In this article we address the topics of market evolution, the beta versus alpha allocation and new areas of bond mandate design.

### Changing markets

The last decade has been an exciting and innovative time for bond markets. A number of significant developments combined to broaden the investable universe and increase the types of instruments available to managers seeking to add value in active strategies.

In the early 1990s, bond market investing was largely a domestic activity, and a highly rated, government debt one at that. High yield and emerging debt was considered exotic and highly risky. Global bond managers were largely investing in government securities, adding value in convergence trades prior to the introduction of the single European currency in January 1999.

Credit analysis and corporate bond investing, while common in the US, was far less advanced in Europe as the market was too fragmented and had less of a capital market culture. But everything changed with the introduction of the euro, creating a single market for debt and the creation of a credit market, which is still developing today. We see parallels with developments in Asia, where nascent bond markets are attracting increasing interest from borrowers and investors alike.

At the same time, the derivatives market for fixed income related products was booming: from futures to options, to interest rate swaps and then credit default

swaps. The creation of synthetic methods of expressing bond strategies has made it easier for managers to go short as well as long and better exploit their best ideas across a wide spectrum of global opportunities.

Nowadays, if a manager wants to buy the best value bond from a particular issuer, he or she can buy any maturity or currency and use derivatives to 'swap' those cashflows and currency into a more suitable vehicle for the portfolio. We can take this analogy one step further and say that, thanks to derivatives, a whole portfolio of strategies can be swapped to an underlying benchmark with a completely different return profile. This is the concept known as portable alpha.

### Why own bonds?

Investors own bonds for many reasons, chief amongst which is the high correlation that fixed income assets have with liabilities. Bonds can also be an efficient part of a broader portfolio that includes equities, real estate and alternative assets.

The liability-matching nature of bonds has historically meant that bond benchmarks emphasised long maturity debt. For pension funds that want a closer alignment with liabilities and minimal trading costs, having an allocation to long-dated bonds is a sensible solution.



This can be achieved in a passive (low cost) or active strategy.

One step on from this is to combine alpha from one source and long-dated beta in one structure. The benefits are an improvement in alpha diversification with the maintenance of the appropriate long-dated maturity target that has been identified for the fund. But there are challenges to this packaged solution: can suitable products be identified and implemented without too much hassle and, more importantly, can one manager deliver the two parts in the most efficient way? There is also the issue of having to collapse the whole structure and start again elsewhere if you want to fire the manager.

The most efficient way to target beta might be to replace bonds with swaps and to target a cash rate as the benchmark for alpha generation. This approach divides the beta and alpha decision, allowing the client to hire the most skilled managers, regardless of the markets in which they operate. However, this approach is potentially expensive to implement and requires a high degree of governance to monitor. Also, it is important to remember that achieving a cash-plus return target is not a risk-free activity and should not be entrusted to a manager without the requisite skills.

### **Freeing the outperformance**

Whether you choose a bond benchmark or move to swaps, there are a number of ways to increase the alpha targets in bond portfolios. Staying in the realm of bond benchmarks, funds can take a mandate from passive through to high alpha and even on to absolute return via the introduction of broader investment guidelines. This includes the ability to own a wide variety of credit, the application of strategies using derivatives (including the ability to short) and introducing currency to the mix.

The possibilities are even more exciting once the benchmark is replaced with swaps, as funds can now focus on garnering the most skill they can find from anywhere, be it global credit, leveraged loans, emerging markets or fixed income hedge funds. As the adoption of derivative strategies becomes more widespread in bond management, Watson Wyatt's research efforts must continue to expand in order to meet the demand for the next generation of bond portfolios.