

Fixed Income: A Great Source of Alpha in Portfolios

- While credit spreads are tight, we believe there are still good values across public fixed income.
- We discuss our position on duration given the rise in energy prices and worries about inflation.
- With geopolitical risks on investors minds, we view Emerging Market debt as a good source of carry, with a low correlation to the drivers of U.S. markets.

Jim Caron: Hello, this is Jim Caron, CIO of the Portfolio Solutions Group. Welcome to another edition of Caron's Corner powered by The BEAT, our asset allocation framework across Bonds, Equities, Alternatives, Taxes and short-term Transitional (cash) investing.

I am super excited about this podcast because we have a special guest speaker, Jeff Miller, who heads our fixed income franchise. And the reason I'm so excited about this is because when we're putting together multi-asset portfolios, fixed income has a major role to play in this asset allocation, and it's not what you might think. It's not just a hedge to your equities. I actually think it's a big source of alpha through actively managing your fixed income, and if you can manage your fixed income properly, you can add alpha to your portfolio more easily than actually managing your equities. So let me get right into it.

Jeff, public credit spreads today are relatively tight and there were concerns obviously about private credit, geopolitical events, and in light of these risks, is there still good value in public fixed income or is the bond market just grown complacent?

Jeff Mueller: First of all Jim, thanks for having me. A succinct question, but plenty of interesting angles for us to dive in on. I'll start with credit spreads. You mentioned that public credit spreads are tight and I'd agree with that when we're talking about certain parts of the market. If we look at investment grade corporate spreads, they're around the tightest decile in history. High yield spreads are in those similar or relative evaluation brackets. Now we think there's some important reasons why spreads are trading in those ranges. If you look at corporate fundamentals, we're in a relatively healthy position, leverage interest coverage in reasonable places. We know earnings growth has generally been strong and on top of that we see in certain parts of the corporate credit market much higher quality than we've seen in the past. For example, you look at the U.S. high yield market, we've got about 58% exposure to BB in that part of the market. That compares to 38% prior to the financial crisis. But certainly when we think about deploying capital in these parts of the market, obviously, these tight spreads can inform our risk posture.

But I also think it's really important to recognize fixed income is not one single market, right? Beneath tight index level spreads, there's real dispersion, whether that be across asset classes, across different sectors, even across individual capital structures. So while high yield spreads might be tight and investment grade spreads might be tight, spreads in other parts of fixed income like loans, securitized

credit or emerging markets can still be attractive. That's where active management really matters because broad credit data can be less compelling when spreads are tight, but credit selection can still add meaningful value.

The other thing worth emphasizing is we need to separate spread valuations from all-in yield levels. We've highlighted that spreads are relatively tight in certain parts of the market, but all-in yields still remain quite compelling, at least on a historical basis. As we know, starting yields is one of the best predictors of forward-looking returns within fixed income. So if we look across that market today, you can still find yields around 5% in investment grade, 7% in high yield, above 8% in loans, and then there are attractive income opportunities across the rest of the fixed income universe, whether that be in securitized communities or emerging markets. I think those yields provide some cushion if conditions deteriorate and they give investors the potential to earn attractive total returns without necessarily taking on some of the risk factors you'd historically have to take, uh, in order to earn those returns.

The last thing I wanted to touch on is private credit. That's a fair topic given some of the indigestion we've seen in that market. I think the reality is that direct lending has become a large, mature market and it's provided important financing to different credits, particularly small and mid-sized companies, and we certainly think that this is going to be a part of the credit asset class that has an important role to play going forward. But certainly understand the reasons for some concern in that part of the market, particularly given the concentration in software and other business models that are facing AI-related disruption risk, that you typically see direct lending BDCs anywhere between 20% and 40%. Exposure to software and those questions around whether it's business model durability leverage refinancing walls or factors that are causing default expectations in the market to move higher. And while I'd expect some sympathetic read through to public credit markets, the reality is that exposure to software in the loan market is much lower, kind of mid-teens, and it's barely present in the high yield market, only 3 or 4%. We would expect those public credit default rates to remain relatively more subdued and don't see those concerns about systemic risks as likely to come to fruition. I think bottom line is that the bond market, like any other part of the financial markets, it's not without risk and spreads in certain subsectors or tight, but that those features of daily liquidity, transparency, active relative value opportunities combined with that all-in yield proposition is one of the things that have attracted investors to the asset class and a real important role for fixed income to play in portfolios going forward.

Jim: Thanks Jeff for unpacking the spread story. It does seem like the index doesn't tell the whole story. The indices these days are higher quality, less leverage and that probably explains some of the tightness and spreads. But as you point out, there are other areas of the market where spreads are wide and very attractive, and that's where active management can play a really big role. The other thing though that I'd like to ask you about is duration and interest rate risk. Given the fact that energy prices have risen and people are worried about inflation, how do you manage the interest rate risk, which is one of the larger parts of return in your portfolio for fixed income? How do you manage that interest rate risk across your fixed income franchise?

