

# Are Unconstrained Bond Funds a Substitute for Core Bonds?

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“The problem is that a core fund right now isn’t providing you a very high level of income, and if rates rise, it will not provide a lot of protection.” **Krisna Memani, Oppenheimer**

“Unconstrained bond funds are popular because people don’t know what they are. They think what bonds used to do isn’t going to work, so now the Holy Grail is show me a bond fund that doesn’t have any interest-rate risk but somehow has returns. Unconstrained funds actually have more risk than total return funds or core funds because they have more aggressive investments.” **Jeffrey Gundlach, Doubleline Capital**

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## Executive Summary

Proponents of unconstrained bond funds suggest that their flexibility in decision making and broader universe (1) helps insulate investors from growing interest rate risk; (2) allows allocation decisions to be made based on the relative attractiveness of assets rather than benchmark mandates; and (3) creates the potential for additional uncorrelated sources of alpha. In practice, it appears that (1) core bond funds continue to play an important role in portfolios that rising interest rates would not negate, including acting as a diversifier of equity risk, stabilizing a portfolio’s value in falling equity markets; and (2) that while unconstrained bond funds are in principle capable of playing the role that core bonds serve, it appears in practice that the universe of managers that employ unconstrained strategies have substituted credit risk for interest rate risk, thereby reducing their ability to perform that role.



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## Introduction

Following three decades of falling interest rates, many investors are anticipating a period of rising rates and are concerned that their bond portfolios will lose value. In response, many are rotating assets from their core bond portfolios to a relatively new approach to managing bonds – unconstrained bond funds. Unlike core bond funds, whose sector and credit quality allocations are set relative to a benchmark, unconstrained bond funds are “go-anywhere” funds whose allocations are based on their perceived relative attractiveness. Unconstrained bond funds not only have the flexibility to own assets in amounts that benchmark sensitive core products can not, such as avoiding interest-sensitive assets, but they can more easily own greater amounts of credits that are not part of a core benchmark, such as lower quality high yield assets or non-U.S. bonds denominated in other currencies. Additionally, these funds have the ability to use derivatives more extensively to shorten the duration profile of the fund in order to minimize interest rate risk.

Their potential ability to reduce interest rates risk has made unconstrained bond funds attractive to investors hoping to protect capital and raise income. Classified by Morningstar in the “nontraditional bond funds” category, of the seventy-plus unconstrained bond funds currently tracked, over fifty have track records of less than five years. Assets in unconstrained bond funds grew to \$123 billion in 2013 – an 80% increase from a year earlier, while core bond funds have experienced withdrawals of tens of billions of dollars, often at the recommendation of core bond managers recommending unconstrained bond funds.

In examining the basis for moving from a “core” to an “unconstrained” approach to owning bonds, we are left with a number of observations. First, that the death of core fixed income is greatly exaggerated. Core bond portfolios continue to play a critical role in investors’ portfolios, one that rising interest rates do not negate.

***Core bonds have generally served their role in a portfolio; providing a stream of income, a liquid source of capital, diversification from equity risk, and portfolio stability in falling equity markets.*** In periods of rising interest rates, the Barclays Aggregate benchmark has delivered negative performance in some periods and positive performance in others. More importantly, while the toolkit available to core bond managers to offset interest rate risk is limited by their willingness to move away from benchmark weights, the universe of core bond managers has generally outperformed the core benchmark during periods of rising rates.

Second, in principle unconstrained bond funds are capable of playing the role that core bonds serve in an overall portfolio; **however, in practice it appears that managers employing unconstrained strategies have typically substituted credit risk for interest rate risk. As credit risk is highly correlated with equity risk, unconstrained bond funds have in effect taken on additional risk in seeking yield, and by doing so have reduced their ability to perform the role that core fixed income plays in offsetting equity risk and protecting capital.**

Third, while unconstrained bond managers can draw from a broader universe, which should provide additional flexibility and greater opportunity to add value and mitigate risk, in practice this does not guarantee better risk-adjusted performance. The additional flexibility afforded managers introduces the possibility of wider dispersion in returns, and so managers must be skilled in macro analysis and in security selection to minimize performance volatility. The direct costs of placing assets in unconstrained bond funds, as well as the due diligence costs of identifying and monitoring skilled unconstrained bond managers, are higher than those for core bond managers.

