Shedding Light on Unconstrained Bond Funds

Unconstrained bond funds have gained popularity because of the freedom to pursue absolute returns in the fixed-income market by shedding the constraints of conventional benchmarks. The relative newness of many of these funds, the lack of standard benchmarks, and the diversity among the funds’ risk exposures and strategies present unique challenges for investors assessing this fund category.

With rising interest rates at the forefront of investor concerns, unconstrained bond funds have proliferated as an alternative fixed-income investment solution. Offering low correlations with the broad bond market, these products have an array of mandates to provide greater income, greater capital appreciation, or less sensitivity to rising interest rates compared with traditional core bond funds. Such mandates can seem particularly appealing after the Barclays US Aggregate Bond Index lost 2.0% in 2013 when the 10-year Treasury yield rose 127 bps.

Unconstrained bond funds are generally managed without typical fixed-income constraints, such as duration, maturity, or credit quality. Whereas core fixed-income funds hold mostly US government and investment-grade corporate securities, unconstrained funds invest opportunistically and may hold global bonds, currencies, high-yield bonds, structured bonds, and even equities. Many use leverage, derivatives, and swaps, taking short positions as well as long ones. Some unconstrained funds minimize interest rate sensitivity, and others have the latitude to take substantial levels of interest rate risk. Common to funds in the category is the lack of a conventional benchmark, a reflection of the funds’ unbounded opportunity sets and potential for alpha. “Because these funds are benchmark-agnostic, they could be very effective in an environment of rising interest rates,” says Frederic C. Filippelli, CFA, director of investment governance at Prudential Retirement.

Funds Defy Categorization
Unconstrained bond funds are essentially a collection of vastly diverse strategies and risk exposures. The choice of fund depends on an investor’s objective and how the fund fits within an overall fixed-income allocation. Many investors use these funds to complement, rather than replace, a core bond fund. “We view unconstrained funds as another opportunity to generate positive rates of return from fixed income,” says Brian Hrabak, CFA, senior managing director at Hartland & Co., an independent investment consulting firm. “We recommend maintaining a core fixed-income allocation and use unconstrained funds to round out our fixed-income allocation.”

The diversity among unconstrained funds means investors must do a fair amount of research before selecting one. The average performance for Morningstar’s Nontraditional Bond Fund category was 2.1% for the six months from 31 December 2013 through 30 June 2014, yet individual fund performance ranged from −4.6% to 9.2% during the period. A fund’s name often provides little information about its primary risk exposures or strategy. Investors who want to neutralize interest rate risk will want to avoid funds that can make large duration bets. Funds that focus on income generation may be heavily invested in high-yield bonds, emerging market debt, or illiquid securities. “In many cases, an investor is trading interest rate risk for credit risk,” says Hrabak, who advises looking at a manager’s historical allocations.
to try to determine the sources of a fund’s risk and return. “You do not necessarily want a high-yield manager disguised as an unconstrained bond fund,” he says.

Reviewing a fund’s current holdings, sector allocations, and duration and maturity positioning can provide a snapshot of how the fund is invested today, but it is essential to read the fund’s description or prospectus to understand how the fund may invest in the future. Unconstrained funds have the leeway to shed securities and shift strategies on short notice. “I don’t think you can look at an unconstrained bond fund and know how it will perform in a rising-rate environment given where it is positioned today,” says Thomas M. Chapin, CFA, chief investment officer at Mill Creek Capital Advisors, LLC. “To some extent, you have to have confidence that the manager has the tools and the people in place to structure the portfolio accordingly.” Chapin advises choosing a fund that provides detailed monthly disclosures. Such communication can tell how active the manager has been historically. “This doesn’t say a whole lot about what will happen in the future, but it does give some perspective on what the manager has done in the past,” he notes.

**INNOVATIVE APPROACHES TO EVALUATING UNCONSTRAINED MANAGERS**

Choosing among flexible funds that lack definable categories, benchmarks, and, in many cases, even a three-year track record, requires an emphasis on a qualitative approach to assessing managers, as well as deep due diligence on the funds themselves. Even a brief history should be scrutinized, with the focus placed first on the management team and the firm. Hrabak says he tries to overcome the difficulty in evaluating an unconstrained manager’s relatively short track record by identifying where the firm has added value in other strategies. “If attribution is showing that a manager’s value added is through bottom-up credit research,” he says, “it may not be the best fit for an unconstrained mandate, in our opinion.”

A firm’s macroeconomic forecast is particularly important given these funds’ dynamic and tactical nature. Filippelli advises reviewing a manager’s past macroeconomic forecasts to see how well their calls have fared. Evaluating the success of a manager’s bets in its core-plus product can give an idea of how well it might do with duration and sector bets in an unconstrained product. “When evaluating a product that has a limited track record, you have to rely more extensively on other quantitative and qualitative data points—for example, the experience and depth of the team(s) that contribute to the strategy,” he says.

If the strategy uses specialty teams, Filippelli suggests reviewing the teams’ past performance in the relevant products, particularly for sectors where large allocations are permissible. For example, unconstrained funds are typically allowed to hold large percentages in high-yield bonds, so the high-yield manager’s historical performance record should be assessed. And because these funds can take extreme risks, it is critical to understand the manager’s risk control process, such as whether the firm has a risk committee, how tail risk is managed, and how counterparty risk is monitored.

