

# Does It Make Sense to Hold Strategic Bond Funds in Your Portfolio?

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## Introduction

Fuelled by a hunt for yield and the anxiety over rising rates, the flexible bond fund space (as represented by the Global Flexible Bond Morningstar Category and IA £ Strategic Bond sector) took off in the years immediately following the financial crisis. These funds promised to insulate bond-fund investors from traditional bond-market interest-rate risk while providing returns at least in line with core bond funds. They are generally conceived as “go-anywhere” bond funds with broad flexibility to invest across sectors, quality strata, and interest-rate exposures, and to use derivatives liberally. Flexible bond funds fall under two camps: multisector, income-oriented bond funds; and unconstrained (including absolute return) bond funds. While several funds in the first group have been around since before the global financial crisis, the latter group has been a post-crisis phenomenon. This paper deliberates on both clusters, but there is a particular focus on the latter group given its contribution to the explosive growth of the flexible bond sector.

## Key Takeaways

- ▶ Over the past five years, flexible bond portfolios have generally exchanged interest-rate risk for some other type of risk, whether high-yield corporate, emerging-markets debt, structured credit, or currency risk.
- ▶ High correlations to credit-sensitive sectors and equity markets reduce the appeal of funds in this sector. They belie the difficulty in successfully capitalizing on the freedom of unconstrained strategies to source alpha and simultaneously avoid market sell-offs.
- ▶ Flexible bond funds face a number of challenges, not least of which is the higher expense hurdles they continue to face in a low-yielding global bond market.
- ▶ Flexible bond funds are generally a poor substitute for conventional bond funds — which otherwise consistently carry marketlike levels of duration — as a ballast to counter equity-market turbulence. Sensitivity to the government-bond market embedded in conventional bond funds can often provide the single most-effective portfolio ballast when market shocks lead to extreme correlations among other bond and equity market sectors.
- ▶ Flexible bond strategies don't all fit the same mould. They also require a high degree of confidence in a manager's skill. A deeper dive is necessary to understand the different types of risks each fund takes in pursuing inherently challenging return objectives.

## What Are Strategic Bond Funds?

Strategic bond funds tend to have broader, more flexible investment mandates compared to traditional, core corporate and government-bond funds. They are generally conceived as “go-anywhere” funds with the flexibility to invest across global fixed-income markets, including rates, credit, and currencies. Allocations to these markets are usually actively managed, to be able to best exploit investment opportunities, based on the managers' assessment of the prevailing macroeconomic and market environment.

The key criteria for funds to be included in the £ Strategic Bond sector, as per the UK Investment Association (IA), is to invest at least 80% of their assets in sterling-denominated (or hedged back to sterling) fixed-income securities. This can span across government bonds, and investment-grade and high-yield credit, amongst other bond types. In contrast, other fixed-income IA sectors tend to be more restrictive. For example, the IA £ Corporate Bond sector requires a minimum 80% of a fund's assets to be invested in sterling-denominated (or hedged back) investment-grade bonds, while the IA UK Gilts requires an even higher 95% of fund assets to be invested in sterling-denominated (or hedged back) government-backed securities, with at least 80% in UK gilts.

Relative to the more traditional, benchmark-oriented bond funds, most strategic bond funds are also managed in a benchmark-agnostic manner. This flexibility allows managers to move a fund's exposure freely across sectors and the credit-quality spectrum, as well as change its interest-rate duration. Varying combinations of these have resulted in a range of differentiated strategies. Unsurprisingly, this also leads to a variety of investment objectives—some funds focus on delivering income whereas others focus on providing diversification; some are marketed as absolute return bond funds while others aim to outperform the peer group. How they go about realising their aim also varies, and funds with similar objectives can achieve their goals through diverse approaches. For example, a fund designed to provide income can achieve its objective by investing primarily in high-yield, emerging-markets, or higher-duration bonds—each with a different risk/reward profile—or some combination of all three.

Such differences lead to a rather heterogeneous IA £ Strategic Bond sector. To better delineate this group and make comparisons more meaningful, we use the Morningstar Categories, which tend to be more focused due to their definitions. The close-to-90 funds in the IA £ Strategic Bond sector map out across 10-plus Morningstar Categories based on the funds' underlying exposures, ranging from GBP Cautious Allocation to Alternative Long/Short Debt. Close to half the funds fall under the Global Flexible Bond – GBP Hedged Morningstar Category, followed by a fifth in GBP Diversified Bond and a tenth in GBP Flexible Bond. The average fund within both the Global Flexible Bond – GBP Hedged and the IA £ Strategic Bond categories exhibits similar characteristics, which is unsurprising given the large crossover between the two. That said, the results for the Morningstar Category can be somewhat accentuated given its more-focused nature. Where possible, we have used averages for both categories for our

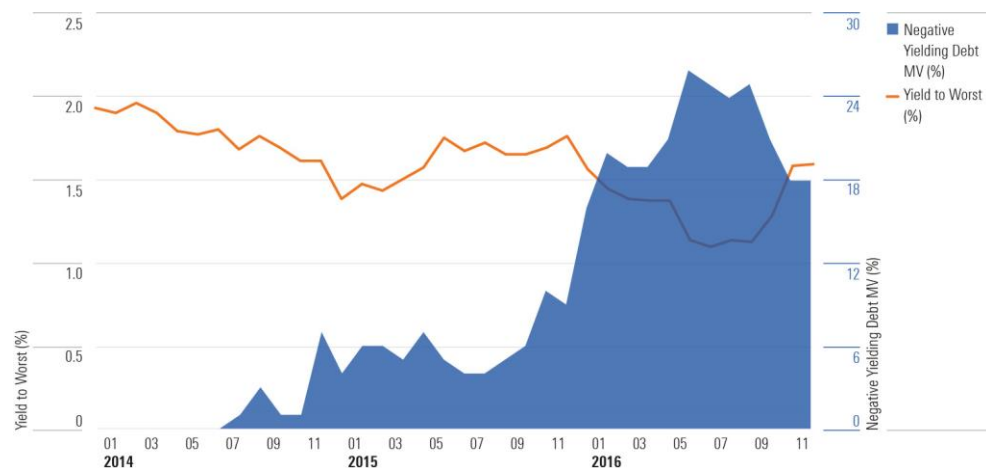
analysis. In this document, we refer to the IA £ Strategic Bond and the Morningstar Global Flexible Bond – GBP Hedged categories collectively as flexible bond funds.

## A Post-Crisis Trend Gathers Storm

In late 2008, the IA replaced its UK Corporate Bond and UK Other Bond sectors with three new sectors: £ Corporate Bond, £ High Yield, and £ Strategic Bond. The new £ Strategic Bond sector was a more useful classification for an explosion of new fund launches and old strategy revamps following the global financial crisis. Many funds in the category dating back to that time were multisector, income-oriented bond funds. These diversified bond funds took more risk—usually credit or country—than standard UK corporate or government-bond funds, which typically serve as core components of UK investors' fixed-income allocations.