As part of the analysis supporting these observations, the paper addresses a number of questions including:

- Do the reasons given for investing with unconstrained bond funds have merit?
- Do unconstrained bond funds serve the traditional roles of fixed income in a portfolio?
- Does moving from a “core” to an “unconstrained” approach mitigate or introduce risk?
- How have core bonds performed during periods of rising rates?
- Have unconstrained bond funds delivered on their promise of mitigating risk and generating absolute returns in different market environments?

## Unconstrained Bond Funds

Broadly, unconstrained bond fund portfolio managers suggest there are four reasons to move from a core bond fund to an unconstrained bond fund:

- The flexibility in decision making that an unconstrained bond fund manager enjoys allows allocations to be made based on the relative attractiveness of assets, while a portfolio managed to a core benchmark finds itself tied to the benchmark’s risks, regardless of their attractiveness (valuation).
- The Barclays Aggregate bond index (core benchmark) has become more sensitive to interest rates at a time when yields are low and many expect interest rates to rise. Investors’ concerns that current yields do not adequately compensate for increased interest rate risk has led many investors to consider unconstrained funds, rather than funds tied to core benchmarks and the risks these benchmarks contain.
- Adherence to a core benchmark leaves investors without access to the growing non-universe opportunity set (global sovereign and investment grade credit, and below investment grade credit), as well as the return and risk diversification properties that this broader universe provides. US investment grade core bonds make up 35% of global bonds. It is a well-accepted principle that broadening the universe from which securities can be selected – greater market breadth – has positive implications for returns and risk diversification.
- The broader universe and flexibility in decision-making permitted by unconstrained bond funds creates the potential for additional uncorrelated sources of alpha. Finally, unconstrained bond funds create the potential for additional uncorrelated sources of alpha as skilled managers make use of a broader universe, greater flexibility in decision making to avoid perceived risks, and ability to choose from a universe of securities; many at different points in their interest rate cycle.

In principle, unconstrained bond funds are easy to understand. In practice, the decisions managers and investors must make are much more complex and dynamic in nature. In principle, proponents suggest that unconstrained bond managers ignore benchmarks and relative performance in favor of delivering positive absolute returns across market environments. Managers can make sector allocation decisions based on the valuation and relative attractiveness of each asset, including assets that are not part of a core benchmark, ignoring benchmark weights. In addition to sector allocation decisions, managers have flexibility in other decisions they must make with regard to the portfolio’s overall duration, allocation across the maturity spectrum, credit quality and currency. Said differently, managers can dynamically adjust their portfolio’s exposure to rates and credit as conditions warrant it. Figure 1 provides a

description of the characteristics and holdings of bond funds ranging from “core” to “unconstrained”.

Figure 1

	<b>Core Bond</b>	<b>Multi-Sector</b>	<b>Unconstrained / Absolute Return</b>
<b>Objective</b>	Outperform a benchmark while closely maintaining benchmark exposures	Focus primarily on total returns	Focus on low volatility, uncorrelated, systematic returns
<b>Source of Return</b>	Fixed beta exposure	Tactical beta rotation	Tactical beta exposure and alpha strategies
<b>Benchmark Aware</b>	Small deviation from benchmark weight	Benchmark aware with flexibility	Benchmark agnostic
<b>Neutral Point of Risk</b>	Benchmark neutral	Benchmark neutral or cash	Cash
<b>Duration</b>	Small deviation from benchmark	Zero to positive	Negative to positive
<b>Spread Risk</b>	Long	Long or short	Long or short
<b>Hedging</b>	None	Limited	Systematic

