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NEWS AND VIEWS FOR INSTITUTIONAL INVESTORS

How active corporate bond investing can beat the index

Relative value approach allied to disciplined risk management requires deep resources

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When interest rates are in flux, a static bond portfolio seems like a gamble.

In the current environment, many investors are looking for active strategies that take no more risk than the benchmark, but are seeking to generate higher returns.

An active strategy that is also disciplined in how it assesses and trades corporate bonds can exploit daily fluctuations in markets. The capability to spot mispricing and trade rapidly and efficiently has been shown to generate significant alpha.

Better use of market information

The Disciplined Alpha team at Loomis Sayles, an affiliate of Natixis Investment Managers, believes their relative value approach has the potential to generate the higher, consistent returns clients are seeking now. The team aims to gain an edge in security selection through deep research and better use of market information to buy the best available investment-grade corporate bonds across the yield curve.

"We spend most of our time and resources on bottom-up security selection," says Lynne Royer, co-head of the Disciplined Alpha team. "Every trade starts with our research team."

Duration, yield curve and industry exposures in Disciplined Alpha portfolios tend to be similar to the wider bond indices. Value is created through security selection and harvesting value through a continuous rotation of bonds to the best opportunities.

A typical portfolio under Royer's watch has well over 100 issuers and many more individual bonds. "The specific issue is as important as the credit," says Royer. "Take AT&T; there are around 60 individual issues but some outperform, and some don't. It's much more than just saying: we like AT&T."

Active approach is boosted by distributed decision-making

The Disciplined Alpha team has a unique approach to portfolio decision-making in that the team's portfolio managers and traders have the authority to buy and sell within their areas of coverage. Royer says: "We have a very active security selection process, so we want those closest to the market and newsflow to make day-to-day decisions. You have to be nimble and capitalise on opportunities as they arise in fast, efficient markets. We need to spot and trade mispricing before it disappears."

Key takeaways:

- The yield on US investment grade corporate bonds has risen to 5.5%, but with recession still a possibility, investors may want to seek active managers who have outperformed through many cycles.
- Annualised gross excess returns since inception in the Loomis Sayles Corporate Disciplined Alpha strategy (inception 31 May 2013) is 92 bps, putting performance in the top 14%[1] among peers.
- Duration, yield curve and sector exposures in Loomis Sayles Disciplined Alpha portfolios tend to be similar to the wider bond indices. Value is created through security selection and harvesting value through rotation of bonds to the best opportunities.

1 Strategy composite. Past performance is not a guarantee of future results. This communication is for informational purposes and does not constitute an offer to sell or the solicitation of an offer to buy any products.

Significant trading experience within the team is required for this distributed model to function efficiently.

While Loomis Sayles has a large, centralized fixed income trading desk located in its Boston headquarters, the Disciplined Alpha team has its own, independent trading desk at its Orinda, CA office. "Trading and timely market intelligence is tightly integrated into our investment process. Our analysts and PMs communicate throughout the day with our traders to spot opportunities and market mispricings," said Royer.

Leveraging the Loomis Sayles' world-class research

Sizeable research capabilities are required for relative value assessments, so Loomis Sayles' long-established and well-resourced fundamental and quantitative research platforms are an integral part of the Disciplined Alpha investment process.

"We heavily leverage Loomis Sayles' firm-wide resources," says Royer.

Deep proprietary research, provided by the Loomis Sayles Credit Research and Quantitative Research Risk Analysis teams, is the underpinning of the Disciplined Alpha team's ability to generate alpha. "The independent analysis and data these teams provide us drives our security selection. Their high quality output enables our portfolio managers to quickly assess and act on buying opportunities if and when the market reveals them. "

Fully risk-adjusted portfolios

Risk management is applied to every step of the Disciplined Alpha team's investment processes. The biggest risk to any bond portfolio is interest rates, says Royer. Because the Disciplined Alpha team aims to outperform through security selection, it neutralises swings in interest rate and movements in the yield curve. "We don't take top-down risk," she says. "We keep duration in-line with the benchmark and we keep close to the benchmark yield curve risk."

The Disciplined Alpha team avoids falling into yield traps – buying cheaper bonds with higher yields and hoping that spreads tighten.

To avoid this, it uses a fully risk-adjusted measure to value bonds. This proprietary measure, known internally at Portfolio Impact (PI), takes into account market value, duration, and beta adjustment.

The PI measure enabled the team to avoid the so-called AT1 securities or "contingent-convertible" bonds issued by Credit Suisse, which went to zero during the 2023 banking meltdown/crisis. AT1s are typically the highest-yielding bank bonds investors can buy, since bondholders expect to be compensated for the additional risks.

"We didn't invest in Credit Suisse's AT1s because our view was that they were too "equity-like" – meaning the yield was attractive when spreads were tight but definitely unattractive from a risk-adjusted viewpoint."

The PI framework is supported by a proprietary, real-time risk monitoring management tool the team developed in 2012 called DART, the Disciplined Alpha Risk Tool. "Because of our distributed decision-making structure, everyone needs to see and understand the current risks. Through DART, risk is visible on all our screens, and can be examined in many different dimensions."

DART also displays performance attribution, which is heavily emphasized by Lynne and Seth. "We believe it is empowering for every team member to see the precise impact of their decisions on client portfolios," says Royer. These impacts form part of employee reviews and compensation.

ESG is also incorporated into the risk framework where financial materiality is an issue. Loomis Sayles can also create bespoke portfolios for investors seeking carbon-neutral portfolios and other specific ESG impacts.

Upper top-quartile returns over the long term, with less risk[2]

The Disciplined Alpha approach is validated by performance. Annualised gross excess returns of the Corporate Disciplined Alpha strategy since its inception in 2013 is 92 bps, putting performance in the top 14% among peers.

At the same time, tracking error is 45bps, which is lower than 99% of other managers. The information ratio, which essentially evaluates the skill of a portfolio manager, is 2.06, which is in the top 1% vs peers.

"It is very gratifying that we have been able to generate upper top quartile returns for clients, while exposing them to less risk," says Royer.

The investment process provides consistency too: portfolios for institutional investors have outperformed in 37 out of the last 39 quarters. "Clients really like that consistency," says Royer. "They see we can produce positive excess return in any interest rate environment."

In 2022, as interest rates rose and investors fretted about their bond investments, the team outperformed the benchmark by around 50bps. The approach also bore fruit as market confidence plummeted in the early stages of the Covid pandemic. Spreads widened fast in Q1 2020 and came back just as fast in Q2 after central banks intervened. The Disciplined Alpha team significantly outperformed during both quarters and produced 246 bps of excess return over the whole of 2020, its best year to date.

Not a time for beta

The outlook for US investment grade corporate bonds appears positive. The current yield is 5.5% and, while recession is still a possibility in the next year or two, credit quality is holding up.

But Royer cautions: "You want to be with an active manager who has been through many cycles and outperformed. It's definitely not a time to be in passive and load up with beta."

For many investors, Disciplined Alpha's relative value approach is a core holding and particularly attractive because it has low correlation with other corporate bond funds and is therefore complementary.

The approach may hold particular appeal for institutions in Europe, where the investment grade universe is relatively small. With yields on US corporate bonds considerable higher than in Europe, they offer a sound complement to returns from European fixed income.

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2 Strategy composite. Past performance is not a guarantee of future results. This communication is for informational purposes and does not constitute an offer to sell or the solicitation of an offer to buy any products.

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