William Blair & Company®

Understanding Risk in Fixed Income Portfolios: A New Field Guide for Investors

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March 2010

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Now is the time for plan sponsors, fund trustees, and investment advisors to make a critical examination of what their bond portfolios are comprised of, the level of risk embedded in their portfolio investments, and the role of fixed income within their overall asset allocation strategy.

Financial innovation often results in unintended consequences and adverse results. In his editor's corner of the September/October 2009 issue of the Financial Analysts' Journal, Richard Ennis, CFA, notes that the nature of active management of fixed income portfolios has evolved, quite dramatically in some cases, over the past 20 years. Most notable has been the explosion in new types of fixed income products, exemplified by the question he received from one client asking him, "when did our bond managers stop buying bonds?"

In hindsight, as with most innovation, after the benefits are reaped, human behavior drives implementation to extremes. With product innovation came new opportunities for fixed income investors but also varying degrees of risk.

As an example, it seemed as though every politician, from the national stage to local officials, took credit for the dramatic rise in the home ownership rate from 65 to 70 percent during the last two decades. This was the result of a change of tax incentives (favorable capital gain changes under the Clinton administration), innovative mortgage financing instruments, and lax underwriting standards (predicated on an assumed continuous price appreciation). These financing instruments were packaged into pools for institutional investors, and naturally made their way into fixed income portfolios over time and with increasing exposure. Notwithstanding FOMC chairman Bernanke's assessment of the residential mortgage crisis in 2007 as being "contained," it was quite to the contrary. The extreme contagion in that sector had far-reaching effects on the fixed income markets, the U.S. financial system and the U.S. economy, which continue to be felt today.

The implications for fixed income investors are clear. First and foremost, investors need to have a fundamental understanding of the level of risk within their portfolios.

The Recent Past Provides a Useful Place to Start

It takes time and effort to measure, analyze, understand, compare, and evaluate fixed income investment managers.

However, with a relatively short but severe credit crisis having played out over the past 18-24 months, we believe a review of bond fund returns provides very important and meaningful insight to the true nature of a fund's risk and return profile. In other words, an analysis of returns for the consecutive calendar years of 2008 and 2009 can be interpreted to determine whether a bond manager owned bonds or other instruments which provide much higher risk and return potential.

Morningstar's bond fund of the year earned 37.0% in 2009 and lost nearly 22.0% in 2008. Indeed, total returns, of ostensibly fixed income portfolios, clocked hefty negative returns in calendar 2008 as the Barclays Capital U.S. Aggregate index earned a respectable 5.24%. Conversely, as risky assets recovered in 2009, some "bond" funds earned 15.0% or more as the Aggregate benchmark posted a total return of 5.93%.

Morningstar's U.S. *Intermediate-Term Bond Category* includes 33 bond funds. Twelve of the top 15 performing bond funds in 2009 earned negative returns in 2008. In addition, the top-performing bond fund in 2009 earned a -20.32% return in 2008. We believe this volatile performance is not what most fixed income investors expect when they consider their "core fixed income" investments.

The devil is in the details in fixed income portfolio management. The term "core" bond fund can, and often does, mean different things to different people.

To begin with, investors need to first understand what their fixed income portfolio is benchmarked against and how much a manager is allowed to own outside of this benchmark. Is the portfolio "core," or "core-plus?" Knowing whether a portfolio is core or core-plus is fundamental to understanding the risk profile of the portfolio. At William Blair & Company, we define core in simple terms. We consider a core portfolio to be "long (position)-only," "cash-only," "dollar-only," with no implicit or explicit leverage .

Assuming a fixed income portfolio is benchmarked against the Barclays Capital U.S. Aggregate Index, we believe one can quickly begin to determine whether a manager is a core manager, or not, by examining their absolute return.

While the Barclays Aggregate Index returned 5.24% in 2008, its return was highly dependent upon a flight to quality/liquidity rally beginning in mid-September of that year. U.S. Treasury securities were the best-performing sector by a wide margin, and thus, the Index beat well above 75% of active managers. However, there were several funds designated as "core bond funds" that had negative total returns of 5.0% or much more. In our opinion, based on our research, these are either not core bond funds, or, if they are truly core funds, they were poorly managed.

