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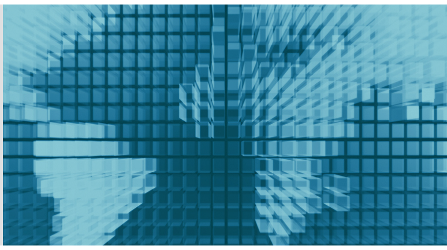

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# Buy and maintain

## A bold alternative to 'buy and hold' for fixed income

**Key Takeaways:**

- A buy and maintain strategy focuses on a desired level of income and aims to ensure the bond portfolio is not impacted by default risk as interest rates rise and economies overheat.
- This income-driven and unbenchmarked strategy, which is agnostic to the market value of the portfolio, continuously monitors and actively manages credit risk.
- Although buy and maintain managers have many points in common, they also have points of differentiation, as the examples of Ostrum Asset Management and Loomis, Sayles & Company demonstrate.

Institutional investors with defined cashflow needs face a two-pronged challenge: selecting the right bonds for their liabilities and then managing the bonds until the liabilities are discharged.

Choosing to tackle the first part of the task alone – selecting appropriate bonds – may not be sufficient. Buy and hold strategies have long been a staple of yield-seeking investors, but these strategies run the risk of not meeting their target amid changing economic conditions and fluctuating interest rates.

A buy and maintain strategy, on the other hand, focuses on a desired level of income and aims to ensure the bond portfolio is not impacted by default risk as interest rates rise and economies overheat.

### Why buy and maintain?

A buy and maintain approach to investing in fixed income is very different from the typical way investors build their bond portfolios.

First and foremost, it is an income-driven strategy, designed to deliver steady income over longer periods than those most fixed income funds target. The strategy is particularly relevant for insurance firms and other institutions with long-term, defined liabilities.

Whereas many bond portfolios are designed to seek capital growth and total returns, buy and maintain is agnostic to the market value of the portfolio.


**Farhat Selmi,**
Senior portfolio manager, Fixed Income Insurance team.
Ostrum Asset Management



**Gene Morrison,**
Relative return product manager
Loomis, Sayles & Company


Although it may sound strange to some investors, capturing yields that match a defined goal is more important than how other investors in the market value the bonds.

Buy and maintain achieves consistent yields by prioritising the minimisation of losses in the portfolio. Buy and maintain portfolio managers seek to hold bonds to maturity if they can, which minimises turnover and keeps transaction costs low.

However, because default risk is anathema to buy and maintain managers, they do not hesitate to sell bonds when the credit profile changes for the worse and the risk of loss rises. They will not simply allow a default as buy and hold investors are willing to do. This means all credit risks in the portfolio must be continuously monitored and actively managed.

### Dynamic management required

The buy and maintain strategy has no benchmark constraints since managing to a benchmark would undermine the search for good credits and consistent yields, and could create a duration mismatch. An unbenchmarked strategy allows portfolio managers to search for suitable bonds across the globe, and across the credit spectrum - investment grade, bank loans, high yield, emerging debt and so on.

The unbenchmarked approach also allows managers to build tailor-made portfolios, with a view to managing specific regulatory or client constraints. Although buy and maintain managers have many points in common, they also have points of differentiation, as the examples of Ostrum Asset Management and Loomis, Sayles & Company (both affiliates of Natixis Investment Managers) demonstrate.

### Ostrum Asset Management: a Euro fixed income specialist

Ostrum Asset Management has nearly €260 Bn of assets under management, of which around two thirds are invested on behalf of insurance clients. While buy and maintain is not solely for insurers, this class of clients is most interested in the strategy.

Ostrum has managed assets on behalf of insurers for over 40 years, and now has managed more than 80 fixed income insurance portfolios for nearly 25 clients. It has the capabilities to manage insurer mandates under regulatory, risk and tax constraints and the capacity to create tailor-made mandates with bespoke reporting.

### Anticipating changes in credit quality

Ostrum's resources give it the widest possible coverage in terms of geography and securities, with deep analysis aiming to uncover changes in credit quality ahead of the market.

Ostrum sees its buy and maintain approach as similar to that of a loan officer, making decisions based on the long-term absolute credit performance of a company, as opposed to quarterly relative value decisions based on what is expensive or cheap at any particular stage of the business cycle. Building and managing effective buy and maintain portfolios therefore requires a different way of thinking and an entirely different fixed income investment process.

Key to Ostrum's investment framework is initial portfolio construction. It believes portfolio management should be based on a customized benchmark rather than a public index, while security selection should be based on rigorous credit research rather than on public ratings. This leads to an intelligently-constructed portfolio which actively manages positions through economic cycles.

### Customising, buying, maintaining

Ostrum's investment process begins with a definition of the investment universe based on client constraints. This entails forensic examination of underlying investors' liabilities and objectives, and any constraints they have in meeting these objectives. Examples of constraints include limiting the portfolio to investment grade bonds only, setting a duration target and meeting SCR targets imposed by the Solvency II Directive.

The next step is to select the appropriate credit instruments. This process is informed by the Ostrum internal credit research team, which is one of the largest among European asset managers, comprising over 20 credit analysts covering the US, Europe and Asia. Resources at the disposal of Ostrum's buy and maintain managers include macroeconomic research, credit research, quantitative research, strategists, sector specialist teams and a trading desk.

"We think the main value of our buy and maintain strategy is in the rigour of our approach and our deep analysis of both issuer and bonds," says Farhat Selmi, senior portfolio manager in Ostrum's Fixed Income Insurance team.

The Ostrum credit analysts provide the investment management team with long-term, forward-looking views that are designed to adjust an issuer's credit score in advance of announcements by the ratings agencies. It is this anticipation which reduces the risk of impairment.

