MAI VIEW

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Bond Ambition

Despite low nominal yields and tight yield spreads, significant alpha may be found in bond markets today. Below, we design a two-pronged fixed income investment approach to consider.

Perspective

Unlike equity investing, the bond markets implicitly have an intellectual clearing house in the form of the Fed. So, most professional fixed income investors and advisors allocate capital to traditional investment programs that implicitly comply with the Fed's ongoing economic outlook, reliably described as: expectations of trend line economic growth and inflation with little chance of major revisions. As a result, the great majority of capital sponsoring sovereign bonds and credit is committed to long-only buy and hold strategies that settle at established consensus and today produce annual returns of 1 to 5 percent.

Risks associated with such traditional allocations are significant. Most obvious is the low absolute level of nominal interest rates, which implies the potential for future capital losses exceeding many years of income. Another risk is liquidity volatility. Asset marketability in credit and structured product markets is far better today than it would be if/when perceptions shift to the expectation either that the economy will slow or that bond yields will rise. Yet another risk is positive nominal returns coincident with negative real returns, which could occur in a stagflationary economic environment. These risks suggest price volatility could rise meaningfully. Given low current levels of real (inflation-adjusted) rates and volatility, the risk/return complexion of traditional fixed income portfolios today is very poor.

So why are interest rates priced as they are? One answer may be that banks and investors trying to match future liabilities care only about spread. They have no professional interest in whether bonds produce positive real returns, and so they are generally unconcerned with nominal yield levels. Further, many large pools of capital cannot hold bonds with certain credit ratings, which has meant credits that come under pressure have been swapped for more stable ones, pushing yields on better credits down. Structurally, the massive reduction in Wall Street inventories has also reduced position hedging, which lessened selling. Most notably perhaps is that markets tend to price assets based on experience rather than the prospect of trend reversals. Despite short-term interruptions, credit has expanded, bond yields have declined and credit spreads have tightened since 1981. Policymakers across the world have further supported low and stable interest rates at the zero-bound when financial crises hit. The longer time spent at zero-bound overnight rates (which in the US was about seven years and in Europe and Japan are still occurring), the easier it has become for tertiary bond investors to reach for ever-narrowing yield spreads. Only the Fed is determined to normalize overnight rates, but has made it clear to the markets that it has no intention of restricting credit. These factors have generally encouraged investors to view bond markets as safe places for income without significant risk of price volatility or principal loss. (We will actually argue below that Treasury yields are too high and high yield credit spreads are generally too tight.)

Though we think we understand why bonds are priced as they are, *we believe capital seeking risk-adjusted returns has been broadly misallocated within fixed income markets. In a twist from conventional portfolio theory, investors seeking positive risk-adjusted real returns in the current environment should seek capital gains from bond markets, not income. Low interest rates, tight credit spreads, high equity valuations, highly-leveraged balance sheets, an aging economic recovery and low expected market volatility suggest that two complementary approaches – we will colloquially describe as betting on the horse and betting on the track – make sense today.*

Sometimes it pays to bet on the horse….

We were reminded of this last week when we ran into Michael Vranos, an old friend many might know. Mike developed and ran the largest and most profitable mortgage trading operation for Kidder Peabody, and then in 1994 opened a fund called Ellington Management. We used to compete with Mike, first as an MBS trader at Drexel and then running an MBS derivative fund called Spyglass Capital. We did well, but there was never any doubt (from us or anyone else in the business) that he and his team represented best-in-class bond analysis and investing.

Today, Ellington's pedigree, sell-side market-making experience, and superior analytics allows it to effectively make markets in mispriced sectors and industries in which it can be *a price setter* (as opposed to the Treasury arbitrage business that relies too heavily on massive leverage and, ultimately, liquidity provided by others). Ellington seems to exact gains across tertiary bond markets much the same way Warren Buffet exacts gains in the equity markets - by being a disciplined, opportunistic liquidity provider and an exceptional capital allocator. Unlike Berkshire, however, Ellington has been careful to maintain a right-sized asset base ($6 billion), which allows it to isolate and take advantage of mispriced opportunities.