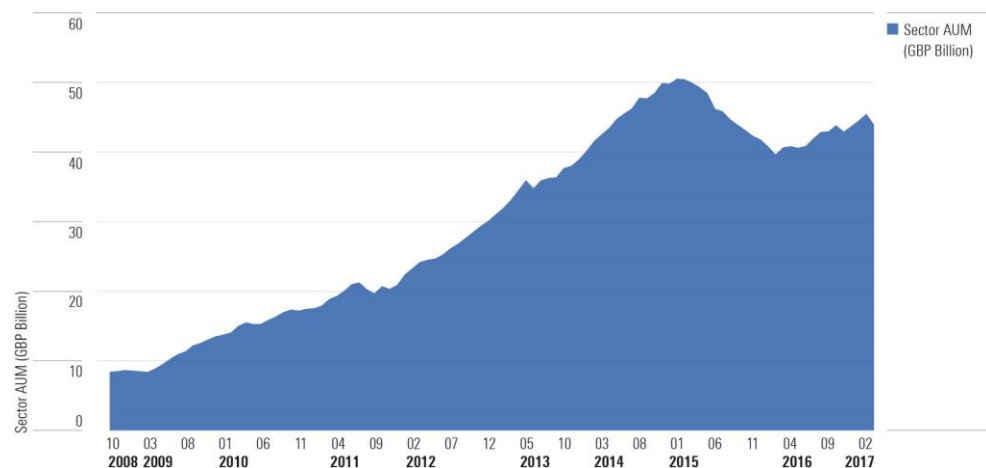
The new batch of fixed-income products, which could invest across a host of sectors and markets that aren't represented in traditional investment-grade bond benchmarks, such as the UK and global Bloomberg Barclays Aggregate Indexes, came with an updated set of objectives and strategies that addressed a mounting dread among fixed-income investors: that unprecedented global central bank policy intervention and accompanying low yields would eventually reverse and thus end badly for traditional fixed-income strategies. In offering a solution to that problem, many flexible bond funds have promised all the benefits of bond exposure—a modest, diversifying return stream with modest volatility—while simultaneously shielding investors from the deleterious impact of rising yields.

To be sure, investors have had reason to be concerned about the impact of rising yields. In the UK, the bank rate at 0.25% is the lowest in the Bank of England's history. Meanwhile, the Bloomberg Barclays Global Aggregate's yield, which averaged around 4.0% pre-crisis, has been stuck in a range of 1.0% to 3.0% under the added burden of negative-yielding sovereign debt in some countries in recent years (see Exhibit 1). With yields across sectors near all-time lows today, it wouldn't take a large increase to result in negative total returns, and marketers have seized on the index's large allocation to government bonds as another reason to abandon core bond funds since the crisis.

**Exhibit 1** Negative Yields in the Bloomberg Barclays Global Aggregate Index

Source: Bloomberg Barclays. Data as of 31/12/2016.

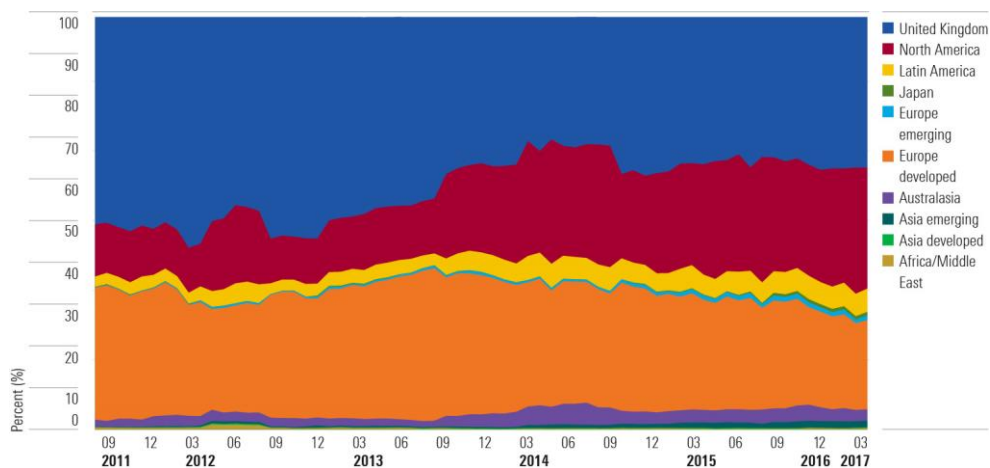
The problem of historically low yields and the view that a multidecade trend of falling yields would inevitably—if not imminently—reverse, fuelled massive growth in flexible bond strategies. Exhibit 2 depicts the IA £ Strategic Bond sector's growth since its launch in late 2008; the category's assets under management had grown to nearly six times their 2008 size at the peak in early 2015.

**Exhibit 2** IA £ Strategic Bond Sector Growth

Source: Morningstar Direct. Data as of 31/03/2017.

The growth in the sector was accompanied by strategies that had historically shown a bias to the UK and European markets, expanding beyond their home markets, as well as a number of new global strategies launched after the financial crisis. The average fund's allocation to the UK had fallen to about 35% by March 2017 from over 50% in late 2011, while that to North America (primarily the US) had increased to about 30% from just over 10% over the same period (Exhibit 3).

**Exhibit 3** Evolution of Geographical Exposures Within the IA £ Strategic Bond Sector



Source: Morningstar Direct. Data as of 31/03/2017.

## What's in Flexible Bond Fund Portfolios?

### **An Assortment of Flavours**

It's important for those considering an investment in a flexible bond fund to understand, and have comfort with, each fund's investment style, given that nearly all have somewhat different risk profiles. While most managers use a variety of their own analytical tools to gauge how much risk they're taking, they broadly fall into two camps.

The first group consists of multisector credit strategies that either focus on total returns or on generating income. Such strategies tend to be more credit-sensitive and have generally been around since before the financial crisis. They also clearly advertise the credit risk they take through their long-term strategic allocations to credit markets or using blended benchmarks with heavy credit representation.

The second group has been more of a post-financial-crisis phenomenon. Many funds in this camp use an absolute return benchmark keyed to short-term rates such as three-month Libor (which usually tracks closely to the Bank Rate controlled by the Bank of England); some others use risk-adjusted measures such as Sharpe ratio. Measures of that kind provide no universe of underlying securities and therefore no template or parameters to measure risk against an appropriate benchmark. In particular, it means that there's no way to judge whether, on the basis of sector or security selection, a fund has earned better (or worse) returns simply because it invested in riskier securities outside of an index otherwise representing its peer group's investable universe. In other words, it's extremely difficult — sometimes even impossible — to make meaningful apples-to-apples risk/reward comparisons among funds. As a result, it's possible for flexible bond funds, particularly the ones falling in this group, to produce similar outcomes while taking vastly different risks.

The most common types of flexible bond funds pursue either unconstrained or absolute return strategies, though the lines between the two can be blurry, and some firms purport to do both. Funds with an unconstrained mandate can invest heavily across a wide spectrum of sectors and can bring their durations to zero, or in some cases even take them negative. And regardless of their investment style (unconstrained or otherwise) funds with absolute return mandates typically attempt to generate consistently positive returns and avoid losses, rain or shine.

