7 WAYS Unconstrained Bond Funds Can Outperform

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Most bond fund managers are required to track an index.

This approach worked well during the 35-year bull market in bonds. But these days, it takes more freedom and creativity to generate income and manage risk.

With interest rates still low, bond prices have very little room to rise. And most of the ways conventional bond fund managers can add value tend to bring unwanted consequences. For example, investing in lower-quality bonds or longer-term bonds might enhance returns, but they can also lead to higher volatility and greater risk of loss.

The reaction among some of the world's leading investment thinkers has been to ease the constraints placed on bond fund managers. This has given rise to a new breed of "unconstrained" manager that is no longer required to mimic a narrow benchmark.

These managers have greater freedom to look for opportunities in new and different places. They can find value in unique issuers, roam the yield curve, jump on a timely play or move quickly to cash in ways that others that simply follow an index can't. And they can backstop every move with risk management tools designed to make market downturns less damaging—and sometimes even profitable.

Unconstrained Bond Funds seek positive returns with less volatility.

As a result of their flexible mandates, unconstrained bond funds cannot be compared to a narrow conventional index. Instead, they seek a positive return in excess of the rate of inflation with less volatility than the index. This may be why, in the U.S., they have attracted assets at a much faster pace than other bond funds since 2013.

Here's a snapshot of seven "performance levers" an unconstrained bond fund manager can pull in pursuit of better investment outcomes.

COMPARING STYLES OF BOND FUNDS

	CONVENTIONAL	UNCONSTRAINED
1. Asset allocation	Limited by index weightings	Unlimited
2. Duration	Limited by index duration	Unlimited
3. Credit	Limited by mandate of the fund	Unlimited
4. Geography	Limited by mandate of the fund	Unlimited
5. Currency	Limited by mandate of the fund	Unlimited
6. Short selling	Allowed but rarely used	Allowed
7. Options	Allowed but rarely used	Allowed

In the following pages, we'll take a closer look at how these levers work.

Lever 1

Asset Allocation

Unconstrained managers are not tied to a narrow benchmark.

That means they can be highly tactical in their asset allocation. They can have any weighting in any fixed income asset class, including cash, without restriction. This table shows you the relative performance of seven fixed income asset classes over a six-year period.

RANKING THE ANNUAL RETURNS OF FIXED INCOME ASSET CLASSES

2012	2013	2014	2015	2016	2017
Emerging Market Bonds	US High Yield Bonds	US Gov't 20+ Year Bonds	Emerging Market Bonds	US High Yield Bonds	US Gov't 20+ Year Bonds
US High Yield Bonds	Euro Floating Rate Bonds	US Treasuries	US Gov't 3-5 Year Bonds	Emerging Market Bonds	Emerging Market Bonds
US Gov't 20+ Year Bonds	US Gov't 3-5 Year Bonds	Emerging Market Bonds	US Treasuries	US Gov't 20+ Year Bonds	US High Yield Bonds
Euro Floating Rate Bonds	US Treasuries	US High Yield Bonds	Euro Floating Rate Bonds	C$/US Cash	C$/US Cash
US Gov't 3-5 Year Bonds	Emerging Market Bonds	US Gov't 3-5 Year Bonds	US High Yield Bonds	US Gov't 3-5 Year Bonds	US Treasuries
C$/US Cash	C$/US Cash	Euro Floating Rate Bonds	US Gov't 20+ Year Bonds	US Treasuries	US Gov't 3-5 Year Bonds
US Treasuries	US Gov't 20+ Year Bonds	C$/US Cash	C$/US Cash	Euro Floating Rate Bonds	Euro Floating Rate Bonds

Source: FactSet, Bloomberg Barclays Indices.

You will note that more than one of these asset classes has been both the best-performing and worst-performing over the period. An unconstrained manager has the freedom to move in and out of these asset classes at will.

Lever 2
Duration

Unconstrained managers can lengthen or shorten the duration of their portfolio in response to the interest rate outlook.

In a falling-rate environment, they may lengthen duration to capture more upside. In a rising-rate environment, they may shorten duration to reduce the risk of loss. This chart gives you a quick rule of thumb for estimating the impact of duration:

DURATION AND THE IMPACT OF A CHANGE IN INTEREST RATES

Portfolio Duration	1% Increase in Interest Rates Impact on Portfolio Value	1% Decrease in Interest Rates Impact on Portfolio Value
3 years	-3%	+3%
5 years	-5%	+5%
10 years	-10%	+10%

For illustrative purposes only.