## Risks of Moving from Core to Unconstrained Bond Funds

More Freedoms, More Risks Unconstrained bond funds are easy to understand in principle, but in practice the decisions managers and investors must make are much more complex and dynamic in nature. By forgoing benchmark-determined weights and drawing from a broader universe of bonds, managers are forced to have well-defined views on (1) the macro environment as it pertains to growth and inflation, and their implications for rates, credit spreads and currencies across multiple global markets as well as (2) the relative attractiveness of bonds within and across sectors.

Managers not only need a view on the implications of Federal Reserve bank policy on short and long rates, but on the plans and implications of other central banks from the ECB to the Bank of England to the Chinese central bank, and what they mean for investment and non-investment grade credit, and currency values across countries and markets. As managers increase the number of bond sectors they can choose from, the amount of necessary research and decisions they must make increases proportionately.

While in principle unconstrained bond funds give managers the freedom to avoid risks introduced by benchmark weights (interest rate risk), in practice managers must not only get those anti-benchmark calls correct, but the alternative decisions, too. Managers that avoid long-dated US Treasuries because of their perceived interest rate risk and in their place own German bunds or high yield bonds, not only need to get the U.S. interest rate call right, but their calls on German rates and high yield bonds, too.

**Risk, Relative Performance and the Role of Core Bonds** The range of performance across unconstrained bonds can be wider than investors are used to with benchmark constrained core funds focused on relative performance, for several reasons. First, unconstrained managers can have very different macro views on the direction of rates, credit and currencies, which can lead to large differences in performance. Second, the

freedom managers have to express those views can vary dramatically. At one end of the risk spectrum, unconstrained bond funds can choose to be long only and manage the fund to the same risk profile as a core benchmark, differing only in its weights relative to a core benchmark. At the other end of the risk spectrum, an unconstrained manager can choose to take short positions and use leverage and derivatives to hedge out risk and capture alpha opportunities. Figures 2A, 2B and 2C provide a sampling of allocations (1Q14) by sector, duration and credit quality for six unconstrained funds. Differences in macro views and how managers execute their views have implications for the risks investors in unconstrained bond funds are exposed to and the role bonds play in a portfolio.

In today's market environment, many unconstrained managers seeking to avoid interest rate risk as well as secure additional yield have chosen to replace US Treasuries with below investment grade credit.