Flexible bond fund investment objectives and parameters differ across strategies, but most adhere to some variation of the following:

- ▶ An absolute performance target of a short-term reference rate, such as Libor or T-bills, plus a spread, such as 3 to 5, or 4 to 6 percentage points, with similar levels of volatility.
- ▶ Generating income, usually at a higher rate than traditional bond funds.
- ▶ Flexibility to manage duration within a wide band, such as negative five to positive 10 years.
- ▶ Few, if any, limitations on sector or country exposure.

- Wide latitude to invest half or more of the portfolio in higher-risk sectors, such as below-investment-grade rated corporates or emerging-markets debt.

The following summary of objectives and parameters followed by some of the funds under Morningstar coverage shows how widely these strategies are permitted to roam.

#### Exhibit 4 Flexible Bond Fund Investment Guidelines

	Duration	Below IG	EM Debt	Shorting	Performance Target	Other
<b>Artemis Strategic Bond</b> (ISIN: GB00B09DMJ21)	No prospectus limit, typically 2 to 6 years	Yes, no prospectus limit	Yes, no prospectus limit	Yes (limited use historically)	Total return (combination of income and capital growth)	Typically 90% hedged to GBP
<b>BlackRock Fixed Income Global Opportunities</b> (ISIN: GB00B8DCRV88)	–2 to 7 years	Yes, no prospectus limit	Yes, no prospectus limit	Yes (15% max limit on cash bond shorts, not including derivatives)	3-month LIBOR + 3.5-5.5%	Has held up to 30% in securitised assets including CLOs, nonagency mortgages, ABS, and CMBS
<b>Fidelity Strategic Bond</b> (ISIN: GB00B469J896)	No prospectus limit, has been between 4 to 8 years since 2008	50% max	Yes (typically under 10%)	Yes	Income, low volatility and diversification from equities	
<b>Henderson Strategic Bond</b> (ISIN: GB0007533820)	No prospectus limit, typically 3 to 7 years	Yes, no prospectus limit	Yes (limited exposure historically)	Yes	Beat IA £ Strategic Bond average.	Has held up to 80% in high yield
<b>Jupiter Strategic Bond</b> (ISIN: GB00B4T6SD53)	No prospectus limit, typically 3 to 5.5 years	Yes, no prospectus limit	Yes (limited exposure historically)	Yes	At least second quartile within the IA £ Strategic Bond sector.	
<b>Kames Strategic Bond</b> (ISIN: GB00B3ZLQW29)	No prospectus limit, typically 0 to 6 years	Yes, no prospectus limit	Yes, no prospectus limit	Yes, primarily for hedging; no shorts in single names	Beat IA £ Strategic Bond average over three-year periods	Has held up to 60% in high yield
<b>Legg Mason Western Asset Macro Opportunities Bond</b> (ISIN: IE00BJVDNR83)	–5 to 10 years	50% max	50% max	Yes	Maximise total return relative to 10% annual volatility budget	Up to 50% in non-USD currency exposure
<b>M&amp;G Optimal Income</b> (ISIN: GB00B1H05155)	No prospectus limit, has usually been between 2 and 6 years after 2008	Yes, no prospectus limit	Yes, no prospectus limit	Yes	Provide income and capital growth	Up to 20% in equity
<b>Man GLG Strategic Bond</b> (ISIN: GB00B581V620)	–3 to 8 years	Yes, no prospectus limit	Yes, no prospectus limit	Yes	Top quartile risk-adjusted returns, as measured by Sharpe ratio, within IA £ Strategic Bond sector; targets a Sharpe ratio > 1 over a cycle	
<b>Muzinich Global Tactical Credit</b> (ISIN: IE00BF5S8P49)	No prospectus limit, typically 0 to 5 years	Yes, no prospectus limit	Yes (usually less than 40%)	Yes, primarily for hedging; no shorts in single names	LIBOR + 5%, annualised, gross of fees	Minimum 50% in USD-assets; up to 10% in loans

Source: Morningstar analysts, fund company materials

Using these extremely broad parameters as a starting point, funds have carved out their own unique investment niches over the years. Among unconstrained funds, Legg Mason Western Asset Macro Opportunities Bond employs one of the group's more intrepid strategies with a relatively high maximum realized annual volatility limit of 10%. The fund has actively used its flexibility to take long-short positions across global credit, rates, and currency markets and doesn't shy away from taking large, concentrated bets, such as its 40%-plus allocation to emerging-markets debt in mid-2014. Its duration has also been managed within a wide negative five-year to positive 10-year range. Between January and March 2015, for instance, the fund's effective duration moved from two years to negative five years

and back up to around positive four years. While the fund has generated strong risk-adjusted returns over the short period since its launch, the inherent risks of this high-conviction, dynamic strategy were on display in early 2016. The fund lost 6.7% from Jan. 1 to Feb. 15, 2016, before bouncing back with a 9.0% gain through the end of March.

BlackRock Fixed Income Global Opportunities has much the same leeway as the Legg Mason fund but has generally made more modest bets on the direction of interest rates. Since this fund was repurposed on March 19, 2015, the strategy's duration has typically ranged between zero and two years. Similarly, M&G Optimal Income maintained a duration between two and three years since late 2014 through early 2016, a stance that weighed on its returns during what was a generally favourable period to take interest-rate risk (though it did help when core government-bond yields sold off in late 2016).

Meanwhile, Henderson's Strategic Bond and Preference & Bond largely maintained a longer duration, between four and eight years, over the same period, which helped relative performance. Likewise, Fidelity Strategic Bond has long favoured duration and broadly maintained it within a similar range as the Henderson funds since 2008. This fits in well with the fund's objective of generating attractive income while limiting volatility and correlation to equity markets over an economic cycle. The fund is at the more plain-vanilla end of the flexible bond space, with a neutral allocation of 60% to investment-grade credit, and 20% each to high-yield and government bonds over a cycle. But it has considerable flexibility to adjust these allocations based on the macroeconomic environment, such as in 2008 when government bonds made up roughly 70% of the portfolio.

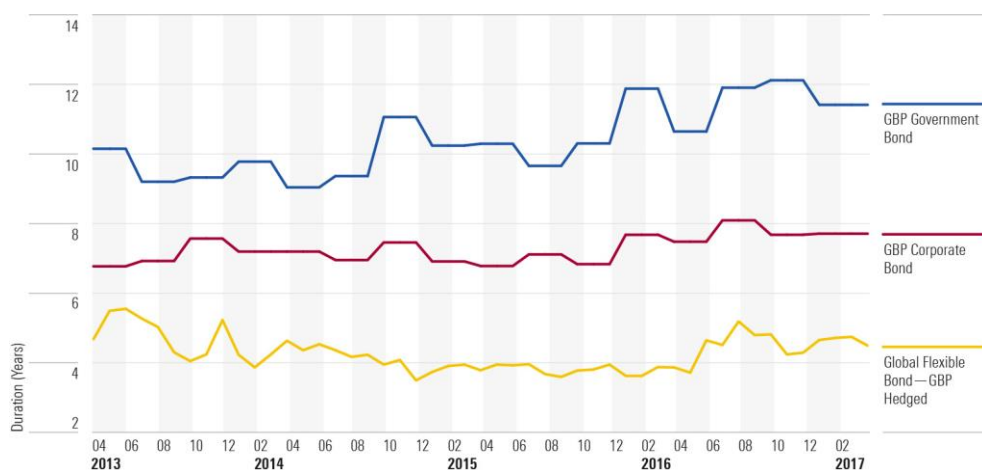
Lastly, although a number of the flexible bond funds have expanded their investment universe to be able to exploit a global opportunity set, some still exhibit a home bias. This is particularly true for some of the funds run by management teams based in Europe, such as Henderson's and Artemis' suite of funds within the IA peer group, all of which have retained a preference for European issuers over the years.