Finally, fees are always a concern when choosing a fund, and particularly so given the current low-yield environment. “A lot of unconstrained mandates are substantially more expensive than a core fixed-income mandate,” points out Hrabak. Investors should consider whether a fund’s past performance, and expected future performance, justify its fees relative to a cheaper core fixed-income fund. Unconstrained bond fund fees often range from 75 bps–125 bps, whereas fees for actively managed core fixed-income strategies generally fall between 30 bps–60 bps.

**BENCHMARKING WITHOUT BENCHMARKS**

In addition to serving as a yardstick for performance measurement, benchmarks provide parameters for an investor’s risk tolerances, a framework for return expectations, and a universe for security selection. Without a standard benchmark, a fund’s return objectives can be vague. The JP Morgan Strategic Income Opportunities Fund, for example, seeks “high total return,” whereas the BlackRock Strategic Income Opportunities Fund seeks “total return as is consistent with preservation of capital.” Some funds provide more guidance, such as the Loomis Sayles Strategic Alpha Fund, which strives for a total return of three-month US dollar LIBOR plus 200 bps to 400 bps. Other funds may use 91-day T-bills or three-month US dollar LIBOR as a benchmark, although these funds are likely taking on a far greater level of risk. Morningstar shows fund performance relative to the Barclays US Aggregate Bond Index, as well as a “best fit” index, which in many cases is a high-yield index. And even without a stated benchmark, some managers choose to show a relative performance comparison in fund communications. The performance for JP
Morgan’s Strategic Income Opportunities Fund is shown alongside the Barclay’s Universal Index, the BofA Merrill Lynch Three-Month US Treasury Bill Index, and the Lipper Alternative Credit Focus Funds Index.

Not all funds provide relative comparisons, however, so investors may need to choose their own reference benchmarks. “For a fund that has a duration close to zero and is seeking a modest positive absolute return, the 91-day T-bill may be a suitable benchmark,” suggests Hrabak. “A universal index or other multi-sector bond index may be appropriate for funds that have the ability to implement many different strategies, because these funds are taking some sort of credit risk if they’re not taking duration risk.” Hrabak may also reference the Barclays US Aggregate Bond Index to determine whether the decision to invest in an unconstrained fund is adding relative value if the allocation came from core fixed income.

Benchmark-agnostic funds present challenges in other ways. Traditional benchmark-based performance metrics, such as tracking error, the information ratio, alpha, and beta, mean little without a benchmark. As a measure of absolute risk, the Sharpe ratio is best evaluated within the context of a fund’s objective. The Sharpe ratio is most useful as a ranking tool, and funds that seek low volatility and low positive return objectives might not be comparable with funds that have high absolute return objectives. The diversity in unconstrained funds’ approaches and objectives means that peer comparisons within the universe are also difficult to evaluate. And because a fund can shift strategies frequently, it can even be challenging to evaluate a fund’s performance against its own history. With an objective of positive returns in all environments, downside risk measures are of particular interest.

Still, many unconstrained bond funds lack sufficient historical data for performance metrics to be statistically relevant. Moreover, there have been few periods of rising interest rates, an environment in which many investors expect the funds to outperform core fixed-income funds. “One of the difficult issues when evaluating an unconstrained bond manager, given the lack of performance history, is that these managers really haven’t been tested in a prolonged rising rate environment,” says Hrabak. The so-called “taper tantrum” of 2013, when interest rates rose swiftly in response to fears of faster-than-expected Fed tightening, provides some context but is too short a period from which to draw conclusions. “We can look at the upside and downside performance of these funds from May through July and October through December 2013, but that analysis is not statistically robust,” notes Chapin. Reviewing current characteristics such as a fund’s duration and average credit quality, as well as how such metrics have varied over time, can be more informative than return statistics for assessing the nature and propensity of a fund’s risk taking.

For funds that do have a performance track record of more than five years, it is important to look beyond the five-year period from 2009–2013 and consider performance during the 2008 global financial crisis. Performance during 2009 was exceptionally strong for many managers because security prices rebounded from steep losses in 2008. Annualized returns based on only a five-year history beginning in 2009 can be deceptively large.

**CONCLUSION**

Investors assessing unconstrained bond funds must piece together a mosaic of qualitative and quantitative data without many of the conventional evaluation metrics. Placing greater emphasis on the qualitative aspects of manager due diligence can help address some of the shortcomings in quantitative data. Although unconstrained bond funds often appeal to investors who want to avoid interest rate risk, the risks assumed by these funds can be quite aggressive. Funds that have great latitude to tactically shift duration have the potential for large losses. Investors should also be wary of managers who rely too heavily on high yield for returns. If performance in high-yield bonds falters, a manager needs to have the expertise to use other tools.

Investors in an unconstrained bond fund should have a defined objective for the fund and make sure it aligns with the fund’s own objective. Understanding a fund’s historical risk exposures and potential sources of return is critical, as is knowing which funds shift holdings and exposures so frequently that their risks cannot be categorized adequately. Such rapidly changing risk exposures may be difficult to allocate within a portfolio’s risk profile. Monitoring risk exposures is useful, but an unconstrained fund’s performance relies on the talent of its team to make strategic and tactical decisions. Monitoring a fund’s management team for turnover is as important as monitoring a fund’s risk exposures.

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