Bifurcate your bond portfolio

You wouldn't ask your private equity manager to oversee your real estate investments, and you wouldn't ask your small cap equity manager to handle your infrastructure assets. So why is your interest rate manager determining your credit exposure?

It is time to ***bifurcate*** the exposures in your bond portfolio. i) Interest rate exposure, also called duration risk, and ii) credit risk are the two major factors in the performance of a bond. Both are powerful and important exposures in a portfolio, that move discretely, for distinct reasons at different times.

The optimal fixed income portfolio has evolved to include a personalized mix of several asset classes, including bonds, mortgages, real estate (equity), infrastructure (equity), private debt, and possibly high yield. Portfolio management is now evolving to recognize the expertise required within the bond allocation to manage the interest rate and the credit exposures separately. From my experience over decades in institutional capital markets, interest rate experts and credit experts are two different people, working in different departments, with distinct skill sets.

Rate Exposure vs. Credit Exposure

Portfolio construction is about diversifying a portfolio to include a mix of exposures that are intended to best meet your return targets, within your risk tolerance. To do that effectively, the exposures need to be carefully chosen and then the best source for each exposure carefully selected. That is all somewhat obvious for the major asset classes or selected exposures, yet it is maybe less obvious, or has been done in a certain way for so long, that interest rate risk and credit risk are very different exposures that need to be selected and managed separately.

Isolated interest rate exposure has long been available, most obviously through a domestic or global sovereign bond fund. It may surprise some that there are proven strategies that isolate the other main exposure imbedded in a bond, namely the credit spread portion of non-government bonds. The credit spread is equal to the bond's total yield minus the government bond yield. This pure credit spread is delivered by a specific credit strategy that owns a portfolio of corporate bonds and eliminates the interest rate risk.

Effective credit strategies are difficult to implement for most investors due to the tools and experience required, and essential access to primary and secondary liquidity. Therefore, pure credit exposure is better sourced through a fund. These expert funds are available for institutional investors who are considered accredited and can accept modest illiquidity, or via a public, prospectus fund with a modest required minimum investment and daily liquidity. They are commonly called Credit Funds or Long/Short Credit Funds.

Rates Expertise

When you stop to consider it, the seemingly simply task of selecting optimal interest rate exposure is in fact quite challenging. The rates manager is required to consider: the shifting direction of interest rates, how different parts of the 30-year curve will react, bond fund flows and demand for bonds by various investor-types, monetary policy, currency effects, new issue supply, inflation effects, benchmark premium, convexity, bond futures, liquidity, etc.

Credit Expertise

Investing in credit requires its own distinct of skills. Some overlap but most are notably different than the focus of the interest rate portfolio manager. A credit manager must have their own skills, experiences, and tools to focus on; corporate credit analysis, rating agency valuations, new issue supply, covenants, structural subordination, the effect of interest rate movements, bond flows, credit market liquidity, relative value versus domestic comps and versus US credit, roll-down between credit-buyer types, etc.

As noted above, few bond experts are elite in one of these skill sets, let alone both rates and credit. That is why trading desks, hedge fund managers, pension funds and life insurance companies have a clear delineation between their rates and credit personnel. Doesn't your portfolio deserve distinct rates experts and credit experts?

To further develop the theme of bifurcating your bond portfolio, or the consideration of investing in pure credit exposure, the chart below depicts the "excess return" of credit over interest rates. The bars on the chart demonstrate the return from an investment grade credit spread index versus a similar term government bond index, where positive returns are the bars above the line. A simple eye test reveals both the distinct nature and consistent appeal of pure credit exposure ovewr the last 10 years. Similarly, Morningstar data confirms that at least one Canadian pure credit strategy had better return and better Sharpe ratio metrics than all traditional long-only Canadian fixed income funds since its July 2015 inception date.[1]

Source: Bloomberg

Gone are the days when a single universe bond portfolio made up 40% of the total portfolio or the entire fixed income allocation. That evolution into a multi-exposure fixed income portfolio now also includes a bifurcated approach to investing in interest rates and credit spreads, and it has improved portfolio performance. Consider adding the right credit expert to your portfolio team.

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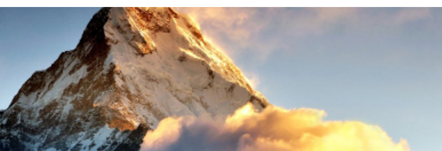
[1] July 1, 2015 to Dec 31, 2022. Long-only fixed income funds are represented by 345 mutual funds and ETFs (Series F or equivalent) in Morningstar's Canadian database. YTM Capital Credit Opportunities Fund had the highest 7 year return and Sharpe Ratio (Class F, distributions reinvested) compared to the group. Investors should read the OM before investing. Past performance may not be repeated. www.ytmcapital.com



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