### **Common Themes**

While individual flexible bond funds don't all fit the same mould, some common themes have emerged across their portfolios over the past five years. We noticed that, to make good on their promise to protect investors from rising yields, many flexible bond funds have simply exchanged interest-rate risk for some other risk, such as high-yield, emerging-markets debt, or other "spread" or "risk" sectors. In addition, these funds tend to use derivatives more heavily than those in other, more-traditional fixed-income categories.

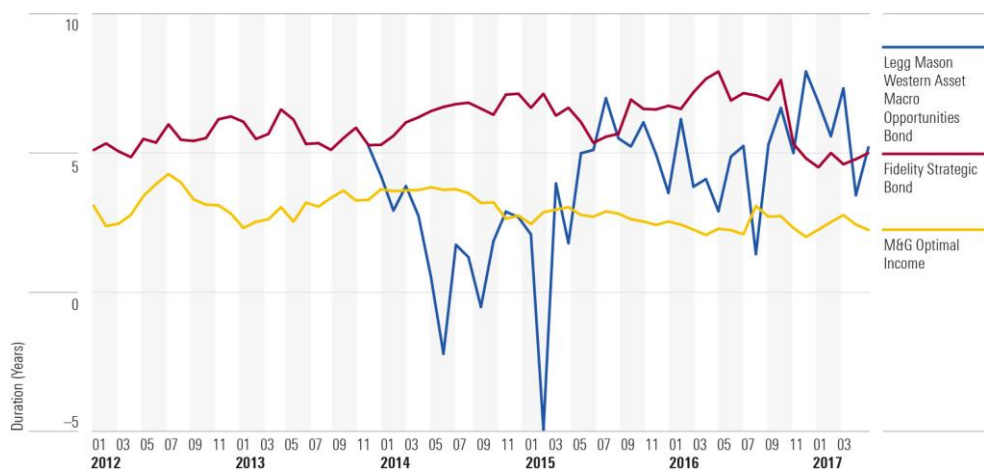
### **Interest-Rate Defence**

During the past few years, the sector's bias toward minimizing interest-rate risk has been evident. Since 2014, flexible bond funds have maintained interest-rate duration between four and six years on average, but mostly towards the lower end of that range (as seen for the Global Flexible Bond Morningstar Category in Exhibit 5). That's shorter than the seven years for the Bloomberg Barclays Global Aggregate Bond index. It's even shorter compared to the eight years for the Markit iBoxx Sterling Non-Gilts Index (which is comparable to the duration of the GBP Corporate Bond Morningstar Category) and 10 years for the Markit iBoxx Sterling Overall Index. Furthermore, a number of higher-yielding, credit-sensitive fixed-income sectors display lower sensitivity to changes in government-bond yields than their duration would suggest. Therefore, funds that invest heavily in sectors such as high-yield debt are likely to exhibit an even lower empirical duration in practice than their stated duration would otherwise suggest.

**Exhibit 5** Global Flexible Bond (GBP Hedged), GBP Corporate Bond, and GBP Government Bond Category Durations

Source: Morningstar Direct. Data as of 31/03/2017.

However, the group's rate positioning has been far from homogenous. While some funds, such as BlackRock Fixed Income Global Opportunities and M&G Optimal Income, have consistently exhibited shorter durations (below three years for both funds) in recent years, others have ranged widely, such as the Legg Mason Western Asset Macro Opportunities Bond (between negative five and 10 years). In comparison, most sterling corporate bond funds' durations have stayed within a tight band of roughly 1.5 years around their respective benchmarks. Still, despite parameters that allow flexible bond fund managers to adjust duration within a range of 10 years or more, the vast majority have been reluctant to extend duration long enough to match the market's.

**Exhibit 6** Fund Durations

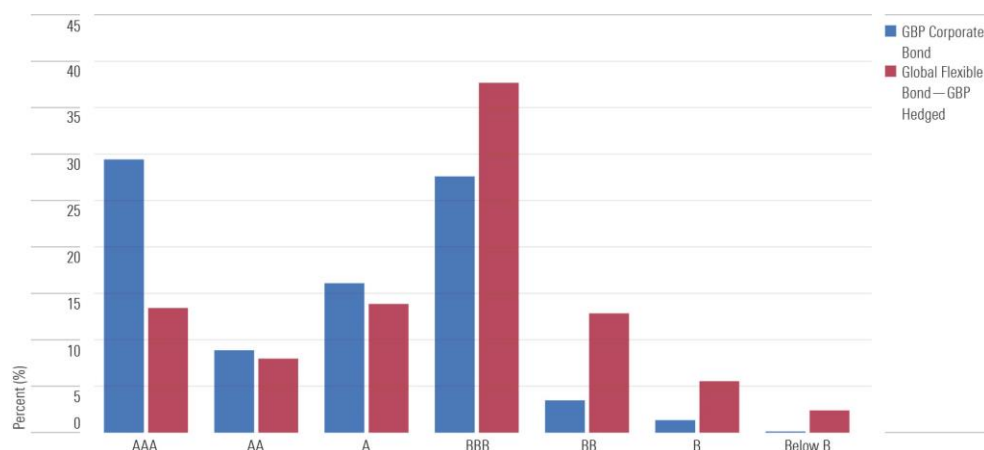
Note: Legg Mason Western Asset Macro Opportunities Bond was launched in November 2013.

Source: M&G, Fidelity, and Legg Mason. Data as of 31/03/2017.

### Heavy Credit Exposure

While minimizing interest-rate risk relative to traditional core bond funds, many flexible bond portfolios have taken on generous helpings of credit risk. This is evident in comparing the categories' exposures to different credit-quality tiers. The typical fund in the GBP Corporate Bond category held around 28% in BBB rated bonds and 5% in below-investment-grade bonds. Whereas, flexible bond funds have been moving down the credit-quality spectrum with an average Global Flexible Bond – GBP Hedged fund holding 38% and 21% in BBB and below-investment-grade exposure, respectively.

**Exhibit 7** Average Credit Quality — Global Flexible Bond (GBP Hedged) and GBP Corporate Bond Categories



Source: Morningstar Direct. Data as of 31/12/2016.

