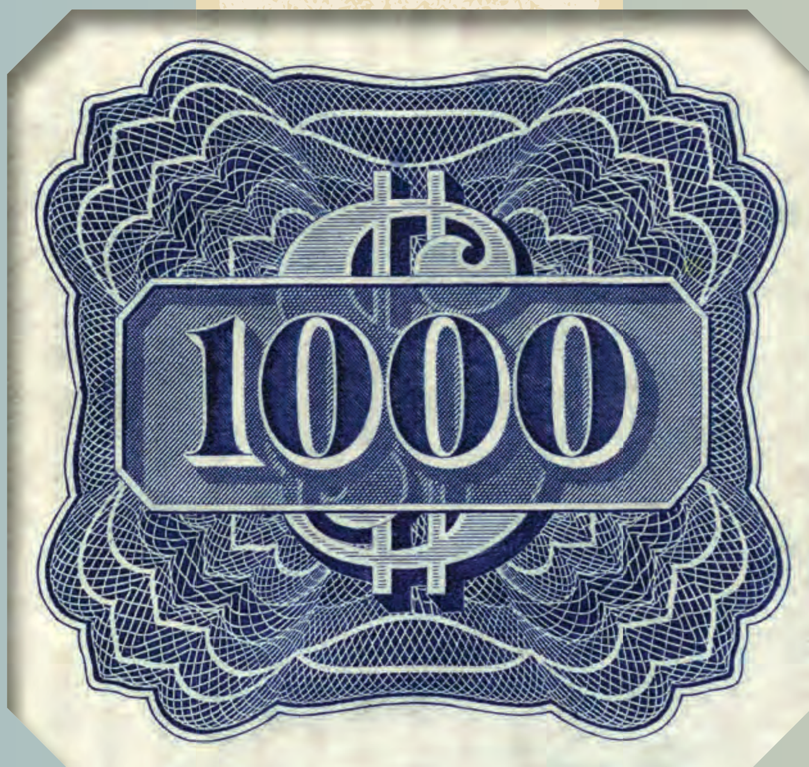
FIXED INCOME INVESTING

Coping with Low Rates, Volatility and Tapering



Charting the Course in Fixed Income Investing

Cutwater Asset Management is a client-focused and solutions-based investment advisor focused exclusively on fixed income investments. With over 20 years of experience managing institutional assets, Cutwater's model combines world-class investment expertise and risk management capabilities with exceptional client service, in-depth consultation, and extensive interaction between clients and the investment team.

Charting the Course in Fixed Income Investing with:

- Expertise across all sectors of the fixed income markets
- Long-term view of the markets with appreciation for the full economic cycle
- Focus on the spread sectors that drive consistent alpha
- Rigorous investment process with dedicated risk management and credit research

For more information contact:
Jesse Fogarty, CFA, FRM
Managing Director, Portfolio Management
(914) 765-3275
jesse.fogarty@cutwater.com

www.cutwater.com

SPONSORS

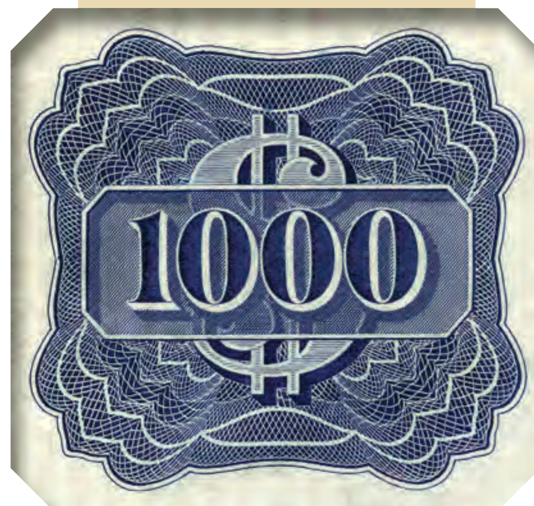
Cutwater Asset Management
113 King Street
Armonk, NY 10504
Jesse Fogarty, CFA, FRM
Managing Director, Portfolio Management
914-765-3275
jesse.fogarty@cutwater.com
www. cutwater.com

Neuberger Berman
605 Third Avenue, 41st Floor
New York, NY 10158
Andrew S. Komaroff
Chief Operating Officer
212-476-9013
Andrew.Komaroff@nb.com
www.nb.com

