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Credit, illiquidity, term: a discussion of three fixed income return drivers

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The defining characteristic of fixed income is that the future stream of income generated by the asset portfolio is defined in advance. The only uncertainties lie in (a) the potential for default (i.e., will the income stream actually materialize?) and (b) discount rates (i.e., what value does the market place today on the income stream?).

While this may make fixed income appear to be a simple, homogeneous asset class, there is in fact significant variation among different types of securities. In this article, we will take a closer look at three of the drivers of fixed income returns: credit, illiquidity and term. Each of these affects how the market prices fixed income securities and, we believe, can be used to add value in portfolios over both short- and long-term horizons.

Three factors

We'll begin with a brief definition of each factor:

Credit: This factor is directly linked to the probability of default of the issuer. We expect that the return generated on debt securities over and above the return available on government securities with similar duration will differ based on credit rating.

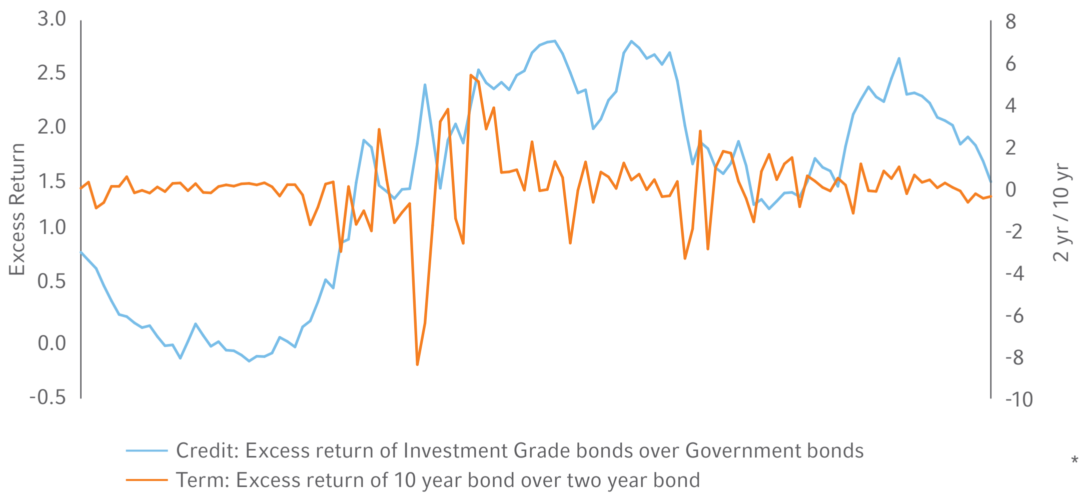
Illiquidity: The most liquid debt securities tend to be those with the lowest default risk. Hence, the credit factor and the illiquidity factor are, in practice, difficult to separate.

Term: This factor is a duration factor, whereby securities with different durations should generate different returns with interest rates being a key factor driving these differences.

Strategic return premiums will be driven by each of these three factors; the credit quality and illiquidity of the bond as well as what duration the bond is. Bonds with additional credit risk, illiquid bonds and longer-term bonds can all be expected to deliver higher returns than the broad market over a full cycle. In each case, this premium can be seen primarily as compensation for some form of risk, rather than as a behavioral anomaly.

Each of these factors also comes with the risk of reversals, particularly over short time periods. Further, they are interrelated: Not only are credit and illiquidity closely linked, but both are also

Figure 1: Fixed income return drivers*



* The premium for illiquidity is not shown.

connected to the term structure, with different characteristics applying at different parts of the yield curve.

While each of the three factors is robust and present across most markets, the size of the opportunity varies significantly over time as market environments change. Dynamic positioning is therefore an important complement to strategic positioning.

Credit risk and illiquidity are closely linked

Each factor has some notable features. We will consider credit and illiquidity together, since they tend to come as a package. The market regards U.S. Treasury securities as being the most liquid, most secure debt instruments; while they do not offer 100% assurance of no default (a fact brought into focus with the debt-ceiling crisis of July 2011), they are the traditional safe haven asset to which investors have fled in times of panic. As a result, all other forms of debt security tend to offer higher expected returns.

In other words, if the market places a value of $100 in today's money on a particular future cash flow that has zero probability of default, it will place a value below $99 on the same future cash flow if it has a 1% probability of default. Thus, the expected return on the uncertain cash flow is higher.

Note, however, that default risk is highly asymmetric. For this reason, the credit premium can be harvested with relatively low volatility for extended periods of time, but this pattern is generally punctuated by occasional large left-tail events (i.e., significant losses).

The additional return that is attributable to illiquidity is, likewise, subject to left-tail events. Most of the time, being less liquid might mean that the bid-ask spread on an asset is a little bit larger, or that trading takes a little longer. But during a market crisis, that same asset might become practically untradeable for a time. The illiquidity premium is captured mainly during those crisis periods. So investors seeking the premium need to be able to hold through those periods.

Dynamic management

It is therefore important to dynamically manage credit exposure in order to reduce the likelihood of sharp losses. Dynamic management is also important due to the significant variations in credit spread over time. We believe that the best opportunities to capture the credit risk premium come—as a general rule—during the expansion and recovery phases of the business cycle. However, close attention must be paid to the

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liquidity environment and the value afforded in spread levels.

Some forms of security offer better means of accessing the credit premium than others. For example, securities that fall just below the cutoff between investment-grade and high-yield securities can be attractively priced, since they lie outside the permissible investment opportunity set for many investors. Similarly, the attractiveness of the credit opportunity tends to vary at different durations; the credit premium tends to generate higher information ratios at shorter maturity points.

The term premium reflects volatility and inflation risk

The term premium, meanwhile, is mainly attributable to two forms of risk: the risk of inflation (which might erode the real value of long-dated cash flows) and the volatility of the security's price. (Even though future cash flows are known, the value that is placed on those cash flows can vary significantly, especially for long-dated securities).

There are some investors—notably, insurance companies and defined benefit pension plans—for whom certainty of long-dated income is more important than stability of asset value. For these investors, it is long-dated securities, not short, that represent the low-risk asset. For nonprofit investors, on the other hand, managing the risk of inflation and stability of asset value is usually more important. We regard the term premium at the very long end of the yield curve as being generally insufficient to compensate for the higher volatility of the price of those securities (except, of course, for the insurance companies and defined benefit pension plans). In general, we favor accessing the term premium at the shorter end of the curve.

The attractiveness of the term premium is related to the steepness of the yield curve, due to what is known as the "roll-down effect"; if a bond has a significantly higher yield than another bond with slightly shorter duration, then that bond may be a benefit as it "rolls down" the yield curve and its value increases.

Like the credit premium, the term premium is dynamic—it tends to be higher when cash rates are lower, and to be highest during low points in the business cycle.

factor exposure management in fixed income

In summary, even though the current conversation around factor exposure management is largely concentrated on the equity market (often referred to as "smart beta"), it is just as relevant to fixed income.

Credit, illiquidity and term are important factors driving fixed income returns. Each of them offers, we believe, a strategic return premium. But each of these represents a risk premium of which investors should be aware, and each comes with the risk of short-term reversals. Dynamically managing exposures to capture cyclicality is important in efforts to avert or mitigate potentially sharp short-term losses.

Credit, illiquidity and the term premium are important drivers of fixed income returns...each comes with the risk of short-term reversals.

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