Ellington's most impressive attribute may be its devotion to risk-adjusted investing. Unparalleled applied mathematics backgrounds at the top and throughout the firm form a culture of precision analytics and modeling. Whatever returns its five disciplines produce each year has been optimized as well as it can be. As a result, Ellington has overcome extreme market disruptions since 1994; migrated with opportunity sets across markets (not through strategy drift but by adding separate vehicles and applying its powerful analytics and infrastructure to them); has retained most of its original partners; and has added highly gifted and energetic younger portfolio managers and analysts to keep the firm dynamic. Ellington is a case study in organizational design and execution in the asset management business; a true thoroughbred.

…and sometimes it pays to bet on the track…

…In other words, to allocate capital to a more discretionary top-down investment program that tries to identify catalytic influences on asset classes, sectors and industries, calculate risk/return complexions, and then structure intelligent risk-adjusted speculations to take advantage of *potentially latent value*. It is a forward-looking top-down discretionary investment model that relies on the idea that the most influential factor in returns is to be invested in the right space at the right time. We will use ourselves to illustrate the merits and risks of this approach and how it applies to fixed-income investing today.

Our particular asset allocation decisions are influenced by our macroeconomic views, which today include a slowing US economy that could hit stall speed by 2018. Given this view, long duration Treasury yields are presently too high and junk bond spreads are too tight. (Low long-duration Treasury yields are also supported by a host of other reasons, including: the ongoing need to match long-term liabilities; positive yield differentials of Treasuries over other sovereigns; secular dollar strength; current Fed policy, which threatens to flatten the curve; zero bank capital weighting; aging demographics; and the ever-present potential for sudden equity and credit market weakness that would re-allocate capital to Treasuries.) We dislike high-yield bond prices presently given their tight spreads and over-sponsorship from junk bond tourists reaching for yield against our assumption of slowing output growth.

Unlike quant-based relative value investing (i.e., Ellington), such a position relies on a subjective belief – that US output growth will drop more than the markets anticipate. Given this bias, we believe holding long-duration Treasuries is a *good risk-adjusted speculation*. (A 100 basis point drop in Long Bond yields would provide a total return of near 25 percent.) Meanwhile, a short junk bond position in a period of burgeoning economic weakness would produce significant gains. Both legs could win if economic output is perceived to be slowing or if stagflation emerges. Either of these economic scenarios would surprise consensus. Since the markets are set up for continued slow growth and modest inflation, we would expect the potential gain if our macro view is right to be greater than the potential loss if we are wrong. Breaching a few standard deviations in the next year would bring far more upside than downside, in our view, because it would unwind crowded trades. It is a positively convex, long volatility position with gamma to underlying economics. The downside is that both long and short legs could lose if economic growth and inflation remain stable over time, or if output growth expands while inflation remains quiescent (a scenario that would benefit relative value strategies). Obviously, discretionary investing based on forward-looking views is speculative and should be sized correctly within a balanced portfolio.

Conclusion

Holding credit passively for income, which today is effectively shorting economic and interest rate volatility in return for insignificant compensation, is like picking up pennies in front of a steam roller. There are two complementary ways to skin a cat in fixed income markets today: systematic, relative value investing and discretionary investing. The former relies on consistently taking advantage of mispriced assets that will revert to mean yield spreads. Successfully executing the strategy takes experience, substantial human and artificial processing power, stable funding, and reliable access to market flow. It seeks to produce consistent, fairly reliable alpha. Discretionary investing usually requires a point of view and is likely to produce lumpier returns, which, in turn, provides a complementary offset to relative value investing. Both strategies require the ability to short assets, and so we think fixed income exposure in the current yield environment is best expressed in the alternative asset bucket of well-balanced portfolios.

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