Prudential Fixed Income
Two Gateway Center, 4th Floor
Newark, NJ 07102-5096
Jeffrey Alt, CFA, CAIA
Head of North American Institutional Sales
973-367-4157
jeffrey.alt@prudential.com
www.prudentialfixedincome.com

T. Rowe Price
100 East Pratt Street
Baltimore, MD 21202
Keith W. Lewis
Head of Global Investment Services, Americas
410-345-2332
keith_lewis@troweprice.com
www.troweprice.com

Wellington Management Co.
280 Congress St.
Boston, MA 02210
Ryan Randolph
Relationship Manager
617-951-5894
rprandolph@wellington.com
www.wellington.com



CONTENTS

4
IT'S A TALE OF TWO CITIES
Operating under different regulatory and accounting regimes means that public DB plans and E&Fs are taking wildly different approaches to fixed income investing than their corporate DB cousins

9
TRACKING THE CREDIT CYCLE
Investors know the party ain't over yet, but it may be time to be a bit more wary

10
THE TRIALS AND TRIBULATIONS OF GLOBAL INVESTING
Emerging markets have had a turbulent 12 months. Peripheral Europe may have calmed down. But tapering will change the global bond landscape in the months to come

IT'S A TALE OF TWO CITIES

For years, fixed income has been the safe asset class. It was the one that did exactly what was expected. When managers talked about well-rewarded risk taking and creative approaches to asset management, they usually meant equity strategies and alternatives. Not so anymore. Bonds are center stage – for some good reasons and some not-so-good ones. Whether it's the perennially low interest rates that are fuelling concerns over meeting return targets or the need to hedge long duration liabilities, institutional investors such as pension plans, and endowments and foundations (E&Fs) have been reassessing their approach to fixed income investing.

The solutions can be wildly different. "In terms of fixed income, we see a split in demand from corporate pension plans that are seeking to hedge their liabilities and other investors – public plans and E&Fs – that are looking to diversify their equity exposure through non-correlated asset classes," says Jeffrey Alt, Principal and Head of North American Institutional Sales at Prudential Fixed Income.

These divergent paths stem from very different investment objectives. "Over the last 12 to 18 months, it has been a tale of two cities," says Jesse Fogarty, Managing Director, Portfolio Management at Cutwater Asset Management. Both public and private plans have been reducing their exposure to the intermediate part of the curve, but the similarities end there. Corporate plans are extending their duration into higher quality bonds to better match their liabilities. On the other side of the coin, public plans are reducing duration and going down the quality spectrum in the search for higher yields."

"Corporate DB plans are now 95% funded, but have seen massive volatility in their funded status over the last 15 years," continues Fogarty. "Many are taking advantage of the improvement in their plans and using this as an opportunity to de-risk. Public pension plans, in contrast, are looking for more opportunistic credit strategies. Many are not in the position to de-risk and are looking for more return out of their fixed income allocations."

UNCHARTED TERRITORY

Public plans and E&Fs are focused on their return targets; corporate plans on the need to minimize funding volatility. These two quite different objectives lead to very different investment – and behavioral approaches. One manager sums up the difference succinctly. "The corporate CFO can sleep easy when their plan assets have a duration of 12 years," says Michael J. Collins, Senior Investment Officer and Portfolio Manager for Core Plus Fixed Income and Absolute Return Strategies at Prudential Fixed Income. "Owning long duration bonds make public plan sponsors, E&Fs and retail investors nervous."

The different objectives can be traced in part to regulatory and accounting regimes. But the different solutions arise from the somewhat idiosyncratic economic environment of the past few years. "We've gone through a period of unprecedented easy money as the world's central banks have flooded the system with liquidity," says Cutwater's Fogarty. "The Fed had done an effective job at stopping the economy from falling into the abyss after the financial crisis. The ultra-low rate environment stabilized the economy and provided a lift to growth, albeit below trend. But these policies put the Fed into uncharted territory – it now has a balance sheet of nearly $4 trillion, increasing the money supply by over 350%. Inflation has been subdued as the velocity of money remains low."