Again, looking at averages can gloss over the different stances that managers in the category are taking. For example, Artemis Strategic Bond and Henderson Strategic Bond held close to 50% in below investment-grade bonds, whereas these accounted for less than 20% of BlackRock Fixed Income Global Opportunities. Furthermore, among the funds that invest more heavily in credit-sensitive fare, the composition can vary widely across corporate, sovereign, and structured credit; cash bonds; and derivatives, each of which is subject to a different set of fundamental factors that drives their performance.

### Prevalence of Derivatives

Another common theme among flexible bond funds is the liberal use of derivatives. It's often easier for many investors to quickly add or reduce market exposures with derivatives such as credit default swaps (CDS), futures contracts, and interest-rate swaps without having to tie up as much capital as would be required when trading cash bonds. Moreover, as tightening regulations following the financial crisis have made it costly for banks to keep bonds on their balance sheets, liquidity in the cash bond market has eroded even further.

That has made derivatives an especially enticing tool for managers seeking to generate positive absolute returns without taking broad, systematic market risks. In theory, one can insulate a portfolio of conventional bonds from interest-rate volatility, for example, by sharply reducing its duration with futures contracts or interest-rate swaps. Several asset managers have also launched duration-hedged variants of their most popular credit funds in recent years. As with interest rates, one can take on credit

exposure to specific issuers while theoretically insulating a portfolio from broader credit-market risk by shorting CDS linked to a broad basket of credit-sensitive bonds.

Many funds within this space also include global currencies in their toolkits, which can be difficult (or impossible) to implement without derivatives. In the case of currencies not easily converted to or from hard currencies, such as the sterling or the US dollar, for example — often as a result of tight government capital controls — so-called nondeliverable forward contracts may be a manager's only practical option.

Furthermore, UCITS regulations, which govern mutual funds available for sale across Europe, have also evolved to recognize the importance of the derivatives market. While the directive initially only allowed for derivatives to be used for hedging and efficient portfolio-management, UCITS III (2003) expanded their scope to be used as instruments available for investment, including implementing shorts. The directive, however, sets restrictions on the underlying security of a derivative as well as limits within which these derivatives can be used. In this respect, the so-called "Newcits" funds may use these alternative instruments to implement strategies, though they are far away from hedge funds in terms of their structure and functioning. Furthermore, to avoid (to a certain degree) situations such as the one that occurred after the collapse of Lehman Brothers, where a number of hedge funds faced margin calls, the directive also lays out a bare minimum level of risk-management systems to monitor derivatives risk as well as approaches to calculate it.

## Measuring Success

The answer to the question of whether flexible bond funds have delivered on their promises to investors is complicated. We've addressed that question by looking at performance a number of ways, including trailing total returns, risk metrics, and correlation with broader markets. Again, our exhibits use data pertaining to the Global Flexible Bond (GBP Hedged) Morningstar Category and the IA £ Strategic Bond sector.

Looking at the risk-adjusted returns (as measured by Sharpe ratio) from Jan. 1, 2009, through March 31, 2017 (Exhibit 8), a period that roughly coincides with the life of the IA £ Strategic Bond sector, results look promising. The average global flexible bond fund (GBP Hedged) managed to edge out the average sterling corporate bond fund, both on an absolute and risk-adjusted basis. It also outperformed both the Bloomberg Barclays Global Aggregate Bond and Sterling Aggregate Bond Indexes over that period. A key driver of this was the strong rebound in riskier fare, such as high-yield bonds, in 2009-10. Meanwhile, the IA £ Strategic Bond sector marginally lags the sterling corporate bond average, but beats it and the indexes on standard deviation and Sharpe ratio. Risk-adjusted returns for both flexible bond categories, again, fare well over a five-year period (April 2012-March 2017), managing to beat the average corporate bond fund and both the aggregate indexes. On this occasion, it's the flexible bond categories' lower volatility that buoys their Sharpe ratios.

**Exhibit 8** Flexible Bond Funds—Performance Comparison

	Apr 2014–Mar 2017			Apr 2012–Mar 2017			Jan 2011–Mar 2017			Jan 2009–Mar 2017		
	Total Return	Standard Deviation	Sharpe Ratio	Total Return	Standard Deviation	Sharpe Ratio	Total Return	Standard Deviation	Sharpe Ratio	Total Return	Standard Deviation	Sharpe Ratio
Global Flexible Bond—GBP Hedged	3.24	2.78	0.97	4.96	3.02	1.43	5.00	3.97	1.09	8.35	5.27	1.41
IA £ Strategic Bond	4.15	3.46	1.04	5.24	3.57	1.29	5.34	3.85	1.21	7.70	4.92	1.38
GBP Corporate Bond	6.53	5.37	1.11	6.77	5.25	1.17	6.84	5.03	1.22	8.06	5.64	1.27
BBgBarc Global Aggregate (GBP Hedged)	3.65	2.83	1.09	3.54	2.71	1.08	3.96	2.63	1.25	4.23	2.59	1.31
BBgBarc Sterling Aggregate	7.98	7.43	1.00	5.93	6.68	0.81	6.78	6.30	0.97	6.48	6.26	0.91

Source: Morningstar Direct. Data as of 31/03/2017.

Those results shift, however, when we change the trailing time period. If we start in 2011, a year in which credit-sensitive assets struggled amid concerns about the health of European banks and their exposure to Greek government bonds, flexible bond funds look less impressive. If we shorten the measurement period to three years, a time frame that excludes 2013's interest-rate sell-off, flexible bond funds once more appear to lag.

Scrubbing off the Sterling Corporate Bond category for funds which exhibit a bias to either long or short duration, we see the return figures for the category decline by 50 basis points on average across the

various periods, while the standard deviation moves up marginally, resulting in a lower Sharpe ratio. However, there is no change (to the observations noted above) in the category's performance pattern relative to the flexible bond funds.

What's more, the same flexibility that can lead to significant variation in portfolio positioning among these funds at any given time can also produce substantial performance differences. In any 12-month period since 2010, for instance, the difference in returns between the best-performing and worst-performing deciles for the IA £ Strategic Bond sector was close to 9 percentage points, on average, versus 5.6 percentage points for the Sterling Corporate Bond category. Adjusting the Corporate Bond category for funds with biases to long- and short-dated credit, the average difference in returns for the top and bottom deciles falls to around 4.5 percentage points, half that of the IA £ Strategic Bond sector. It is therefore important not to paint with too broad a brush.

### Strong Interest-Rate Defence

Another way to measure whether flexible bond funds have delivered on their promises is to see how they fared during different market environments. Let's start with interest-rate risk, the chief source of anxiety that drove the category's explosive growth in recent years. We use the 10-year generic US Treasury yields as the reference given the increasingly global nature of flexible bond funds and the dominance of US-dollar-denominated debt in the global fixed-income markets and benchmarks; moreover, the sell-offs in UK gilts more or less overlap with those of US Treasuries. Granted, the category hasn't been tested much in that regard since the financial crisis; UK, US and other developed-market government-bond yields are generally lower now, and there are only two instances of the US 10-year note rising by more than a percentage point in that stretch. Looking at flexible bond funds' performance during periods in which the yield on the 10-year US Treasury has risen by half a percentage point or more (Exhibit 9), the group on average has proved reasonably effective at outperforming the typical sterling corporate bond fund in periods of rising interest rates. (The conclusions remain the same even after removing both long- and short-duration funds from the corporate bond category.)

