

Active Fixed Income in an Uncertain World

Active fixed income management had a disappointing third quarter. A number of factors resulted in a substantial flight to quality during the third quarter, with the yield on the 10-year US Treasury reaching levels not seen since the 1940s. Several of the factors that drove heightened risk aversion remain in place. Against this backdrop, **Rocaton's Lisa Florentine**, Head of Fixed Income Research, discusses the fixed income market and what role active management strategies play in today's macro-driven environment.



Q: What drove the relative underperformance of the spread sectors in the third quarter?

A: We believe that there was no single factor, but a confluence of events that prompted an escalation of the “risk-off” trade. These included the contentious debate regarding raising the debt ceiling, S&P’s downgrading of the U.S. long-term credit rating, largely disappointing economic data triggering expectations for a double-dip recession, and the ongoing European sovereign and banking crises. Additionally the Federal Open Market Committee’s decision to implement “Operation Twist” was an important factor in the strong rally in the long bond and a flattening in the yield curve.

Q: Were there segments of the fixed income market where active management held up better than others?

A: There were few ports in the storm for active managers, as nearly every spread sector produced negative excess returns during the third quarter. Only asset-backed securities held their ground, finishing flat versus Treasuries. As such, only a handful of broad market managers invested in core

and core plus strategies were able to outperform the benchmark, given their tendency to overweight spread sectors. Generally, single sector strategies such as high yield and emerging market debt did better, yet still less than half of the active managers in these sectors were able to outperform their benchmarks during the third quarter largely due to selling pressure, particularly in the most liquid names.

Q: How would you compare the third quarter of 2011 to the 2008 post-Lehman market environment?

A: There were several similarities, including policy uncertainty, extreme risk aversion, and periods of indiscriminate selling. However, there were also a number of key differences. A key driver of the 2008 credit crisis was the unwinding of excessive leverage, which was not apparent in the third quarter of 2011. Furthermore, the credit and funding markets are largely open and we are seeing less impairment risk, as corporate balance sheets are generally flush with cash, and most U.S. banks have recapitalized their balance sheets. In contrast, in late 2008 the interbank lending markets were frozen as banks refused to extend each other credit.

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Q: How have spread sectors performed in the past following substantial drawdowns?

A: It's instructive to look back to the credit crisis and its aftermath to gain some perspective. During the '07-'08 period, credit spreads widened substantially, in some cases to record levels. In hindsight, implied default rates were clearly excessive and, barring a complete collapse of the global financial system, there were numerous opportunities to capitalize on the selloff. Active managers who had the discipline and wherewithal to buy into the oversold market were richly rewarded in the rally that occurred over the next two years. While credit spreads today are not at the extreme levels witnessed in 2008, they are wide relative to historical averages. In addition, fundamentals in markets such as domestic high yield are generally better than they were in 2008 suggesting greater confidence in risk taking.

Q: What is your perspective on passive management given the volatile market environment and recent underperformance of active fixed income managers?

A: Typically, active fixed income managers tend to underperform during periods of extreme risk aversion. In such an environment, passive strategies usually fare better as they seek to mirror an index—often the Barclays Capital Aggregate Bond Index (“Index”)—which has a large exposure to Treasuries. We feel that passive strategies can play an important

role in an overall portfolio, especially for investors seeking to minimize tracking error. But it's important to understand that passive investing has its own set of risks, particularly in the fixed income market. For example, the Index is capitalization-weighted, meaning that the larger the debtor, the larger its allocation in the benchmark. As a case in point, from October 2009 through October 2011, the percentage of government-related issues within the Index rose from approximately 39.9% to 45.6%. As a result, a disproportionate share of the expected risk in indexed strategies is coming from interest rate movements alone at a time when interest rates are at historic lows.

Q: What qualities does Rocaton look for in an active fixed income manager?

A: We continue to favor fixed income asset managers that have solid organizations, experienced professionals, deep credit research capabilities and robust risk management practices. There may likely be continued global uncertainty, which can lead to opportunities for active managers, albeit with potentially higher tracking error relative to the benchmark. This type of environment will also lead to more dispersion of performance results among managers. We continue to try to identify portfolio management teams that consistently adhere to a disciplined process, but that have also demonstrated the ability to adapt to fluid economic and market environments.

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