Discovering What Exactly Is In a Name

It is difficult to ascertain the nature of a fund by its name (core, core-plus, income, bond, aggregate, high current income, total return, etc.). Some funds with innocent sounding monikers like "yield plus" or "enhanced index" may contain very leveraged investments and very unattractive risk/return profiles.

In the arena of fixed income investing, we believe risk management is portfolio management, and vice versa. One of the critical metrics an investor should ascertain is the amount of "plus" their manager uses. Originally, the plus sectors were typically high yield, non-dollar denominated investments, and emerging markets. Plus sectors now may also include non-agency mortgages, swaps and derivatives, and other highly complex instruments which we would characterize as "out of index" bets. The plus portion of core-plus portfolios has ballooned from the 10-15% range in the 1990's, to now upwards of 25% to close to 50 percent.

Simply put, we do not believe these more volatile securities should be the bedrock foundation of an investor's fixed-income portfolio. Many of these funds are quite good; nevertheless, they should not be categorized as a core allocation. They are hybrid funds which, as we see, can meaningfully outperform or underperform their benchmark based on market conditions.

As noted investor Warren Buffet commented during the recent bear market, we have the opportunity to view which investors (fund managers, financial services firms, etc.) have been “swimming without their trunks on.”

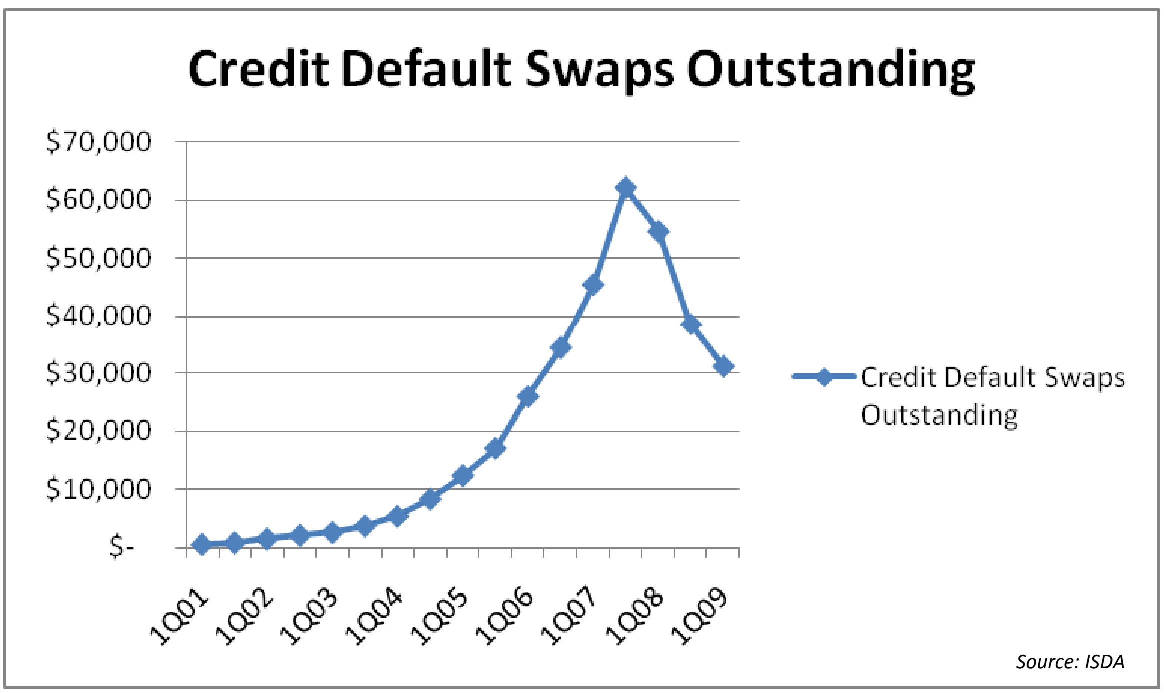
Execution, Implementation, and Liquidity

The bond market is an over-the-counter market, and as such, is highly dependent upon liquidity constraints. The asset size of a fund, the product offerings and their relative sizes, instruments employed, the number of “plus” sectors used and to what degree, and many other metrics should be analyzed to determine a fund’s true nature. Is the fund manager using cash securities or does the manager get its exposure by investing in derivatives?

