Russell Investments

Mid-year outlook: Unconstrained Total Return Fund

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JULY 2018

Many investors have amassed reasonable allocations to credit in recent years. But in our complex situation, it makes sense to amplify diversification, reduce risk to traditional risk premia, focus on alpha and maintain some liquidity.

When it comes to unconstrained-investing, I've a feeling we're not in Kansas anymore.

If you're like me, then perhaps your head is spinning from the bewildering array of headlines that we're seeing in the world today. We've seen rapprochement between the U.S. and North Korea, a divided G7 and the Republican establishment driving the U.S. to World War II-level budget deficits. And then there's a senior member of the UK Tory party, the British "party for business", using four-letter words when asked about the business sector's concerns on the progress of Brexit.

Boris Johnson may be the only politician lobbing expletive-laden comments at business interests, but with the current U.S. administration engaging in trade conflicts on multiple fronts, businesses may be wondering what happened to their traditional champions in government? We investors are waking up to the thought that recent political shifts may also apply similar sentiments toward us. Global markets are being knocked about by forces that have little precedent for today's cohort of investors, meaning that the previously well-worn path of buying the dips with risk assets requires, in our opinion, more bravery than normal.

Add into that the unwinding of an easy monetary backdrop. The European Central Bank (the ECB) recently announced on June 14 that it would end quantitative easing by December this year, down from an average of €30bn a month earlier this year.[1] At the same time, the U.S. Federal Reserve (the Fed) is currently allowing $30bn a month of securities on its balances sheet to mature—effectively selling the securities.[2] At the same time, the Fed is also raising interest rates.

This alone should have investors on guard. Significant amounts of quantitative easing were being injected into the broad U.S. equity and credit markets during 2017. We saw 10-year U.S. Treasuries slowly fall through most of 2017, and credit spreads continued to grind into cycle lows. There was barely any volatility in the markets during 2017, with the most successful strategy being: **Go long everything and go home.** Now the markets are faced with **quantitative tightening,** which, although gradual and well telegraphed, is still significant. This has caused the sharp rise in bond yields this year, and may auger trouble further afield.

Whatever your view is about our ultimate destination, it is less than controversial to imagine a world with more volatility.

[1] Source: https://www.cnbc.com/2018/06/14/ecb-holds-rates-discuss-qe-end.html

[2] Source: https://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm

Harvesting credit risk responsibility

Many investors have amassed reasonable allocations to credit in recent years. This has likely paid them reasonable rates of return with limited volatility relative to their equity holdings. Economic growth is strong, which allows debtors to service their debts well. However, credit spreads reflect this strong growth environment and thus the amount of excess return expected from spread is not sufficient if there is a negative economic surprise.

As rates go higher, will this trigger weakness in credit assets? **We believe we are late in the market cycle,** and corporate bonds have higher leverage. Issuers will be faced with higher refinancing costs as yields go higher, which ultimately will erode their fiscal position. How should portfolio managers deal with the subsequent volatility?

I believe that some exposure to credit is warranted, although maintaining some liquidity, given valuations, is prudent. Additionally, I believe one should focus on high Sharpe-ratio (Sharpe ratio is the average return earned in excess of the risk-free rate per unit of volatility) parts of the market, which allows investors to continue to collect the credit-risk premium, but minimize the risk of default or drawdown. In particular, I believe the focus should be on the safest segments of high-yield—namely BB-rated credit with a short duration.

I also think leveraged loans offer reasonable exposure to corporate credit. This segment of the market pays a reasonable spread, and the associated potential rising rates allow loans to capture higher future returns as rates rise. It should be noted that loans are sub-investment-grade securities, and there has been deterioration in covenants and credit metrics around this segment. However, on an absolute basis, this portion of the credit market is more protected than broad high-yield, because loans are senior-secured in the capital structure and have better default recoveries than traditional high-yield bonds.

Maximizing diversification through volatility

Even high Sharpe-ratio credit is prone to drawdowns. Now, more than ever, we believe investors must focus on effective diversification. However, the traditional method of diversifying a credit portfolio is buying interest-rate risk. This is problematic, because if the Fed continues down the path of raising rates, as expected, rates will not be as effective of a diversifier, and may even be the cause of a future problem.

Enter volatility. I believe volatility will increase and global markets will adjust to the dramatic reduction of the role of central banks. It is possible to profit from volatility in portfolios, and this is done primarily through the options market.

One of the key inputs into the price of an option is the market-expected volatility. The higher the volatility, the more an option is worth. Thus, if you hedge the underlying market exposure when you buy an option, the main risk left over is a bet on where volatility will likely go. In other words, options strategies can profit when volatility rises.

In the Unconstrained Total Return Fund, we have actively deployed an options strategy focused on seeking to profit from increased volatility. It is very difficult to find successful volatility strategies and not many firms can do this successfully. Historically, being long volatility has lost investors' money, in much the same way that being short credit would generate poor performance over time. Therefore, I believe it is important to have an active strategy and our detailed manager research process has identified one that we have successfully been using for a number of years now, that is also in the Unconstrained Total Return Fund.

In a market where volatility is still low—and quantitative tightening is reducing market liquidity—I believe it makes sense to focus in this area, as it may be one of the only sources of diversification in the coming years that actually works.

Opportunistically looking for return

Looking for return drivers off the beaten path can help, especially if you're focusing on areas that have some secular drivers that may fuel capital growth. I find that the U.S. mortgage market offers an array of options, many which are not driven by credit spreads. This is an area that we focus on in our Unconstrained Total Return Fund.

For example, agency-mortgage derivatives, such as interest-only strips and inverse interest-only strips, may offer some good opportunities. (An interest-only strip is created by separating the principal and interest portions of the payments on the underlying loan pool and selling them as distinct products.) Some of these securities benefit from rising interest rates

and can have significant mispricing of their risks. This allows return to be generated from a rising-rate environment, thus diversifying a core-bond portfolio.

There are several specialist opportunities in this marketplace that may allow for extra diversification. These assets have risk, but their underlying drivers of performance are different and thus can go in different cycles. For example, even buying **mortgage credit** offers diversification away from **corporate credit.**

Bringing it together

We are in uncharted territory, with dramatically different politics, central banks in reverse gear and markets offering little risk premia. This unfamiliar environment is forcing investors to be creative. We are actively seeking to amplify diversification, reduce risk to the traditional risk premia of credit and interest rates, focus on alpha and maintain some liquidity.

Finally, recognize that at this stage in the game, some caution is warranted.

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First used: July 2018

RIFIS 20297