Conventional bond fund managers have to construct their portfolios' duration to mirror that of their index. The FTSE TMX Canada Universe Bond Index is the benchmark most commonly used by Canadian bond managers. The duration of this index has steadily increased as interest rates have fallen over the years and is currently at a duration of approximately 7.4 years*. This means that these funds, traditionally viewed as safe, have in fact a high degree of interest rate sensitivity and can be quite volatile.

*Source: FTSE TMX Canada Universe Bond Index.

Lever 3
Credit

Unconstrained managers know that the global fixed income market is not perfectly efficient.

This means that it is sometimes possible to invest in bonds of lower credit quality that can add a unit of return without adding an equal unit of risk. When these opportunities emerge, unconstrained managers can take advantage of them to improve risk-adjusted returns.

THREE EXAMPLES OF UNCONVENTIONAL CREDIT OPPORTUNITIES

AUTO CREDIT

During the financial crisis, the credit rating of bonds backed by auto loans was being downgraded. This forced traditional bond funds to sell. But unconstrained managers had the option to continue holding the bonds or to buy them at lower prices during the sell-off.

ENERGY SECTOR

Most funds that track a high yield bond index had significant exposure to the energy sector during the steep decline in oil prices. However, unconstrained bond funds had the option to exit the sector during the decline and buy back at lower prices later.

CROSSOVER BONDS

Crossover bonds are rated as junk bonds, yet have risk characteristics like investment grade bonds. These bonds are often issued by fast-rising companies in transition and are another unique opportunity available to unconstrained bond fund managers.

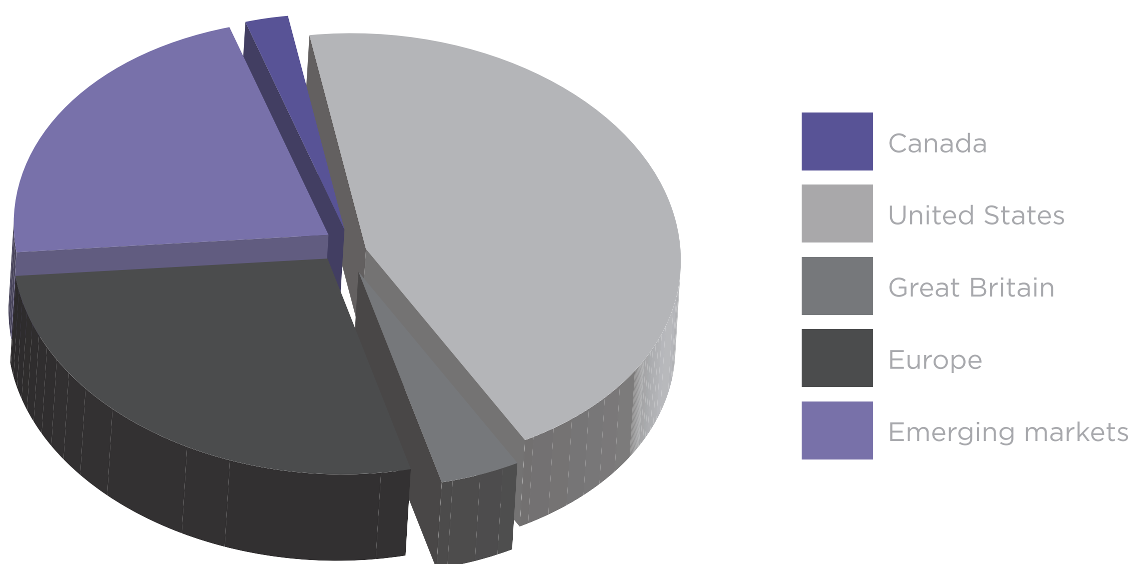
For illustrative purposes only.

Credit quality is one of many factors prescribed by an index. This can prevent conventional bond fund managers from taking advantage of certain opportunities, and it can also force them to remain in areas of the market that are likely to underperform. Flexibility around credit quality is another important lever that the unconstrained manager can pull.

Lever 4
Geography

Unconstrained managers can invest anywhere in the world.