Figure 2A



Figure 2B

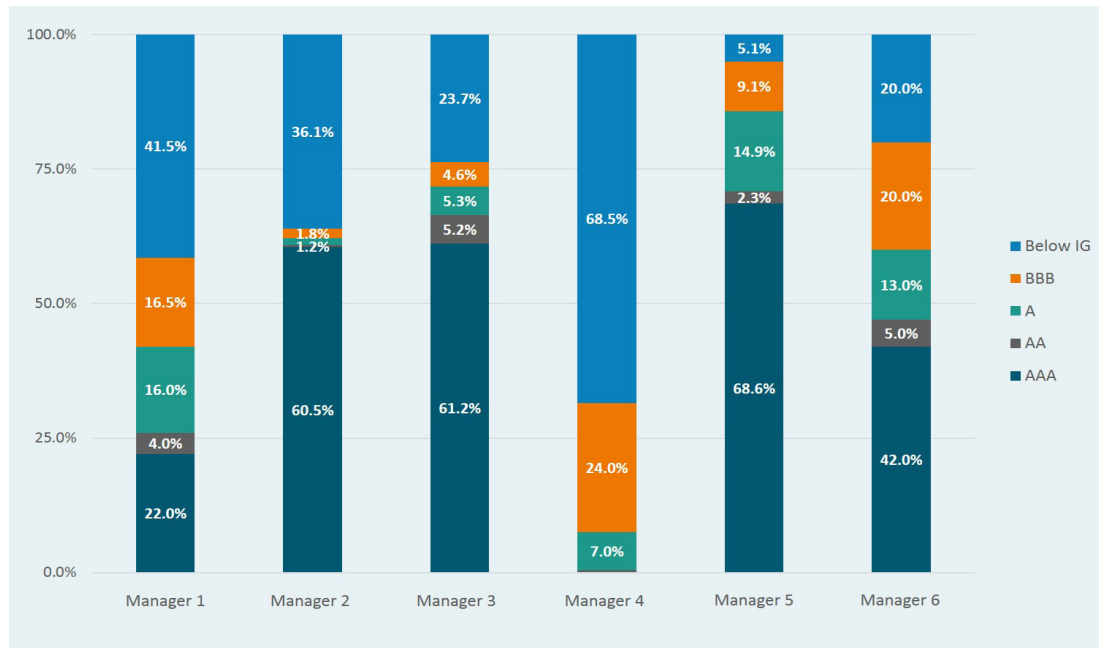
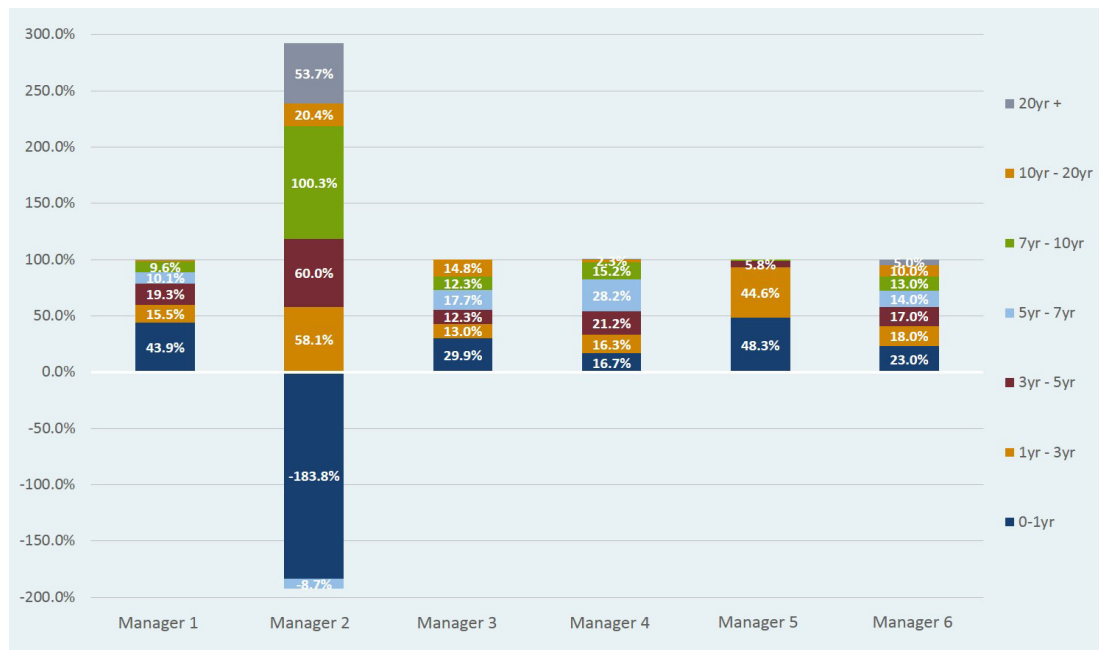


Figure 2C



Historically, these assets have been highly correlated to equity performance. In an environment where Fed tightening reduces expected growth, both equities and equity-like assets such as high yield bonds are likely to sell-off. ***The risks introduced by making use of non-core assets raises questions about whether, in building a portfolio that is less interest sensitive, unconstrained bond funds forgo some of the desirable characteristics of core bond funds.*** Investors must determine whether

the risk characteristics of any unconstrained bond fund under consideration allows it to serve the role of a core bond fund or whether it exposes the investor to additional equity or other risks.

