IS CORE FIXED INCOME A COMMODITY?

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In the investment industry, there is a widely-held belief that a Core Fixed Income strategy is a commodity. There are variations among managers and styles of course, but over time those distinctions will offset and there will ultimately be an immaterial difference in returns. Further, with yields across the investment grade universe near historic lows, the distribution of returns across managers should be even less substantial on a relative basis.

The question necessarily becomes, is there evidence to support this belief? Or are there in fact significant differences in returns over longer periods of time? If there are, the costs of assuming homogeneity could be more significant than investors realize.

REMOVING THE NOISE

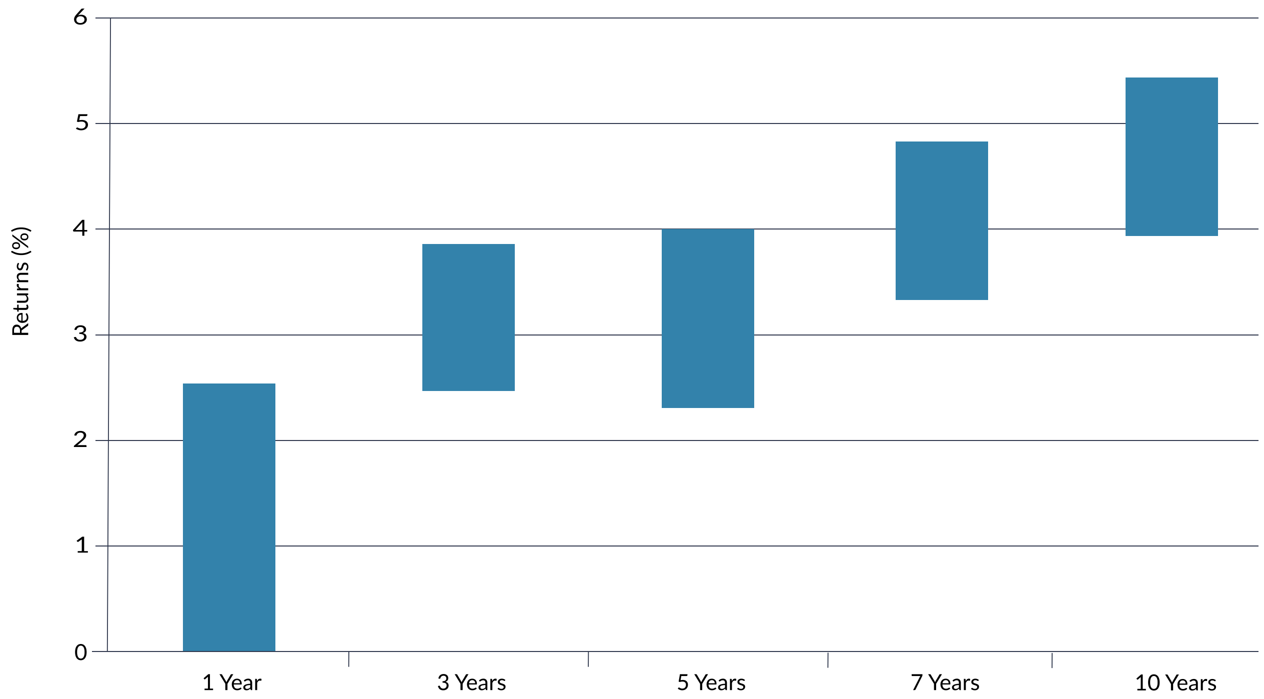
We wanted to explore this concept further, but to do so objectively, it was essential to level the playing field. Return differences between core managers can most often be explained by two factors: managing to either different benchmarks or duration targets, and/or a measurable allocation to "non-core" or below investment grade securities.

With these factors in mind, we evaluated a universe of institutional core managers with the most comparable objectives and characteristics we could find. The Core managers in this peer group all list the Bloomberg Barclays Aggregate Index as their primary benchmark, share a common duration range, and have an inconsequential allocation to "non-core" bond sectors such as High Yield or Emerging Markets. Finally, all return statistics for these managers were viewed gross of fees to further eliminate any nuances caused by expenses. In other words, we constructed the most "commoditized" group of institutional core managers possible.