Using the internal ratings, the managers then choose the optimal portfolio composition in terms of forward-looking risk and reward, and duration. To enable dynamism in maintaining the portfolio, there is considerable diversity by asset class, duration and credit, with 100-150 holdings in Ostrum's buy and maintain portfolios on average.

The third step is maintaining the portfolio through the active monitoring of the instruments to anticipate downgrades and avoid forced selling. The Ostrum portfolio managers prefer to hold each security until maturity, but they will sell if the likelihood of default increases and substitute the security with one that has a better credit profile.

The managers also have leeway to arbitrage between primary and secondary markets, as well as between sectors, and along the yield curve. "This gives us the opportunity to, for instance, arbitrage securities issued by the same companies, but in different markets and with different maturities," says Selmi.

The expected income from the strategy depends on the market timing, and is usually in the range of 0.5% to 2%. "With sensitivity to the credit cycle and drawdown risk greatly reduced via this strategy, a rising interest rate environment will have less impact on our clients' holdings than on benchmarked portfolios," says Selmi.

In other words, while other credit investors may need to sell their holdings as interest rates normalize, buy and maintain investors are better placed to ride out turbulence.

### Loomis Sayles: a leader in credit research

Loomis Sayles' investment pedigree goes back nearly a century. The firm is widely recognized for its credit research expertise and security selection has consistently contributed to long-term performance.

### A client-focused evolution

Loomis Sayles' buy and maintain strategies were born out of partnership with the firm's institutional clients. Loomis Sayles developed these strategies to meet the needs of banking and insurance clients looking to invest in high-quality, income-producing securities that consistently yielded more than their financial liabilities.

In 2014, the relative return team worked with Loomis Sayles' foreign currency trading desk to begin offering buy and maintain strategies fully hedged to a client's home currency, to help non-US-dollar clients avoid the unstable effects of currency markets. Loomis Sayles now provides full or partial hedging to any client interested in reducing or neutralizing currency exposure. Being able to fully hedge portfolios has enabled non-US investors to access the US bond markets, which offer higher yields than many other major fixed income markets. In addition to the US investment grade buy and maintain strategies managed by the relative return team, the firm offers buy and maintain strategies in emerging market debt, bank loans and high yield. The Loomis Sayles relative return team's buy and maintain strategies rely on disciplined collaboration across the firm. The investment team, credit and quantitative research analysts, and traders work together to build optimised portfolios.

### A straightforward, yet powerful, investment process

The investment process begins with portfolio design, helping the team shape a universe based on client needs and internal strategy limits. The team works with the client to define the desired maturity, risk tolerance, average credit quality, country and sector allocations, and any SRI requirements. The client may also want to avoid investing in its own bonds or those of competitors, or avoid allocating to sectors that are already well represented in other parts of its overall portfolio.

The next step is portfolio construction, which leverages portfolio optimisation techniques to better understand potential risk/reward tradeoffs.

The team then reviews each individual issuer and the overall portfolio characteristics to ensure the best fit to the portfolio design. Once these steps are completed, the team moves to the "Ramp-Up" phase where they establish an investing timeline and begin execution.

### Proprietary credit-rating system

Like Ostrum, Loomis Sayles puts great emphasis on credit research. The firm's history dates back to 1926 and it has one of the oldest credit rating systems in the US. Loomis Sayles' credit research professionals provide the fundamental analysis that underpins the buy and maintain investment process. Skilled credit selection enables the firm to minimise adverse credit events and implement a long-term value approach with minimal turnover. "We aim to make sure that each of our credits are fundamentally strong – that they will provide both income and capital repayment," says Gene Morrison, relative return product manager at Loomis Sayles.

In addition to examining statutory company-issued information, analysts look at companies through the prism of competitors, suppliers and customers to get a well-rounded view. Changes in fundamentals may also take place at the industry or macro level, and the team's analysis considers any potential large-scale disruptive changes. The team also assesses how "friendly" company management teams are to bondholders and shareholders. "Do they give mixed signals about their credit rating?" says Morrison. "If they say they are committed to being a single-A entity, will they stick to that?"

The portfolio managers may sell a credit when fundamentals deteriorate or are forecasted to change substantially, but they do not panic over short-term price movements, particularly in buy and maintain mandates.

### Incorporating liquidity and yield optimization tools

The Loomis Sayles relative return team has a differentiated approach to liquidity in buy and maintain portfolios.

The team believes liquidity is essential for efficient trading and portfolio construction. The firm has developed its own liquidity toolkit to ensure bonds that score well in the credit process also possess sufficient market volume to be traded. For this reason, the portfolio managers only invest in very liquid bonds and avoid instruments where volumes may be opaque. "Establishing our internal liquidity guidelines is critical to delivering what clients expect. Without them, you can promise very high yields using a model portfolio of illiquid bonds, but when you try to buy that portfolio in the market, you may find the bonds aren't available," says Morrison. "We want to put our investors' capital to work and get the yield they require straight away. That's why we emphasize liquid issues as part of our process."

Loomis Sayles also employs other proprietary quantitative tools. "We use a tool to help us quickly maximise yield per unit of risk," says Morrison. "If we are looking to achieve a client's target yield of say, 4%, but the portfolio model we have built is only at 3.7%, we have developed tools to help us efficiently analyse what constraints we would need to change to reach the target. Then we help the client understand the tradeoffs in changing any constraints before they agree to move forward. We will also monitor yields each day to see when available market yields reach the client's target. In this way, we are ready to ramp up the moment we see that the target yield can be achieved."

### Look for buy and maintain managers with deep research capabilities

Many buy and maintain managers offer a customized, client-oriented approach. However, a successful buy and maintain strategy is often the result of extensive credit research. Potential investors should seek out a manager with deep research capabilities, enabling managers to better assess each credit's default risk and income potential.

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