## Core Bonds and Interest Rate Risk

In the last five years, expansionary central bank policy has not only led to low interest rates and coupon income, but their purchase of sovereign assets has increased the interest rate sensitivity of core bond benchmarks. Together, these outcomes have encouraged investors to move from core to unconstrained bond funds, reflecting concerns that in a low yield environment core bond portfolios offer too little yield relative to the interest rate risk they take on.

Figure 3 describes the fall in the U.S. Federal Funds and 10-year Treasury rates, while Figure 4 describes the changing composition of the Barclays Aggregate Bond index. In the last seven years, the indexes' allocation to interest sensitive government securities has increased, leading its effective duration to rise by 20% while its yield dropped from more than 4% to about 2.4%.

Investors are right to be concerned about interest rate risk at a time that bonds offer little yield and face the prospect of rising interest rates.<sup>3</sup> But before abandoning their core bond portfolio, investors should consider its behavior over periods of rising rates. Even as interest rates have fallen for three decades, there have been periods of rising rates; Figure 5 describes the bond performance during each of eight periods of rising rates and the performance of active core bond managers during those periods.<sup>4</sup>

A number of observations can be drawn from the results of Figure 5:

- Core bonds did not always lose value during periods of rising rates.
- Differences in the way that sectors behave during various rate environments provide an opportunity for portfolio managers to manage risk and protect capital even as they are constrained by benchmarks.
- The median active core manager generally outperformed the Barclays Aggregate Bond index.