Below we show the distribution of returns for this peer group across 1, 3, 5, 7, and 10 year periods. As you can see, even over the longest time interval (10 years), the average annualized return difference between the 5th and 95th percentile is substantial at 1.58%.

In economic terms, that's a difference of $15.8 million every year for a $1 billion core strategy.

Figure 1: US Core Fixed Income Distribution of Returns



Annualized Returns	1 Year	3 Years	5 Years	7 Years	10 Years
5th Percentile	2.51	3.82	4.01	4.90	5.53
95th Percentile	-0.01	2.38	2.32	3.42	3.95
Percentile Return Difference	2.52	1.44	1.69	1.48	1.58

EXPLORING THE DIFFERENCES

So if performance does in fact affect returns for investors, what is driving the differences in a low interest rate environment? When you dissect the core universe by size, there is a consistent pattern of manager returns relative to the benchmark Bloomberg Barclays Aggregate Index. Figure 2 shows a heat map of the average risk adjusted excess returns versus the benchmark by core managers within each size category.

The colors move gradually from dark green representing the highest (and therefore the best) returns to dark red representing the lowest. Noticeably, the mid-size managers with core assets ranging from $10 billion-$25 billion exhibited consistently superior performance, while both the largest and smallest managers uniformly trailed.

Figure 2: Risk Adjusted Excess Return* Dispersion Annualized (bps)

Size of Manager	1 yr	3 yrs	5 yrs	7 yrs	10 yrs
Under $1 Bln	0.23	0.33	0.41	0.51	0.58
$1 - 5 Bln	1.00	0.55	0.70	0.75	0.71
$5-10 Bln	0.90	0.41	0.62	0.72	0.82
$10-25 Bln	0.97	0.58	0.79	0.95	0.91
$25-50 Bln	0.64	0.34	0.47	0.50	0.42
Over $50 Bln	0.44	0.31	0.37	0.45	0.41

Source: InvestWorks US Broad Market Core Fixed Income Separate Accounts and Common Funds Universe. Average Annual Data as of 3/31/2017 US Core Managers benchmarked to the Bloomberg Barclays Aggregate Index. Excludes those with 2% or more in Emerging Markets, High Yield, or Bank Loans.

**Risk Adjusted Excess Return is defined as Alpha. Alpha is the measure of the difference between the portfolio's actual return versus its expected performance, given its level of risk as measured by beta. It is a measure of the portfolio's performance not explained by movements of the market.*

One way to analyze this underperformance is to explore the managers' average sector allocation along the same size segments we examined above. In Figure 3, the table highlights that larger managers had hefty allocations to liquidity sectors such as US Treasury and Agencies and the lowest allocation to credit related sectors that traditionally offer more yield. Green indicates the highest average allocation in the peer group while red indicates the lowest.

We can see that the $50 billion and over category had the lowest allocation to credit sectors and overall, the most benchmark-like allocations. This helps explain why the largest managers appear to have the most difficulty delivering excess returns as their positioning closely aligns them with the benchmark itself. There is a 50 basis point difference between the alpha of a $10-25 billion manager relative to a $50+ billion manager.

For the smaller managers there is no specific explanation for their underperformance other than they lack the resources or scale to gain full access to bond dealer offerings.

Figure 3: Investment Grade Sector Allocation (%)

	Liquidity Sectors		Credit Sectors		
Size of Manager	Treasury/Agency	MBS	US Corporates	ABS	CMBS
Under $1 Bln	28.96	23.37	32.82	5.42	3.69
$1 - 5 Bln	22.35	25.21	35.03	6.34	4.80
$5-10 Bln	30.43	25.29	34.29	2.42	3.25
$10-25 Bln	21.71	27.86	28.00	8.86	5.43
$25-50 Bln	28.20	31.80	30.80	5.30	5.50
Over $50 Bln	34.75	26.50	20.50	2.25	2.50
Bloomberg Barclays Aggregate	39.54	27.29	25.43	0.48	1.78