To a certain extent this picture started changing last May. "Markets did respond violently to the Fed's announcement about

Operating under different regulatory and accounting regimes means that public DB plans and E&Fs are taking wildly different approaches to fixed income investing than their corporate DB cousins

tapering last spring," says Thomas Coleman, Fixed Income Product Manager at Wellington Management. "And they were anxious in January. As long as the Fed is not doing anything with rates, it is hard for investors to interpret what tapering means and how it will impact markets. This volatility is likely to continue, leading to a steady flow of alpha opportunities."

The Fed's move last year ushered in an era of uncertainty, tinged with a continued worry about the level of rates. "A year ago, all fixed income investors were worried about the prospect of rising rates," says Peter Austin, Head of Fixed Income Solutions at T. Rowe Price. "But the Fed tapered $10 billion more in January and indicated that tapering will continue. The curve did not change. That's a source of comfort for investors."

It's hard to understate the importance of the Fed and its actions when it comes to fixed income investing. It's the lodestar. This has always been true, but is even more tangible today as the Fed plots a course out of its unprecedented period of quantitative easing. "Part of the impetus comes because the Fed is acting," says T. Rowe Price's Austin. "From a psychological standpoint, tapering has allayed fears about a double dip recession and recently, the Fed took the second step, indicating that it is moving toward forward guidance as a policy. The statement did not mention emerging markets or the U.S. economic condition. Notwithstanding intra-period volatility, the FOMC is still committed to tapering."

EYES WIDE OPEN

Though not all observers are as sanguine about the Fed's commitment to tapering in an orderly fashion, most are looking forward. "We are more comfortable with the timing of the taper approach and are expecting the Fed purchases to be reversed," says Nolan O'Neill, Senior Research Associate at Slocum. "Now the question becomes, when will they raise the Fed funds rate? Last year, most people thought that would happen in late 2015. Now many market participants are pushing up the timeline."

As always though, events could throw a wrench in the works. "Markets don't like uncertainty," says Cutwater's Fogarty. "The market was not ready for Bernanke's taper talk in May, however, it prepared the market for the reduction at the end of the year. The market has accepted that bond buying is coming to an end and is taking the Fed's forward guidance at face value for the time being. What could cause volatility, in a perverse way, is an economy that is stronger than expected causing policymakers to be more aggressive in raising rates."

Because many investors have been exploring new fixed income investing options in the last year, they have started to focus on a range of risks, not just the prospect of rising rates. "I would rank the concerns of investors about fixed income in this order," says Andy Johnson, Managing Director at Neuberger Berman. "How much, how fast and how soon will interest rates rise? How do I generate sufficient return from my fixed income allocation?"

"I think investors are making the decision to accept incremental risk because they need additional return," continues Johnson. "They are going in with their eyes wide open. Traditional core normally has approximately 100 basis points of tracking error versus the benchmark, while unconstrained has 300 to 400 basis points of tracking error – or three to four times the relative risk."

DOWNPLAY RISK MANAGEMENT

Others identify this trend as part of the natural cycle. "As the cycle matures, investors reach for yield and downplay risk management," says Prudential's Collins. "We may be seeing that mindset shift again with investors looking for more aggressive, leveraged strategies."

In going beyond the norm, managers suggest carefully assessing the range of risks involved. "Risk in fixed income takes various forms," says T. Rowe Price's Austin. "It's not just interest-rate risk – it's also spread risk, which is highly correlated with equities. What's important to understand is the relationship between fixed income and the other asset classes in the portfolio. When bad events occur, you could experience losses in your fixed income portfolio in a range of different ways. For example, a concentration in credit will typically increase a portfolio's equity risk. So managing fixed income risk is not simply a matter of diversifying rate exposures, but also currency and spread."

"One slight word of caution," says Cutwater's Fogarty. "Investors need to recognize the risks embedded within their portfolios – as they take additional credit risk in the search for income they are increasing volatility. "When you vacate traditional fixed income sectors, you lose some of the benefits of diversification against your return-seeking assets, and with it you are giving up some of the ballast that protects you on the downside."

Beware of unintended consequences. "A lot of fixed income trends reflect a real

continued on page 6

appetite for active risk," says Wellington's Coleman. "And while active risk can certainly lead to better return outcomes than traditional bond benchmarks it will do so following a different pattern. Benchmark comparisons are inevitable but investors should reserve those comparisons for longer time periods, and rely on risk and return metrics over the shorter term."

DOUBLE WIN

While some investors, largely public pension plans and E&Fs, are looking to increase return, others are concerned about capital preservation. "We do have some clients, that are worried about rates going up," says Prudential's Collins. "They are looking to protect the value of their assets in that environment and some are shortening duration."