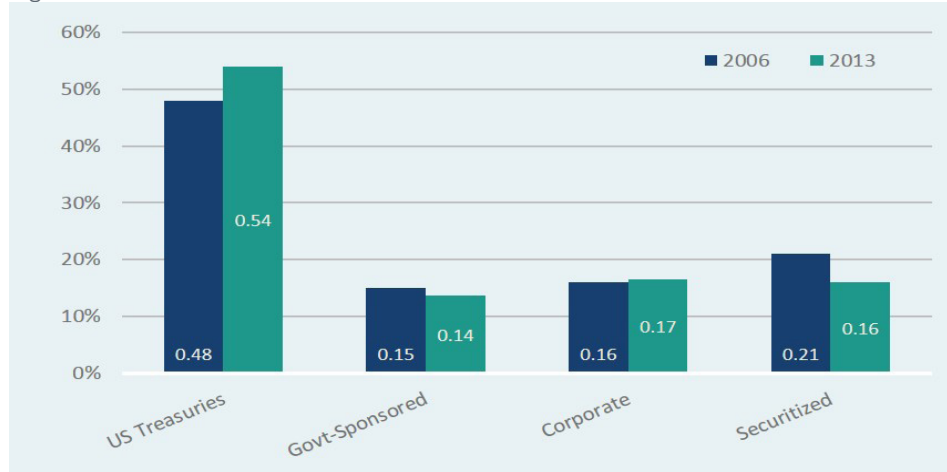
Figure 3



Source: Federal Reserve Bank



Figure 4



Source: Barclays' Global, BlackRock, date as of December 31, 2013

Figure 5: Bond Performance During Different Periods of Rising Interest Rates

	Period 1 10/93 to 11/94	Period 2 2/94 to 2/95	Period 3 1/96-6/96	Period 4 10/98-1/00	Period 5 6/03-6/04	Period 6 6/04-6/06	Period 7 6/05-6/06	Period 8 12/08-6/09	Period 9 10/10-2/11	Period 10 7/12-12/13
US Core Bonds	-3.6	1.8	-1.2	-0.6	0.1	3.1	-0.2	5.7	-0.9	-0.2
Short Treasury	3.8	4.6	2.6	4.8	0.9	3.2	3.9	0.1	0.1	0.1
Long Treasury	-2	2.2	-0.1	0.3	-0.6	1.8	0.1	-0.5	-1.7	-0.5
MBS	-1.7	2.8	0.3	1.3	2.2	3.5	0.7	4.6	0.5	-0.3
US Investment Grade	-4.9	1.4	-2.1	-1.3	0	2.9	-1.3	15.7	-0.6	2.2
US High Yield	0	1.8	3.5	3.1	12.4	8.2	6.3	40.5	6.9	10.4
EM Debt	-2.6	-15.8	13.3	26.3	5.4	13	7.5	28	-1	3.8
Global Bonds	-0.2	4.9	-0.8	-3.6	3.2	-0.2	-0.2	7.8	-0.6	0.1
S&P 500	0.1	7.4	10.1	28.3	18.9	8.2	8.1	-30.4	17.3	25.3
Core Universe (5%)	-1.2	1	3.2	4.5	6.2	6	3.6	24.9	4.3	7.6
Core Universe (25%)	-2.6	1	0.1	1.1	2.9	4.3	1.2	14	1.6	3.9
Core Universe (median)	-3.6	1	-0.8	0.1	1.5	3.9	0.7	10.8	0.7	2.3
Core Universe (75%)	-4.4	0.9	-1.5	-0.5	0.9	3.5	0.2	8.2	0	1.3
Core Universe (95%)	-6.2	0.9	-2.1	-2.2	-0.1	2.9	-0.5	5.5	-0.9	0.3
Starting 10-year Treasury Rate	5.17	5.97	5.52	4.16	3.33	4.73	4	2.42	2.54	1.53
Ending 10-year Treasury Rate	8.03	7.47	7.06	6.79	4.73	5.11	5.11	3.72	3.58	2.9
Change in 10-year Treasury	286 bp	150 bp	154 bp	263 bp	140 bp	38 pb	111 bp	130 bp	104 bp	137 bp
Starting Fed Funds Rate	2.99	3.25	5.56	5.03	1.22	1.03	3.04	0.16	0.19	0.16
Ending Fed Funds rate	5.98	5.92	5.27	5.45	1.03	4.99	5.25	0.21	0.16	0.09
Change in FF rate	299 bp	267 bp	-29bp	38 bp	-0.19	496 bp	221 bp	5 bp	-3 bp	-6 bp

While 20-years of rising interest rate history offers multiple examples of core bonds protecting capital, proponents of dispensing with a core benchmark and employing unconstrained bond funds will suggest that the flexibility of the approach means an even lower probability of investors losing capital in periods of rising rates as well as other periods of market stress. Figure 6 examines the behavior of core and unconstrained bond managers over several periods of market stress (Global Financial Market Crisis, Greek Financial Crisis and Emerging Markets Debt sell-off) and rising interest rates during the last six years. Its results are revealing in a number of ways:

- During periods of market stress when equities lost value, the median unconstrained bond manager performed more in line with equity markets than bond markets; only managers in the top 5% of



performance protected capital. In these same periods of equity market stress the median core bond manager delivered positive performance, protecting capital and providing diversification to equity risk.

- During recent periods of rising interest rates unconstrained bond managers outperformed core bonds and core bond managers, but their absolute level of performance was more in line with equity market performance than that of core bonds.

From these observations, investors are left to legitimately question whether unconstrained bond funds have replaced interest rate risk with equity risk, and in doing so given away a primary role of core bonds—to diversify equity risk.

