INVESTMENTINSIGHTS

PERSPECTIVES ON INVESTMENT STRATEGIES

Opportunistic fixed-income investing has the potential to improve yields, returns and diversification, says Brij Khurana, multi-asset portfolio manager at Wellington Management. We asked him to share his perspective on opportunistic investing and on global fixed-income markets.

WHAT DO YOU MEAN WHEN YOU DESCRIBE AN INVESTMENT APPROACH AS "OPPORTUNISTIC"?

Opportunistic investing is well-timed. It is responsive to the changing environment and shifting opportunity sets, and takes advantage of market dislocations. When applying this philosophy to fixed-income investing, we encourage asset owners to consider an approach that is total-return-oriented and benchmark-agnostic, focusing on niche areas outside core fixed income and constructed independently of market indices.

HOW DO YOU SET YOURSELF APART FROM OTHER UNCONSTRAINED FIXED-INCOME MANAGERS?

First, based on our observation, a lot of unconstrained managers in the post-crisis world have had persistent credit biases and a lack of focus on downside mitigation. In our view, a successful unconstrained approach does not rely on a single alpha source, but can access active risk from a diverse set of opportunities: multiple time horizons, styles, geographies, asset types and credit tiers.

Second, we tend to focus on non-core areas of the fixed-income universe as we think it's easier to identify potential alpha opportunities there. They are less well-researched, many competitors are too large to trade within them, and specialist expertise can have significant impact.

Finally, another differentiating area of focus is market-neutral strategies. These are absolute-return-oriented fixed-income strategies with low correlations to traditional market risk factors like duration and credit. In the past, these types of exposures have tended to drive performance when returns from broad market fixed-income approaches have been low or negative.

WHAT BROAD MARKET AND ECONOMIC DEVELOPMENTS ARE OF MOST CONCERN TODAY?

The rise in U.S. treasury yields is draining capital from the rest of the world and causing appreciation in the U.S. dollar, which is now only 2% below its highest level of real exchange rate based on our models. So far, the effect has been felt outside the U.S., with non-U.S. equity markets significantly underperforming the S&P 500. However, we believe if U.S. yields continue to move higher, tightening financial conditions and slowing residential investment are likely to weigh on U.S. growth and asset prices. We believe that spreads on U.S. high-yield and investment-grade credit, in many cases currently don't adequately reflect these risks.

WHAT ARE AREAS OF OPPORTUNITY?

We believe that we have entered an attractive environment for opportunistic investing, as both global macro fundamentals and the pricing of fixed-income assets are diverging. As fundamentals diverge across countries, credit sectors and individual issuers, we are identifying plentiful and significant sector rotation, security selection, duration, currency and country opportunities.

We find valuations in emerging market debt – both external debt and local debt – compelling. Emerging market credit spreads are close to their highest level relative to U.S. high-yield since the pre-crisis environment, real interest rates (rates adjusted for inflation) are close to their highest level relative to developed market yields, and real exchange rates in some countries are at multi-decade lows.

At the same time, we think U.S. high-yield and investment-grade corporate sectors are among the most overvalued in the entire global fixed-income universe.

DO YOU SEE ANY OPPORTUNITIES IN CANADIAN SECTORS OR ISSUERS?

We do see opportunities in Canada. While employment growth remains strong in Canada, we think the neutral policy rate is likely lower in Canada than in the U.S. due to high household debt and uncertainties regarding North American trade policy. The Bank of Canada should be reluctant to raise rates too quickly given the risks to the housing sector, so we expect the spread between U.S. and Canadian rates will likely continue to widen. We also believe that the Canadian dollar is currently undervalued because it has underperformed oil, with which it had been strongly correlated.

HOW DO YOU IDENTIFY PROMISING STRUCTURAL THEMES?

In identifying themes, we believe every economic business cycle is unique and creates singular investment opportunities. These opportunities are amplified by negative investor biases. When investors experience a long period of frustration with one area of the market, unwinding sentiment can take time even after fundamentals have started to turn positive. But once sentiment begins to improve, it can reinforce positive fundamental change and help launch long-term bull markets.

Based on our experience, the ideal investment has a long period of underperformance, with apathy to the sector creating a valuation discount. There is great skepticism about the investment area and little analytical capital committed to it. There is also a catalyst for structural change that reverses previously negative fundamentals.

HOW SHOULD CANADIAN INVESTORS THINK ABOUT THE RISK OF ALLOCATING AWAY FROM CANADIAN MARKETS?

I think the biggest risk Canadian investors should consider is concentration risk. We are now exiting a 10-year period of unprecedented synchronized global monetary and fiscal stimulus that has dampened the volatility of riskier, higher-yielding sectors of the global fixed-income markets. As this unprecedented level of liquidity is removed and central bank policy diverges, we expect volatility in higher-yielding sectors to return to their pre-crisis averages. We strive to diversify risk by not concentrating on any single sector or risk factor and by pursuing a volatility profile that is in line with relevant core fixed income indices.

WHAT CAN INSTITUTIONAL INVESTORS GAIN BY INCORPORATING OPPORTUNISTIC INVESTING INTO THEIR FIXED-INCOME ALLOCATION?

Opportunistic allocations can access non-Canadian markets that offer more attractive yields and return potential, while providing significant diversification by region, country, and sector and security type. Moreover, well-designed opportunistic strategies can be highly dynamic, allowing for timely allocation, which many institutional investors would be challenged to replicate given the internal review process required to make new standalone allocations.

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BRIJ KHURANA
MULTI-ASSET PORTFOLIO MANAGER
WELLINGTON MANAGEMENT

OPPORTUNISTIC FIXED-INCOME INVESTING CAN TAKE ADVANTAGE OF VARIATIONS IN SECTOR RETURNS

Calendar-year total returns (%)

2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
6.4	5.4	6.7	8.9	3.6	-1.2	8.8	3.5	1.7	2.5
9.1	57.7	19.0	9.2	19.2	6.5	8.1	1.8	15.6	15.2
8.5	51.6	15.7	7.9	18.0	5.3	7.6	1.5	10.2	8.4
-5.0	26.0	15.1	7.0	16.8	0.3	6.2	1.4	9.9	8.3
-5.1	25.6	11.8	6.3	10.9	0.1	6.1	0.9	9.6	6.0
-5.2	22.0	10.1	5.5	9.7	0.1	5.7	0.7	6.2	4.1
-9.7	16.6	8.2	4.8	9.2	-0.1	3.4	-0.2	4.2	3.5
-16.7	16.5	7.2	3.6	6.6	-1.5	2.6	-0.7	3.9	2.8
-25.2	5.7	5.5	1.5	4.5	-8.3	1.6	-0.7	3.2	2.5
-29.1	1.0	3.6	-1.8	2.6	-9.0	-5.7	-14.9	1.7	2.1

Governments · MBS · CMBS · Bank loans · Emerging local
Corporates · ABS · High yield · Emerging external · FTSE Canada Universe Bond

Returns are as of 31 December 2017 and are sourced from third-party index providers. Sub indices of the Bloomberg Barclays Global Aggregate hedged to USD index were the source of Treasuries (governments), corporates, MBS, ABS and CMBS data. The Bloomberg Barclays Global High Yield Index and the S&P LSTA Leveraged Loan Index were the sources of the high-yield and bank loan data, respectively. The JP Morgan EMBI Global Diversified and the GBI-EM Global Diversified indices were the sources of the emerging external and emerging local data, respectively. The FTSE TMX Canada Universe Bond Index was the source of FTSE Canada Universe Bond data. Past results are not necessarily indicative of future results and an investment can lose value.

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