Fixed-Income Opportunities in a Changing Rate and Regulatory Environment

Executive Summary

Investors continue to be concerned about the prospect of higher interest rates despite the fact that those who have positioned portfolios for higher rates have yet to be rewarded.

We believe that an increase in rates will likely be gradual and unfold over a longer time horizon requiring unique investment solutions.
Pending regulatory changes will likely alter the investment management industry in both subtle and profound ways.

We are now 7 years past the crisis lows and when equity prices began their recovery in March of 2009. Since that moment, investors have persistently feared an equal but opposite reaction in the fixed-income markets in the form of lower bond prices and higher yields. The fact is that since the beginning of the recovery, 10-year Treasury note yields have declined to 1.77 (as of 3/31/2016) from 2.86 (on 3/9/2009) while equity prices as measured by the S&P 500 have risen to roughly 2060 (3/31/2016) from a low of 676.53 (on 3/9/2009). This represents a threefold increase in equity prices and a decline of 109 basis points (bps) in the yield of the 10-year US Treasury note—not quite what we would have expected.

Dealing with a (Potentially) Changing Rate Environment

Still, investors wake up each day concerned about the prospects of higher rates. Certainly we have come a long way. The aggressive posture of the Federal Reserve (Fed's) quantitative easing program has passed and zero short-term rates in the US are also history (kind of). That said, 10-year rates remain low by historical standards and, as of 3/31/2016, were only 40 bps higher than the post-crisis lows.

As we all know, short-term rates are driven by policy and long-term rates are driven by inflation expectations (generally). So the fact that rates remain low despite a lackluster yet long and steady recovery suggests that investors continue to believe that the Fed will not be able to meaningfully alter the trajectory of inflation or disinflation, as the case may be.

It is interesting to note that investors who have consistently positioned their portfolios for a rapid normalization of rates have left money on the table. Those who remain concerned about rising rates should contemplate strategies that are less sensitive to rising rates rather than considering portfolios that will benefit from a rapid rise in rates. This is a subtle yet important distinction. For example, floating rate securities traditionally benefit from higher rates, yet in the post crisis period these securities have deprived investors of substantial yield versus longer-term securities.

Likewise, any macro strategy that entered 2012, 2013, 2014, 2015 and now 2016 with near zero or negative duration has generally underperformed the Barclays Aggregate Index. Assuming these managers have sufficient intestinal fortitude to stay with the trade, they can only benefit from rising rates if and when rates actually rise.

Yet there are strategies that can do well in a stable-to-rising rate environment. These include more credit sensitive strategies such as corporate, emerging market and/or structured product portfolios. Global strategies that are diversified by country and currency will also tend to be less sensitive to changes in US rates. Each of these strategies can offer higher yields than core US fixed-income exposure (but of course with a different risk profile) and can allow investors to earn income while waiting.

We have laid out two important alternatives here. The first is a strategy to counter a rapid and substantial rise in rates, like the 1994 experience (i.e., floating rate securities or net short duration positions). Each reduces (or even produces negative) income. The second approach is designed to deal with low, but likely stable rates that may drift higher over time as the modest expansion continues and inflation pressures remain subdued. Let’s explore each independently.

The first is designed to deal with a significant and rapid rate rise; the best approach would be a low, no or negative duration strategy. This approach will tend to minimize income. It involves moving to the front end of the yield curve or selling US Treasuries or their derivatives short. This is the investing equivalent of hiding under the desk.

The second alternative is designed to deal with a scenario in which rates are stable and may drift higher over time. This would suggest a strategy that should feature either tactical management of duration or maintain a strategically low duration, each of which can mitigate the sensitivity to changes in longer-term rates over the short or long term. The approach should also incorporate greater exposure to credit sensitive strategies as described above, providing the investor with a higher yield that, when combined with shorter or more tactical duration positioning, can further mitigate sensitivity to prevailing risk-free rates and compensate investors while they wait. We must also ask the question, "What is the objective of our fixed-income allocation?" Is it to generate total return or is it designed to hedge the volatility that is inherent in the equity portion of our portfolios? Modern portfolio theory would suggest the latter, as would the Swensen approach[1], often used by foundations and endowments. Under these approaches, an investor should remain in high quality bonds that are either US Treasury securities or are highly correlated to US Treasury securities regardless of the investor's outlook on rates. Longer-term Treasuries and related instruments can provide an effective hedge to equities as they tend to respond positively to volatility shocks that typically have a negative impact on equities.

Not wanting to sound like two-handed economists, we would like to offer a comprehensive strategy for the current environment. First, we would suggest that a significant and rapid rise in rates is highly unlikely in the near future. Rather, we suggest that a gradual increase in rates, notably US Treasury rates, will unfold over a longer time horizon. To insulate a portfolio from this potentiality, investors should have an element of tactical duration management as well as a higher allocation to credit sensitive securities including corporate, structured and/or emerging market debt. This can provide less correlation to US Treasury rates and can provide an enhanced yield. Depending on how this is implemented, it may also offer a lower duration profile.

Investors should also consider a separate allocation to longer-dated US Treasuries as an offset to potential equity risk. Given that this approach brings with it substantial duration exposure, fewer dollars can be deployed and each dollar can potentially deliver a bigger bang for the buck.