**Figure 6: Performance of Core and Nontraditional Bond Manager Universe**

	Financial Market Crisis 05/2008 - 01/2009	Greek Financial Crisis 05/2011 - 10/2011	Emerging Market Debt Sell-off 03/2013 - 07/2013	Rising Interest Rates 12/08-6/09	Rising Interest Rates 10/10-2/11	Rising Interest Rates 7/12-12/13
<b>BC Aggregate Bond</b>	2.3	5	-2.1	5.7	-0.9	-0.2
<b>S&amp;P 500 TR USD</b>	-39.2	-7.1	12.2	-30.4	17.3	25.3
<b>Core Bond Manager Universe</b>						
Top 5%	5.5	6.1	-0.8	24.9	4.3	7.6
Top Quartile	3.5	5	-1.8	14	1.6	3.9
Median	1.6	4.4	-2.1	10.8	0.7	2.3
Third Quartile	-1.8	3.8	-2.3	8.2	0	1.3
95th Percentile	-8	1.9	-2.8	5.5	-0.9	0.3
<b>Nontraditional Bond Manager Universe</b>						
Top 5%	2.7	2.2	1.7	35.5	5.9	15.1
Top Quartile	-4.3	-0.2	0.2	19.2	3.8	9.3
Median	-12.7	-1.7	-0.6	15.3	2.3	5
Third Quartile	-15.5	-3	-1.8	9.6	1.1	1.7
95th Percentile	-26.5	-5.4	-3.2	2.5	-1.3	-2.2

## Conclusion

Proponents of unconstrained bond funds suggest that their freedom in sector selection and portfolio construction allows them to make decisions based on the relative attractiveness of investment options rather than benchmark imposed constraints, making them superior to owning core bond portfolios. This flexibility should allow them to minimize their exposure to interest rate risk and capture attractive risk-adjusted yields.

Investors considering replacing their core bond portfolio with an unconstrained bond allocation must decide if the risks they are attempting to minimize are replaced by another set of acceptable risks, and as a result if the new strategy serves the traditional role played by core bonds (income generation, capital preservation in the face of equity risk).

A review of core bond and unconstrained bond performance reveals that:

- Core bond funds continue to play a critical role in investors' portfolios. Rising interest rates do not negate this role. Core bond funds have generally provided a stream of income, a liquid source of capital,

and equity risk diversification, which stabilizes the value of portfolios in falling equity markets. In periods of rising interest rates, core bonds have delivered negative performance in some periods and positive performance in others; and the universe of core bond managers has generally outperformed the core benchmark during periods of rising rates.

- In principle unconstrained bond funds are capable of playing the role that core bond funds serve in an overall portfolio; however, in practice it appears the universe of managers employing unconstrained strategies have substituted credit risk for interest rate risk. As credit risk is highly correlated with equity risk, unconstrained bond funds have taken on additional risk in seeking yield and have typically failed to serve the role of core fixed income in offsetting equity risk and protecting capital.
- While the broader universe from which unconstrained bond managers can draw and the additional flexibility in decision making afforded them would appear to offer a greater opportunity to add value and mitigate risk, in practice it does not guarantee better risk-adjusted performance. The additional flexibility afforded managers does introduce the possibility of wider dispersion in returns, and so managers must be skilled in macro analysis and in security selection to minimize volatility in performance. The direct costs of placing assets in unconstrained bond funds as well as the due diligence costs of identifying and monitoring skilled unconstrained bond managers are higher than those for core bond managers.

## Notes & Disclosures

1. As an example, for investors seeking to avoid rising US rates, European rates may be more attractive as the ECB seeks to increase liquidity and reduce rates
2. As an example, a core manager facing benchmark duration of 5 years and concerned about rising rates may choose to have a duration of 3 years. Following a 1% rise in rates, the fund would lose 3% instead of 5% and the manager would outperform by 2%. An unconstrained manager may choose to be short duration by 3 years, such that it gained 3% following a 1% rise in rates.
3. It must also be recognized that there is a silver lining to rising interest rates: income from coupon payments and capital from maturing bonds can be reinvested at higher yields. Over time, the increased income from reinvesting at higher yields can offset the initial loss of capital from rising rates.
4. Periods of rising rates were defined by a 1% or greater rise in either the Federal Funds rate (short end of the yield curve) or the 10-year Treasury yield (the long end of the yield curve).

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