Jeff: Duration is one of the most important risk levers in fixed income, and we treat it as an intentional portfolio decision. It's not just a passive byproduct of benchmark exposure and our investment style is

definitely anchored in bottom-up fundamental research. But there certainly are markets where those top-down duration positions could really be a significant determinant of return. So we've got to be nimble and we've got to use the full toolkit in terms of explaining how do we manage that risk. The first thing we do is distinguish between different types of inflationary pressures. If we're talking energy-driven inflation that can certainly lift headline inflation quickly but is episodic. The more important investment question is whether those shocks become persistent through a rise in inflation expectations through wages or central bank reaction functions. But I think that distinction matters because not every inflation shock should lead to the same portfolio response. In some cases if we're dealing with supply side constraints, you might want to express caution through curve positioning or breakevens rather than simply cutting duration across the board. But if it becomes more entrenched, that's where a more defensive posture's really important.

I'd say across our franchise, the approach has a couple of different pieces. First, you've got to separate level risk from curve risk, and you might not want a large outright duration position if inflation risk is rising, but there can still be attractive relative opportunities along the curve. In today's market, we think the belly of the curve is interesting. The second point is that we don't plan for just one scenario. We stress test portfolios across multiple regimes. We've got to look at scenarios where growth is slowing down and duration as a benefit or inflation shocks where it hurts or a stagflationary environment where correlations increase and you've got to manage both credit and rates appropriately. The third point is we can still use duration as a diversifier. We've mentioned credit spreads being tight in some sectors. High-quality duration can still play an important defensive role if you really believe that growth is going to deteriorate or risk assets are going to reprice meaningfully. So we're not structurally avoiding duration in this market, but we're certainly being selective about how much we own, where we own it and what role it plays. The last point is that within fixed income there are certain parts of the market which have a lot of duration, but there's a lot of tools that you can use in a lot of different parts of the fixed income space. You can reduce interest rate sensitivity, whether that be in the floating rate loan market or CLOs which have less duration exposure. There's parts of the securitized market that certainly come with higher income and less pure rate sensitivity. We can use TIPS and breakeven on a tactical basis. Then importantly, multi-sector portfolios have the ability to dynamically rotate across duration and spread opportunities as market conditions change.

But I think for us to tie it together, we don't want to just solve an inflation problem slowly with a rates trade. We want portfolios that can absorb a range of outcomes. And it's valuable as a diversifier from a duration perspective, but in this environment, you really need to actively manage across rates, across the shape of the curve and across your broader portfolio risk budget.

Jim: Effectively what you're saying is that the approach that you are taking is that you don't want to be held hostage by the interest rate cycle, that you use active management and think about duration also as a diversifier because look, let's face it, long duration is a tail risk hedge for markets, so it's very important to have that in the portfolio in combination. Now speaking about some of these risks that are out there let's talk a little bit about emerging market (EM) debt in the context of geopolitical risks. This is absolutely top of mind. So is emerging markets a viable investment opportunity, or an area to avoid until there's more clarity?

Jeff: Emerging markets is incredibly topical, Jim. There's a lot going on out there and a lot of client conversations that we're having revolve around this topic. The first thing I'd say is we can't treat emerging markets as a monolith, right? This is a very broad universe. The opportunity set depends heavily on what's happening from a country fundamental standpoint, from a policy credibility standpoint and certainly from a reform momentum standpoint. If we take a step back from a cyclical perspective, coming into this year we were very constructive on the backdrop for emerging market debt. If we look at inflation, it is generally more contained in many economies, in some cases below pre-pandemic levels, which certainly contrasts with a lot of the developed world. Base rates were generally high, real yields attractive and we had a weak U.S. dollar environment which was a helpful tailwind for EM. The geopolitical backdrop has clearly created some of that near-term volatility. We've seen commodity prices on the rise, currency weaknesses and some selective spread widening. Our posture from a portfolio perspective remains nimble given the immediate uncertainty, but I think if we take a medium to longer term view, the base case is certainly that there will eventually be a resolution to this conflict.

This then really goes to our philosophy, one which is to use the full investable EM universe, which is much broader than just the benchmarks and allows us to lean into different countries that are showing positive structural change and economic reform. Then we can avoid those places where there's fiscal stress, policy uncertainty or commodity import vulnerability. That could repair the ability for these countries to repay debt. It's important to recognize that fundamentals are improving in many of these countries. Central banks are in good positions in countries that went through really difficult periods post the pandemic, which forced a lot of conservative fiscal policy stances. The cleaning up of weaker balance sheets means that EMs are in a pretty good position right now, and I think within a diversified portfolio. EM can really help be a source of carry and diversification. We're in a world where developed market duration is exposed to all the things we talked about before from an inflation perspective. We've talked about spreads being tight, but in emerging markets, we can get high starting yields, we can get policy-driven alpha opportunities, and we can get country-specific reform stories that are not purely dependent or correlated with the U.S. economic cycle. That's why I would say that EM is an opportunity, especially for investors that want to diversify away from exposure to only U.S. assets. It's a market where active management is essential because the winners and losers from geopolitics, energy prices and from policy credibility are going to look very different across countries. In my mind policy is what will ultimately continue to drive asset prices over the long term.

Jim: It's interesting the way that you've laid this out in the sense that we are in a very interesting period for markets. The interest rate cycle is not just trending lower anymore, it's moving more sideways. There's a lot of geopolitical risks. We have a new chair of the Fed that's coming in and it seems like your approach is that you have a strategy and a process for implementation. To deal with the risks of interest rates but also credit and you have a lot of different options to invest across the entire spectrum. But this really underscores the point that I made in the beginning of this conversation, which is that actively managing fixed income to me seems more optimal than just doing it passively, especially in the environment that we're in. In summary active management can be a key source of alpha in a multi-asset portfolio. That's my takeaway from this.

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