**Exhibit 9** Returns During US Treasury Sell-Offs

	22-09-2011 to 27-10-2011	25-07-2012 to 05-02-2013	01-05-2013 to 05-07-2013	23-10-2013 to 31-12-2013	30-01-2015 to 06-03-2015	08-07-2016 to 15-12-2016
Global Flexible Bond - GBP Hedged	1.54	6.92	-2.77	1.02	0.88	1.46
IA £ Strategic Bond	1.30	5.44	-3.67	0.38	-0.15	1.14
GBP Corporate Bond	0.66	4.54	-4.90	-0.49	-1.81	0.27
BBgBarc Global Aggregate (GBP Hedged)	-0.73	1.03	-3.17	-0.42	-0.93	-3.65
FTSE 100 TR	8.17	16.19	-0.05	1.36	2.10	8.89
BofAML Global HY Constrained (GBP Hedged)	2.57	9.62	-3.20	1.51	2.31	5.18

Source: Morningstar Direct. Data as of 31/03/2017.

The taper tantrum from May through early July 2013 — during which markets reacted to then Federal Reserve Chairman Ben Bernanke's suggestion that the Fed might slow down its rate of bond purchases — was an especially challenging period for flexible bond funds because sectors that are less correlated to Treasury moves, such as high-yield corporates and emerging-markets debt, sold off as well. Before that sell-off, yields on high-yield corporates had dipped below 5% for the first time on record, with yield spreads over Treasuries also tight of their historic norms. As a result, the high-yield sector became more vulnerable to rising Treasury yields than it had been in the past. Nevertheless, the average

flexible bond fund lost substantially less than the Corporate Bond category mean during that two-month stretch.

More recently, UK and other global sovereign bond yields rose in the back half of 2016, as global central banks took steps to roll back recent years' accommodative policies, from the Bank of Japan shifting to a yield-curve control policy designed to push up yields on long-maturity bonds relative to short-term rates, to the European Central Bank's tapering of bond purchases, and the Federal Reserve's succession of outright rate hikes. During the second half of 2016, when corporate bond funds and indexes were stung by a sharp sell-off, flexible bond funds protected their investors from the pain. The typical flexible bond fund outperformed the Corporate Bond Fund category median again.

### Weakness During "Risk" Sell-Offs

That success during periods of rising US Treasury yields has come at a cost, however. In particular, flexible bond funds have struggled when riskier fare has slumped. Exhibit 10 compares the performance of the two flexible bond categories against the Sterling Corporate Bond category during equity market troughs over the past five years. In each case, the sterling corporate bond cohort fared better in limiting losses versus the flexible bond group. Again, there are no marked changes in the observations when we adjust the Corporate Bond category for long- and short-duration funds.

The pain was particularly acute in the most recent equity downdraft that spanned the second half of 2015 through early 2016. That period coincided with a sharp high-yield bond sell-off, as falling commodity prices slammed high-yield debt issuers in energy- and commodity-related industries. The commodity price rout also had an impact on emerging-markets debt and currencies, as well as the currencies of some developed-markets commodity exporters.

**Exhibit 10** Returns During FTSE 100 Troughs

	07-07-2011 to 04-10-2011	18-03-2012 to 01-06-2012	04-09-2014 to 16-10-2014	21-11-2014 to 15-12-2014	27-04-2015 to 20-01-2016
Global Flexible Bond — GBP Hedged	−5.68	−0.09	−1.03	−0.29	−3.23
IA £ Strategic Bond	−2.91	1.16	−0.25	0.34	−3.21
GBP Corporate Bond	−0.42	2.48	1.76	1.49	−1.48
BBgBarc Global Aggregate (GBP Hedged)	3.22	2.55	0.94	0.92	0.09
FTSE 100	−16.87	−11.00	−9.78	−7.39	−17.83
BofAML Global HY Constrained (GBP Hedged)	−9.68	−1.42	−2.84	−2.99	−9.70

Source: Morningstar Direct. Data as of 31/03/2017.

These numbers also underscore how difficult it has been for managers in this space to use their duration flexibility to their advantage. In late 2014 and early 2015, for example, many were convinced that the Federal Reserve would finally embark on a succession of rate hikes, and they took steps to shorten their funds' durations, even taking them negative in some instances. That was the right call in the first quarter of 2015, as Treasury yields rose modestly. However, funds that maintained a defensive stance toward interest-rate risk throughout the year missed out on a flight-to-quality Treasury rally in the second half of 2015, which could have offset some of the losses among their credit positions.

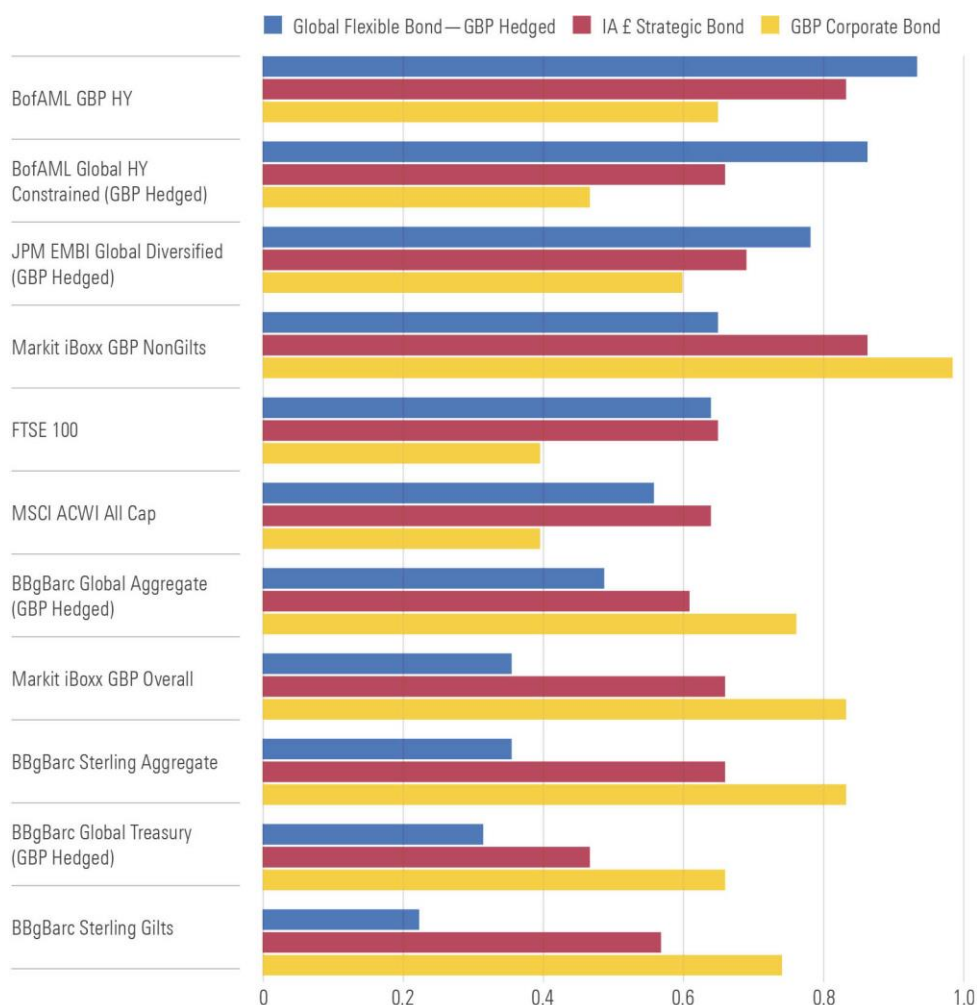
### Supplanting Rate Risk Leads to Higher Sensitivity to Credit and Equities

