What is the issue with the way traditional fixed income managers try to beat the benchmark and how can a systematic approach help mitigate it?

Traditional fixed income managers have too much credit beta. They tend to try to beat the benchmark by continuously overweighting higher-risk, higher-yielding sectors of the fixed income market. This behavior is ubiquitous across fixed income categories, whether intermediate bond managers, global aggregate portfolios, or unconstrained bond strategies. In fact, our research shows that this credit overweight explains a very large portion of fixed income manager performance over the past 20 years.\(^1\)

If your fixed income manager is overweight high-yield, or segments of the market very highly correlated with high-yield, it may be a problem. High-yield has historically been correlated with equities, so those managers are reducing the overall diversification benefit of your fixed income allocation.

At AQR, we use a systematic process to pick securities. We overweight attractive bonds and underweight unattractive bonds within each fixed income sector, but we aim to match the overall risk — interest rate, credit, securitized — of the benchmark. Our systematic approach has the ability to generate attractive levels of returns relative to the benchmark while still preserving the diversification properties of fixed income as an asset class.

How should investors think about systematic investing in fixed income?

Systematic investing is an innovative and diversifying approach to active management within fixed income, which offers investors the potential to beat their benchmarks without a persistent credit tilt. Our investment approach is to take fundamental investment ideas — for example, we prefer cheap securities to expensive securities — and apply them systematically across the fixed income universe.

Interestingly, given the pervasiveness across managers of overweighting higher-yielding, higher-risk segments of the fixed income market, the case for owning systematic might be even stronger in fixed income than in other asset classes. Since our systematic fixed income portfolios offer the potential to generate excess returns without being overweight credit risk, they may be better diversifiers to an investor’s overall portfolio (which is often dominated by equity risk) than the traditional fixed income manager. Second, because traditional fixed income managers tend to generate returns by being persistently overweight credit, managers are often very highly correlated with one another. Our systematic process, in which we generate excess returns by security selection and not by overweighting traditional risk premia, tends to be very lowly correlated to the universe of traditional managers.

\(^1\) Source: Alternative Thinking 2017 Fourth Quarter, “The Illusion of Active Fixed Income Diversification.”
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Q: Is this smart beta, which blends passive and active investing approaches?

A: No. At our core we are fundamental investors. Our systematic or “quant” approach is a tool to implement fundamental investing ideas. Smart beta is a subset of systematic investing in which a manager might use a few highly commoditized factors in the investment process, in many cases with limited risk management. But in our implementation we don’t confine ourselves to a narrow subset of factors as smart beta managers do. We have many signals in our investment process, covering a wide variety of investment themes. And tightly managing the risk of our portfolio relative to the benchmark is ingrained in our investment process.

A systematic approach can generate attractive levels of returns relative to the benchmark while still preserving the diversification properties of fixed income as an asset class.

Q: How does AQR implement a systematic approach in this asset class?

A: The foundation is the same as in other asset classes. We believe in value within fixed income — cheap bonds outperform expensive bonds, just like we believe cheap stocks outperform expensive stocks. And momentum — bonds that are improving tend to do better than those that are worsening. Further, higher-yielding bonds outperform lower-yielding bonds (carry), and low-risk, high-quality bonds tend to do better than high-risk, low-quality bonds (defensive). These investment themes, in addition to being intuitive and transparent, have proven persistent and pervasive across asset classes and through time. What differs in fixed income is how you define the underlying signals. I can measure value in equities, richness or cheapness, looking at something like book-to-price ratios. That’s not my measure for a corporate bond, though — we need to use something like spread relative to probability-of-default. So, the ideas are the same but the definitions differ.

And how you implement these ideas becomes particularly important in fixed income. This is a place where a systematic process flexes its muscles. Fixed income benchmarks contain an enormous number of assets with many different types of risks: interest rate, credit, volatility, liquidity, and so on. A systematic process can implement fixed income in the most efficient manner possible because we’ll take explicit bets on the risks that are well compensated and make sure that we’re not taking bets on any of the other risks that are not.

Q: Why isn’t systematic fixed income investing more pervasive?

A: In my opinion, one reason is data, particularly on the corporate bond side. We have very good single-stock data going back to 1926 at least. But in U.S. corporate bonds, no such data existed until the early part of the 2000s. An implication of this is there’s been very little academic research investigating systematic investing in fixed income, and academia tends to be where these ideas are developed and vetted. A second reason is it is simply a lot more difficult to run a systematic process in fixed income than it is in equities. For example, fixed income benchmarks are complicated and contain a very large number of securities. And even if you only own 100 or 150 names, you need to be able to model the risks in every security in that benchmark.

While it is more difficult to run a systematic process in fixed income than in equities, it is not impossible. Ultimately it requires two distinct sets of skills. You have to be a fixed income
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investor — you have to know the instruments inside and out, understand the risk exposures and economic drivers and how to manage them. And you have to know systematic investing. We have expertise in both.

With datasets now available for corporate bonds, we are seeing more academic interest in the asset class, as well as investor interest. In our view systematic investing is about to change the way that fixed income portfolios are managed in the same way that it has revolutionized equity management.

For more on Systematic Fixed Income, visit our Learning Center at aqr.com/LearningCenter.

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