Although Canada is generally a desirable market, it makes up a thin slice of the global pie. The face value of all Canadian high yield bonds outstanding was about USD$50.8 billion at February 28, 2018, or just 2.42% of the $2.1 trillion global total, as this chart illustrates.



Source: Bloomberg, Bank of America Merrill Lynch.

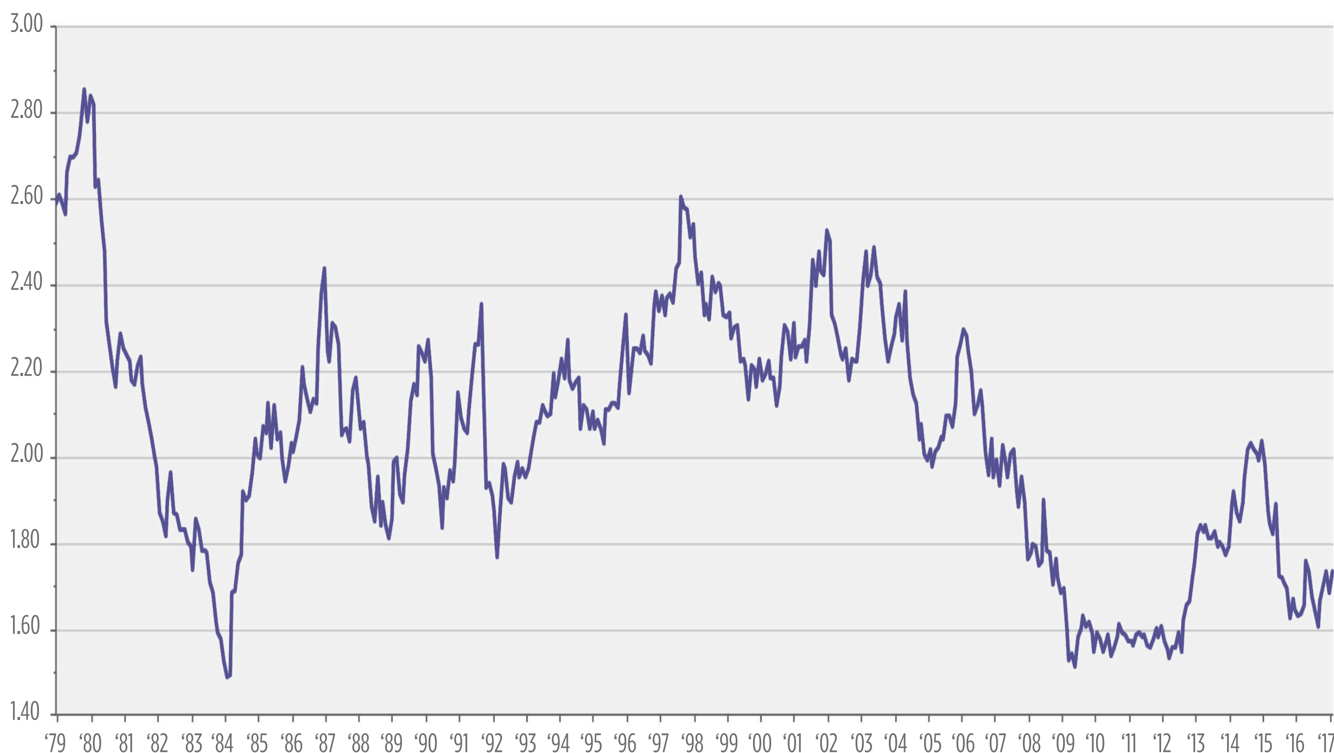
Being able to cross borders gives unconstrained managers the ability to pursue value wherever it may be found. This is in contrast to conventional managers who may be tied to an index with undesirable traits. For example, global bond managers must contend with the fact that heavy bond issuance by Japan has given the country a disproportionate weighting in the index.

Lever 5
Currency

Unconstrained managers can buy bonds denominated in almost any currency.

This graph uses the exchange rate between the British Pound and Canadian Dollar since 1980 to illustrate how widely currencies can vary over time. Choosing to hedge or expose a bond portfolio to these fluctuations can be a source of alpha for unconstrained managers.

BRITISH POUND VS. CANADIAN DOLLAR (1980 TO PRESENT)



For illustrative purposes only.
Source: Factset at December 31, 2017.