The flexible bond categories' struggle during these periods points to a larger issue. Short-term floating rates tied to banking are, outside of very unusual circumstances, usually very low. Using Libor-based benchmarks makes it much easier for fund companies to tout or defend their results from criticism by pointing to the fact that they beat their stated return hurdles. Despite those efforts to temper investors' return expectations, most managers recognize that fundholders won't often stick around unless their fund's returns stay within the range of more-conventional options.

In their efforts to protect investors from rising yields and still produce sufficiently attractive returns, many funds exchange exposure to interest rates for other types of risk, as we've discussed above. In fact, minimizing or eliminating the income "carry" advantage normally inherent in longer-maturity exposures makes investing in riskier options among the only ways in which managers can surpass their high expense hurdles and still produce returns high enough to keep investors happy.

As shown in Exhibit 11, the flexible bond categories' performance has been highly correlated to equities, high-yield corporates, and emerging-markets debt.

**Exhibit 11** Trailing Five-Year Correlations with Market Indexes



Source: Morningstar Direct. Data as of 31/03/2017.

Once more, it's important to note that given the wide range of investment styles employed by many funds in the flexible bond space, these correlation coefficients vary among individual funds. However, over 80% of distinct funds in the IA £ Strategic Bond sector have exhibited correlations of at least 0.50 to sterling high-yield corporate bonds during the trailing three-year period, and around 40% have exhibited correlations of 0.80 or higher. Over 60% of the group has exhibited correlations of at least 0.50 to global and UK equities, as represented by the MSCI ACWI All Cap and FTSE 100, respectively.

This is a crucial consideration for investors who are weighing whether to replace at least part of their core bond stake with a flexible bond strategy. While flexible bond funds have displayed low or negative correlations with high-quality bond market risks, their high correlation with equity-market risk hampers their use as a portfolio diversifier.

## Challenges Ahead

Whether or not market conditions become more favourable, the flexible bond category continues to face challenges.

### **Fees**

Flexible bond funds charge higher fees than traditional bond funds, giving them a built-in disadvantage. For example, the average clean share class within the Global Flexible Bond (GBP Hedged) Morningstar Category charges 0.74%, compared with 0.60% for the GBP Corporate Bond category. Likewise, the median for all retail share classes within the former is 1.13% versus 0.93% for the latter category.

It's hard to justify these added costs, especially given that most asset managers haven't had to invest in additional resources in order to run strategic bond mandates. Most have simply placed an additional strategy onto the plate of a manager already responsible for running conventional bond portfolios. In fact, in most cases managers themselves argue that they have had the wherewithal to identify value in places and to degrees that they were restricted from exploiting in their conventional portfolios, and that running flexible bond strategies allows them to take better advantage of those insights, only now with a freer hand.

In many instances, fund companies have been opportunistic in surfing the recent trend of flexible bond strategy launches. These strategies are run by investment teams that may have longer track records managing more traditional bond strategies but have not yet managed flexible strategies over a full market cycle. Investors are therefore being charged higher fees to accept substantial manager risk.

### **Flows**

After the IA £ Strategic Bond sector's fund assets peaked in early 2015, it appears that some early investors may have grown impatient waiting for the dreaded rising-rate environment that failed to materialise. As a result, the category suffered outflows for the rest of 2015. However, investor sentiment changed again around the time that Federal Reserve chairwoman Janet Yellen raised the federal-funds rate for the first time in almost a decade in December 2015, and flows somewhat stabilised.

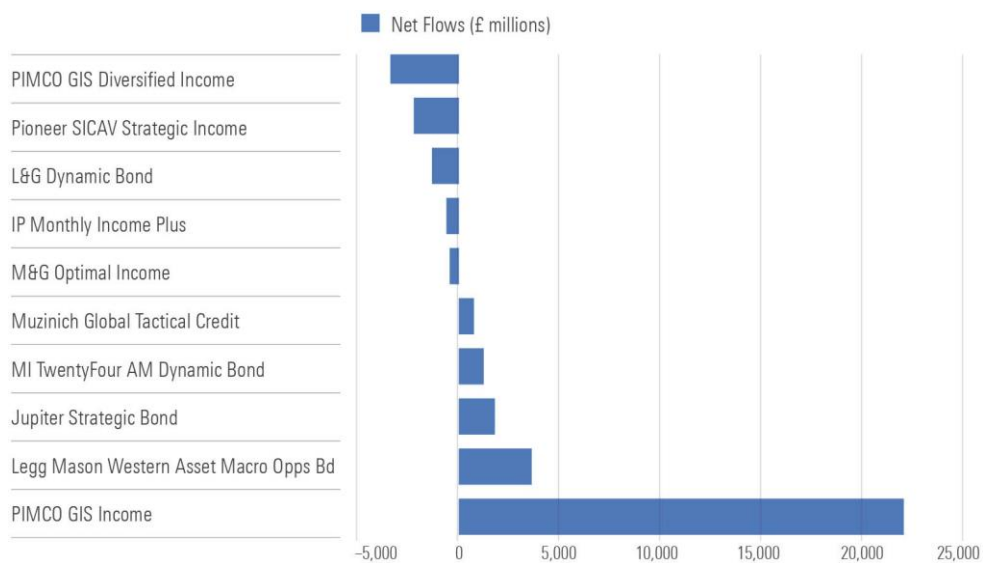
Given that flexible bond funds generally performed relatively well in the second half of 2016, it appears that some investors may have given up on the sector too soon, highlighting the difficulty investors face if they're expressly looking to time their investment in flexible bond strategies to specifically avoid an anticipated market event, namely a pronounced rise in yields.

That said, following a stretch of relatively robust performance during the latest bout of rising yields, the sector has seen inflows in early 2017. Some prominent global strategies have seen strong inflows, most notably PIMCO GIS Income, backed by its solid performance amongst its peers. Other beneficiaries

include Legg Mason Western Asset Macro Opportunities Bond and Jupiter Strategic Bond. Meanwhile, another PIMCO strategy, GIS Diversified Income (and its duration-hedged variant), have seen the largest outflows. In addition, L&G Dynamic Bond, which experienced some manager turnover and lacklustre performance since, has lost more than half its assets over the past three years. M&G Optimal Income is another notable fund. While its current assets, at GBP 17.5 billion, are close to where they were three years ago, the fund's assets peaked at close to GBP 25 billion in early 2015 before seeing large outflows. Funds with the largest net flows since 2014 are highlighted in Exhibit 12, which captures flows at an overall fund level across all share classes available for sale.