We believe the sheer size of some firms—and of the portfolios that they manage—begs the question of how nimble they can be in the management of their portfolios. In our view, several of the so-called oligopoly firms must implement strategy via derivatives. They are simply too big to operate effectively in the cash markets.

The graph below shows the phenomenal growth of credit derivatives, a tool used by some of the largest managers to obtain exposure in corporate credits. The graph shows the subsequent unwinding of credit default swap positions due to the credit crisis of 2008.

ISDA Market Survey
Notional amounts outstanding, semiannual data, all surveyed contracts
Notional amounts in billions of US dollars, adjusted for double counting



These markets are not universally more liquid than the cash markets and are sometimes less effective. The buy-out of Equity Office Properties, the large REIT which Sam Zell traded to Blackstone in 2007, resulted in the ironic situation that cash bondholders enjoyed covenants, while those with exposure via CDS did not. The more esoteric the strategy, the more difficult and/or arcane the nuances of pricing (and measuring total return) may be. We believe the transparency of a daily priced, open-end mutual fund should be very important to investors.

In addition, we believe investors may do themselves a disservice by not evaluating smaller and "overlooked" fixed income managers.

Many smaller firms' fixed income professionals have the benefit of being integrated into a multi-asset class platform, where they are exposed to information and communication about broad sectors of both the equity and fixed income markets.

We believe the more sectors a firm invests in the more integration and communication is necessary across investment professionals to stay on top of news and information which may have implications for their respective areas. The importance of this communication was especially evident during the credit crisis of 2008, where information sharing between fixed income and equity investment teams was crucial.

Common Sense, Common Practice, and the Enron Rule

It is extremely difficult to measure the risk in a fixed income portfolio, and this especially applies to more aggressive bond strategies, including core-plus strategies. Enron perpetuated its fraud with an arrogance to the security analyst community of "you aren't bright enough to understand our financials." And yet, this attitude continues to be pervasive today, even among some advisors who take what fixed income managers might state at face value, without delving into specific details about what their portfolios invest in. This strategy worked for a fairly long time. But at the end of the day, an investor should be able to pick up the holdings list of a bond fund and understand, with a minimum of explanation, what they own. We believe that if that is not the case, there's a good probability an investor owns a core-plus fund with the associated return, but also risk, of something more than the Aggregate Index.

What's at Stake

Ultimately, we now see with the benefit of hindsight the cost of being aggressive in the fixed income portion of a portfolio. Several state college savings programs inadvertently ended up in a "core" bond fund which lost 35.0% in market value during 2008, and subsequently rebounded just more than 7.0% in 2009. We think a severe lack of due diligence or understanding of risk and the plus (out of index) sectors employed has resulted in a great deal of angst for investors.

In a similar situation, the widely employed endowment portfolio model of utilizing a variety of alternative investment vehicles and abandoning core fixed income has resulted in a series of cancelled capital expenditure programs, layoffs and tuition increases at some of our most prestigious academic institutions.

The Question of Whether or Not to Use Index Funds

Are index funds a solution to the implementation of core portfolios? It's a good question to ponder. Significant differences exist between these "passive" investment strategies and actively managed portfolios. But those investors who believe they are addressing the issue of risk may be making a critical mistake. The same risk measurement analysis criteria applies to index funds as it does to actively managed portfolios.

We have two time periods in the modern era to evaluate this strategy. In the 2001-2002 corporate governance scandal era typified by the WorldCom and Enron bankruptcies (and the Tyco debacle), index funds significantly failed to achieve their benchmarks. Their performance shortfall was generally due to owning some credits which did experience high and negative volatility. Investors should keep in mind that the index is comprised of a couple thousand corporate bond Cusips, and the index managers own a stratified sample of names. (Note, WorldCom, Enron and Tyco were large and frequent, and importantly, liquid issuers which were commonly held by active and index managers.)