As most Canadians are well aware, our dollar declined sharply in 2015. Because of this, a Canadian unconstrained manager who held bonds denominated in British Pounds throughout the year could have brought the proceeds back home and added a currency gain of nearly 13% to their returns.

Lever 6
Short Selling

Unconstrained managers have the freedom to use short selling.

In essence, short selling means "selling high and buying low." You borrow a bond from a broker, sell that bond in the market, re-buy it for a lower price at a later date, give it back to the lending broker, and keep the difference (minus interest) as a profit. Here are three scenarios where an unconstrained manager may use short selling.

THREE SHORT-SELLING STRATEGIES

1

ANTICIPATING A FALL IN THE VALUE OF A SECURITY

If an unconstrained manager anticipates that a given bond will fall in value, he or she can **seek a profit** by shorting the bond.

2

ANTICIPATING A RISE IN INTEREST RATES

If an unconstrained manager anticipates that interest rates will rise and bonds will fall, he or she can **protect against loss** by shorting the bond market.

3

TAKING ADVANTAGE OF CREDIT SPREADS

If there is a large gap between government and corporate bond yields, an unconstrained manager can **seek a profit** and **reduce interest risk** by shorting government bonds and buying corporate bonds.

As this table shows, unconstrained managers can use short selling to seek profits and to manage interest rate risk. This strategy can be used to capture returns from securities that are expected to decline in value, or as a pre-emptive move against market declines, or to take advantage of attractive credit spreads.

Lever 7

Options

Unconstrained managers can use options to reduce losses and enhance returns.

The two basic types of options are puts and calls. When you buy a put option, you are buying the right to sell an asset—such as an individual bond or a bond index ETF—at a specified "strike" price before a certain expiry date. Call options are the opposite—they give you the right to purchase an asset at a certain strike price before the expiry date. Unconstrained managers can buy or sell puts and calls either to be defensive or opportunistic.

TWO OPTIONS STRATEGIES	
DEFENSIVE **Buying Puts to Reduce Losses**	OPPORTUNISTIC **Buying Calls to Enhance Returns**
If an unconstrained manager thinks the bond market is at risk of a decline, he or she can purchase a put option on a bond index ETF. If the index declines below the strike price, the option should rise significantly in value. The manager can then exercise the option and realize a profit that can help offset the overall impact of the market decline.	If an unconstrained manager expects a bond to rise in value but wants some downside insurance, he or she can purchase a call option on that bond. If the bond fails to rise above the strike price before expiry, the only loss will be the cost of the option. But if it rises above the strike price, the manager can exercise the option and realize a significant profit.

Sometimes, an unconstrained manager will simultaneously buy or sell a number of put and call options at the same time with the goal of improving the overall risk/reward profile of the portfolio. Strategies using multiple options are often aimed at reducing the portfolio's downside potential in exchange for a small reduction in its upside potential.

It's all about calculating the trade-off between the cost of purchasing options and the benefits they can provide.

Thoughts on implementing an unconstrained bond strategy

Unconstrained bond funds have at least seven different performance levers that are simply not available to most conventional bond funds. Knowing this fact, the next question is how to implement an unconstrained bond strategy within a broader portfolio.

AT NINEPOINT PARTNERS LP, THERE ARE A FEW THINGS WE BELIEVE YOU SHOULD CONSIDER:

ADD TO EQUITY OR FIXED INCOME
An unconstrained bond fund does not perform like an equity fund or a conventional bond fund. It seeks positive real returns with reduced volatility, and can be added to almost any other asset class to achieve the benefits of diversification.

CHOOSE A SMALLER FUND
Unconventional bond funds should be nimble, and a fund that's too large can actually be constrained by its size. Look for a smaller, more nimble fund that can get in and out of positions quickly without moving the market.

GET THE VALUE OF ACTIVE MANAGEMENT
It's now very difficult for active managers to add value in the conventional bond space. Consider using a passive fixed income core then adding an unconstrained bond fund that truly lets the portfolio manager shine.

The financial crisis, record-low interest rates and a 35-year old bull market in bonds have created a unique environment—one that demands greater freedom and creativity to capture yield and protect the capital of investors. From where we sit today, we believe an unconstrained bond fund can play a positive role in virtually every investor's portfolio.

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