The combination of these two strategies should be funded from the existing fixed-income allocation and should deliver less sensitivity to a change in risk-free rates in the US, reasonable performance from tactical management of duration and enhanced income from the credit-sensitive portion of the portfolio. The longer-duration, Treasury-focused portion of the portfolio may not deliver particularly good performance if rates rise, but should offset some of the volatility that is inherent in the equity portion of the portfolio, potentially improving risk-adjusted returns.

Approaches will differ and the size of these programs will vary by investor. For large, institutional plans there are many options that can be used as substitutes for or complements to existing core fixed-income strategies, including unconstrained, alternative and privately placed fixed-income strategies. When venturing away from core, it is generally a good idea to seek manager diversification as well as diversification by sector within the fixed-income market. A large plan must also consider the role of liquidity—particularly for the fixed-income portion of the portfolio.

For smaller plans or for individuals in either taxable or tax deferred accounts such as IRAs or 401(k)s, simpler is generally better. The simple approach would focus on a core or core-plus fixed-income strategy and perhaps either an income-oriented strategy or an unconstrained strategy as a complement. These strategies are widely available and, generally, reasonably priced.

Implications of Pending/Proposed Regulatory Changes

In addition to re-thinking asset allocations, we will all be forced to re-think our business models in light of two key regulatory changes on the horizon. The first is the Department of Labor's Fiduciary Rule. The second is the Securities and Exchange Commission's (SEC's) proposed Derivatives Rule for mutual funds.

The Fiduciary Rule intends to change the defined contribution and IRA markets in a profound way. It will, if implemented in its current form, significantly broaden the definition of fiduciary under ERISA to cover the financial adviser's role acting for clients in the management of IRAs, retirement plans and other tax-favored accounts. Existing business models for advisors will be become problematic under ERISA with that expansion and many, if not most, advisors will need to adjust their business models and/or look for an exemption (known as a Prohibited Transaction Exemption, or PTE, in ERISA jargon). The most significant exemption is the "Best Interest Contract Exemption." Under this exemption, advisors will need to enter into new legally binding contracts that acknowledge their fiduciary status and impose a broad range of ERISA prudence and other obligations, including the requirement to act in each client's best interest.

Two key Fiduciary Rule changes will affect how advisors and asset managers do business:

Regulatory authority over financial advice to retirement account holders is expanded

Compensation models that conflict with the client's best interest are prohibited

The exact definition of “a client’s best interest” is open to interpretation, so the initial approach will be that of caution. It will likely lead to an even greater shift to low cost strategies, in particular passive strategies and target date funds. Will this really be in the client’s best interest? Will a lower fee unequivocally lead to higher performance? Will target date funds offer the best possible asset allocation? Will these approaches protect financial advisors from the inevitable lawsuits that will arrive when active strategies beat passive or vice versa? Probably not. It will likely result in fewer choices, lower fees for managers and less dispersion across plans as fiduciaries opt for market performance in an attempt to avoid future litigation.

The second major change is the SEC’s proposed mutual fund Derivatives Rule. This 421-page document is officially titled “Use of Derivatives by Registered Investment Companies and Business Development Companies” and it is intended to limit the notional value of derivatives in a portfolio, establish criteria under which they can be used and provide for more oversight from boards on their use. If adopted, it will, for funds that use derivatives more extensively, institutionalize Value at Risk calculations and significantly complicate and change compliance regimes.

Despite its girth, it will likely be more of an administrative issue for most investment strategies rather than have a profound impact. For certain categories of funds, such as taxable bond funds and alternative investment funds, the rule could impact how the funds are managed or even threaten their existence. Given its limited focus, the Derivatives Rule is likely to have a less significant economic impact than the Fiduciary Rule, whose implications may be profound both in economic and legal terms.

Conclusion

As Bob Dylan once so eloquently wrote and sang, “The times they are a-changin’.” Investors will need to seriously reassess their portfolio objectives. The notion that rates will rise and investors will need to reduce exposure to fixed-income will only serve to increasingly focus portfolio risk on the performance of the equity markets, which are already largely dependent on capital gains to drive returns. In effect, a reduction in fixed-income exposure can and likely will reduce diversification and increase risk. Alternative approaches to fixed-income need to be considered in lieu of an exodus. These alternatives can include strategies that seek to benefit from rapidly rising rates as well as strategies that can do well if rates rise modestly—a subtle yet extremely important and consequential distinction. It will be up to each investor to decide.

That said, the part of the industry that is focused on retirement investing will likely reduce innovation, move toward lower fees and greater passivity in an attempt to avoid the legal tests that will inevitably arise from the Fiduciary Rule. The net result will likely be a substantial change in the way this business is conducted.

The industry will also be forced to adapt to pending changes to the rules that cover derivative use. For most funds these changes will likely be more administrative in nature and of greater consequence to the manager than the investor, although certain categories of funds may be impacted to a greater degree.

[1]David F. Swensen has been the Chief Investment Officer at Yale University since 1985. He is the author of *Unconventional Success: A Fundamental Approach to Personal Investment* (2005).