Recently, index managers seem to have performed better (lower realized tracking errors) in the 2008-09 crisis. Investors need to remember not to approach index funds blindly. As with active management, due diligence requires a thorough review of the philosophy, strategy, and tactics. Liquidity and risk management are critically important.

Fixed Income Investing Cannot be Compromised

Core fixed income is not the latest buzz and is normally not the center of discussion at cocktail parties. It is somewhat analogous to managing money market funds, and other forms of bond investing: it is only noticed when something else is going wrong, and it needs to be right. It cannot be compromised, and there is no substitute. In the money market space, SIVs and extendable issues created havoc. In core and core-plus, it was non-agency and other aggressive tactics. Regardless of the vehicle, active management is a trade-off between anticipated or expected yield, and various forms of risk. The risks can be credit quality, asset-liability (duration) mismatch, a give up in liquidity, or a variety of other strategies. Some of these are easy to measure, others are not.

Ultimately, investors would be well served to remember this tenet regarding fixed income trading and management: Things work until they don't, and when they stop working, they can do so very, very abruptly, with very negative consequences. We believe that if a manager is employing a core strategy, they should have very limited exposure to aggressive strategies which went awry in 2008.

Lastly, for smaller enterprises, we believe a great deal of effort has been devoted to the relentless pursuit of filling in all the boxes of the "best in breed" mantra. We firmly believe a great deal has been lost with the demise of the balanced portfolio. After having experienced the "never before experience" of a negative 10-year compound return on stocks, we think the last couple of years demonstrate the value of a serious dialog between equity and fixed income investment professionals. We are not calling for the return of a balanced mandate. However, it might make great sense for enterprises to prudently employ a manager to capture returns with a disciplined, and risk-controlled perspective.

William Blair & Company's Unique Fixed Income Approach

William Blair & Company's philosophy is to exploit the inefficiencies in the bond market by utilizing a disciplined investment approach. Our total return products are built around experienced sector specialists, who are integrated rather than "departmentalized." They function as analysts, traders, and portfolio managers. Each investment professional is charged with idea generation or research, trading, as well as knowing the risk parameters of their sectors/portfolios. Under this platform, we believe we can move effectively to implement a good idea without the communication delay of larger teams.

Additionally, our portfolio management style is individual security based. We believe our smaller platform often results in identifying securities which may be "overlooked" by mega-managers.

Time to Refocus Fixed Income Strategy

Plan sponsors, fund trustees, and investment advisors should refocus their fixed income strategy by conducting a critical examination of how their bond portfolios are constructed. Because there is no easy way to measure the level of risk in bond funds, a good way to start the process is to look at the volatility of 2008-2009 calendar year returns. The next question to ask oneself is whether or not derivatives or leverage is used in the fund, and to what extent. If this cannot be easily quantified, then the investor needs to have a discussion with their fixed income manager.

Employing a fixed-income manager to capture returns with a disciplined and risk-controlled process makes a great deal of sense and we believe is the prudent approach for investing in this asset class.

Christopher T. Vincent, CFA

Christopher Vincent, CFA, a principal of William Blair & Company, L.L.C., is head of the Fixed Income Group within William Blair & Company's Investment Management Division. He joined William Blair in June 2002 as a fixed income portfolio manager, became manager of the Income Fund in August, 2002, and manager of the Ready Reserves Fund in February, 2003. A 27-year veteran of fund management, previously, he was a managing director/senior fixed-income portfolio manager with Zurich Scudder Investments for 14 years. Before that he was with Ralston Purina Company for five years in the Treasury department, where he was responsible for fixed income investments for the company's benefit plans. Mr. Vincent is a former board member of the CFA Society of Chicago and remains a volunteer speaker and teacher on the topic of fixed income investing. Additionally, he serves on the nominating committee of CFA Chicago and is a member of the CFA Institute. He has a B.S.B.A. from the University of Missouri and an M.B.A. from Saint Louis University.