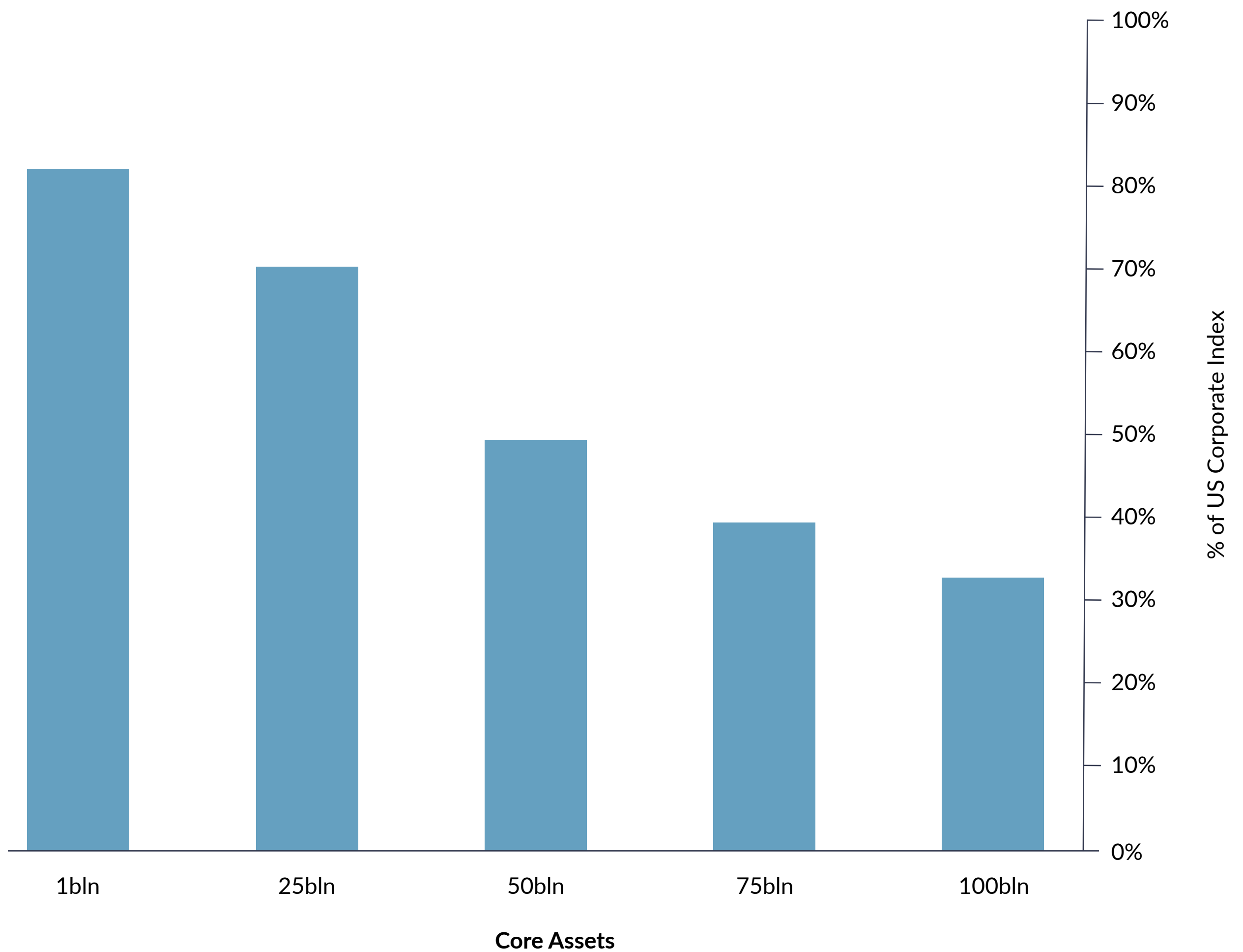
Source: Investworks, excludes some smaller sectors labeled as "other" in the Investworks database

IDENTIFICATION VS. EXECUTION

It stands to reason that the largest managers have more difficulty allocating to credit sectors simply because these sectors make up a much smaller portion of the investment grade universe. And even if you successfully allocate to these sectors, it is even more challenging to accumulate an overweight position in a particular credit that offers value. To illustrate this point, the figure below shows the percentage of the US Corporate Universe that is eligible to accumulate a 0.5% position, again segmented by asset size. 0.5% indicates an overweight level of conviction for a corporate bond relative to the index, yet also ensures a prudent level of diversification in a portfolio. We define eligible issuers as those large enough to accumulate a 0.5% position without exceeding 10% of the corporation's total bonds outstanding.