Given the rapid growth of the sector, capacity has become a greater concern for certain individual funds. While some funds with a broader remit may be able to cope with increasing assets, funds with biases to less-liquid areas such as high-yield might find it hard to manage a large asset pool. For many flexible bond funds, remaining nimble is an important ingredient, so it's no surprise to see capacity arising as an issue. Moreover, altering the investment universe to maintain the process' effectiveness could force a manager to move into territory where it hasn't previously demonstrated competency. The heterogeneity of these strategies makes it more difficult to objectively verify noted capacity limits and assess whether these actions will ultimately prove beneficial for fund investors.

**Exhibit 12** IA £ Strategic Bond — Net Flows (January 2014-March 2017)



Note: PIMCO GIS Diversified Income includes duration hedged variant of the strategy.

Source: Morningstar Direct. Data as of 31/03/2017.

## Regulation

Disclosure requirements by market regulators have not always kept up with the proliferation of exotic instruments and strategies. For example, even though the UCITS rules in Europe require full portfolio disclosure in the funds' annual reports, a list of line items is difficult to interpret, particularly for derivatives-heavy portfolios. Investors therefore need to exert extra vigilance to make sure they understand the risks of the funds they own, and to be able to form expectations on how the funds will behave in various market environments.

That said, although not likely to have a direct impact on them, European investors should still note that the SEC floated a proposal in December 2015 that, if implemented as proposed, could badly upset the management of US-domiciled flexible bond funds heavily reliant on derivatives. The stated goal of the proposal is to "enhance the regulation of the use of derivatives" by registered investment companies, a term that includes mutual funds, exchange-traded funds, and closed-end funds.

Among other things, this proposal would require funds to comply with one of two rules designed to limit the amount of leverage they can develop with derivatives. The first rule would cap a fund's exposure to certain kinds of transactions (including derivatives) at 150% of net assets. The second would allow for exposure up to 300% but would require the use of a so-called value-at-risk test that would ensure a fund was taking on less market risk than if the fund did not use derivatives.

At its core, elements of the proposal could either restrict the overall amount of derivatives exposure that a fund can use, or make it so difficult for managers to use them effectively in portfolio construction that many would either use them extremely sparingly or not at all. Of course, there's no telling what the final rules, if any, will look like and if the UK/European regulators will follow suit. But there is clearly meaningful risk that the SEC's actions could change the face of the sector in the US.

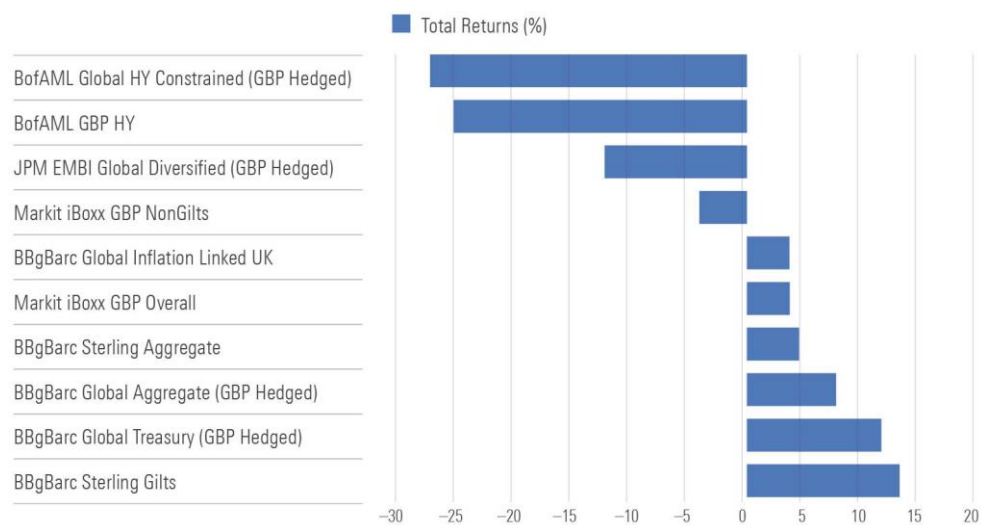
### **Portfolio Construction Quandary**

Of all the issues surrounding flexible bond strategies, one of the most crucial may be the tendency among some investors to view them as a complete substitute for the core bond portion of a portfolio.

Doing so courts an important risk. An investor who might otherwise maintain fairly consistent exposure to the UK Gilt market—via a conventional core bond fund—can be caught without any such exposure during a broad market sell-off, or worse yet, something approaching a 2008-style crisis.

There have been less dramatic examples during a handful of periods since, but the market's 2008 experience clarified just how important exposure to government bonds could be (Exhibit 13).

Substituting a flexible bond fund, whose duration is either consistently short or unpredictably short and long, could leave a portfolio devoid of what might otherwise be the single most reliable insurance policy in the event of broad market sell-offs—high-grade, long-tenor bond exposure.

**Exhibit 13** 2008 Fixed-Income Sector Returns

Source: Morningstar Direct. Data as of 31/03/2017.

There's another potential structural problem that could affect flexible bond funds that court heavy credit or liquidity risk but use derivatives to hedge out their interest-rate risk. Such portfolios are effectively betting against the government-bond market. Thus, in the event of a credit sell-off, for instance, investors fleeing corporate bonds for the safety of Treasuries could hit these funds with a double whammy: Their core corporate assets sell off as investors dump risk, while their interest-rate hedges suffer losses as government bonds rally.

## Conclusion

There are clearly numerous challenging factors for the flexible bond sector and thus for investors who would select from its menu. Strategies in the category come in different shapes and sizes, making it important to understand the risks each fund takes in pursuing inherently challenging performance objectives. That's especially crucial given the number of funds that have effectively exchanged interest-rate risk for other risks, such as those linked to credit or currency. In doing so, many funds wind up with high correlations to credit-sensitive sectors and equity markets, which can have unintended consequences for the overall balance of an investor's portfolio. In particular, without government-bond market sensitivity, investors can be left with little if any portfolio ballast when market shocks lead to extreme correlations among other bond- and equity-market sectors.

Flexible bond funds also face challenges from trends toward tighter regulations governing the use of derivatives, and the difficulty of generating sufficient returns to overcome high expenses, particularly to the degree that the global bond market's low-yield environment persists. As fund companies have rushed to capitalize on the flexible bond trend, often positioning these strategies as the ultimate showcase for active management, investors have wound up taking substantial manager risk. In many cases, managers are relatively new to such flexible investing, and thus run the potential risk of stepping beyond their circles of competence.

In general, funds in the sector suggest that their investors can enjoy returns commensurate with what core bond funds would otherwise produce, sidestep interest-rate sensitivity while doing so, and expect to avoid losses given the use of absolute return strategies. So far, though, the overall category has struggled to deliver on its contradictory set of promises, and we believe a sceptical eye is warranted when deciding whether to use a flexible bond fund as part of an overall portfolio plan. ■■

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