As you can see in the chart below, the corporate issuers eligible to purchase an overweight position shrinks dramatically for managers with assets above $25 billion. Less than half of the index is eligible at $50 billion and only one-third of issuers are large enough at $100 billion. This indicates that acting on recommendations from credit teams becomes increasingly difficult for strategies above $25 billion given the limited size and scale of credit related markets. These managers have the ability to purchase the issues, but it is much more difficult to accumulate more than a market weight position. This makes it challenging to outperform the index. While this example addresses issues related to purchasing, it also pertains to the potential difficulties these same firms encounter when selling large positions as credit or valuation concerns arise.

Figure 4: % of US Corporate Issuers Eligible to Overweight



Source: US Corporate Universe = Bloomberg Barclays US Corporate Index US Issuers as of 6/30/2017.
** As of 6/30/17 JPM is the largest US Corporate Issuer Representing 0.53% of the Bloomberg Barclays Aggregate Index. The average largest holder in the Us Corporate Index is 9%*

Additionally, even the ability to trade substantial amounts of bonds has declined significantly. Bond dealer corporate inventories have withered as a regulatory consequence of the financial crisis. Because dealers have less capital to make markets buying and selling bonds from their customers, trading volumes overall, especially in larger sizes, have contracted. For example, only 6% of the trades that occurred for the 10 largest bonds in the index were $5 million or greater. To put that in perspective, $5 million represents a 0.50% position for a $1 billion portfolio.

Figure 5: % of Largest Corporate Bond Trades Based on Size

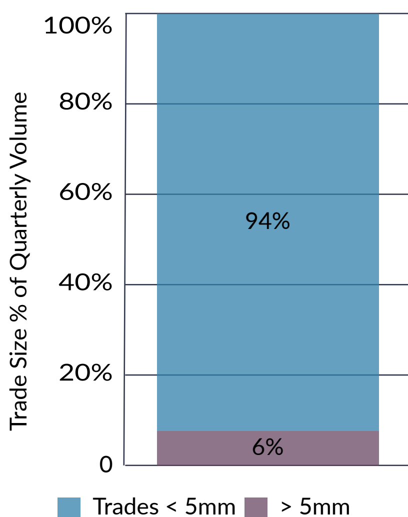
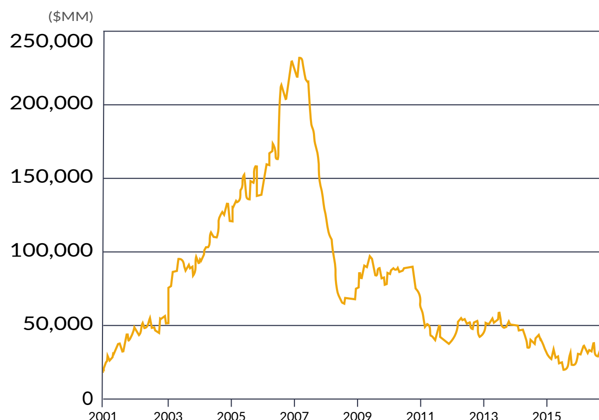


Figure 6: Corporate Dealer Inventories



Source: AAM, TRACE Data. Average trade stats for 10 largest US Corporate Issuers 3/31/17-6/30/17.

KEY TAKEAWAYS

This analysis has focused on the corporate universe because it is the largest credit related sector. A similar evaluation of the ABS and CMBS sectors would show even less flexibility given the smaller size of these markets. The industry can sometimes assume that larger managers provide superior returns given their size and market influence. However, it can be demonstrated that size potentially limits the ability to implement relative value views across investment grade sectors or individual credits. Scale and trading limitations can result in portfolios with heavy allocations to Treasury and Agency related securities that are not desirable for income oriented insurance investors.

Ultimately, we have shown a connection between the size of a manager's assets and their portfolio characteristics, which is then reflected in their investment performance. Managers need size to provide the expertise to successfully navigate the market, but being too large can limit execution of investment ideas.

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