This approach is seen more obviously in larger pension plans. "A number of big plans are trying to hedge tail risk in fixed income," says Prudential's Collins. "They want a risk management overlay to limit potential downside risk. They want an absolute level of risk and don't want to lose money either on rates or credit."

When it comes to corporate pension plans, the direction of travel is just one way, toward de-risking. "Rising equity markets and rising rates was a double win for hedge ratios in 2013," says Kevin Loescher, Director, LDI Strategy and Implementation at Cutwater Asset Management. "The funding ratios for corporate DB plans rose from 79% to 95%. But of course, it can work both ways. Through the first month of 2014, they are giving a good amount back with Treasuries rallying and equity markets suffering significant declines off their 2013 closes."

Even if this year has seen some erosion in funded status, the Fed's behavior is seen by many as a positive impetus for plans to continue down the de-risking path. "If the Fed had amended its plans in January, then markets would have watched every indicator going forward, and reacted to every intended and unintended move," says T. Rowe Price's Austin. "Instead, the Fed has reinforced its commitment to tapering. The stability of interest rates will give equity markets encouragement. That in turn will give U.S. corporate DB plans confidence that continuing to de-risk is appropriate."

Timing is important. "Corporate plan sponsors are concerned about when to de-risk," says Prudential's Alt. "They have an issue with not if, but when to lengthen duration. Conversely public plans are concerned about the negative effects of rising interest rates, Fed tapering and inflation. These investors aren't as concerned about spread risk and are still investing in credit."

Investors not constrained by generally accepted accounting principles (GAAP) accounting and Pension Protection Act (PPA) funding rules look at fixed income from first principles. "Those investors with a total return focus – public pension plans and E&Fs – are viewing risk in a more traditional way than those corporate plans on a de-risking path," says T. Rowe Price's Austin. "One of big concerns of total return investors is the adequacy of fixed income benchmarks as guideposts for the construction of fixed income portfolios. What many are finding is that the best way to realize their return goals is by accessing global fixed income markets, a choice that didn't exist to the same degree and scale 10 years ago."

> **Unconstrained mandates are like snowflakes – no two are alike. Few have track records that show how well they perform in different market conditions**

MANY DEFINITIONS

"Many public plan sponsors are focused on generating alpha," says Prudential's Collins. "And they recognize the need for fixed income to contribute. So they are taking on more credit risk, loosening the constraints around a benchmark like the Barclays Aggregate to include more high yield and emerging markets, or shifting from a highly constrained mandate to core-plus."

These investors sometimes eschew benchmarks entirely. "Some plans are considering unconstrained or absolute return mandates that are benchmarked off of cash or LIBOR," says Prudential's Collins. "These mandates give flexibility to the manager to generate low- to mid-single digit returns without duration and interest rate beta. Some mandates may also be using long/short credit or multi-sector strategies. A version of this might be to use a long/short strategy within a bond portfolio, which has very little beta exposure or correlation to traditional equity or fixed income. But this type of strategy generally requires leverage, which three or four years ago was a dirty word. Today, in this low-rate environment, though, some plans are more interested."

The go-anywhere strategy, also known as opportunistic fixed income, doesn't necessarily require leverage. "We see total return investors interested in global strategies with a focus on opportunistic credit characteristics," says T. Rowe Price's Austin. "This allows them to capture opportunities across markets, countries and sectors. It includes global high yield in both the U.S. and Europe, bank loans, and all three forms of emerging market debt, though unhedged local currency exposures are a bit challenging for some given their recent volatility." (See story page 10)

"Public funds and E&Fs are thinking about total return," says Wellington's Coleman. "Every dollar invested needs to maximize total return. In this environment, they have a tough time stomaching negative fixed income returns. They are more interested in products and strategies where interest rate exposure plays a return-seeking versus a benchmark-relative role. Unconstrained funds usually have less systematic interest rate risk than other total return products."

Definitions can be important here, as absolute return, total return, opportunistic, multi-sector and go-anywhere are terms that can be sometimes used interchangeably, making it difficult for investors to understand fully the nature of the strategy. "If you ask 10 people about opportunistic fixed income, you might get 10 different definitions," says Neuberger Berman's Johnson. "We think of it within two broad categories. One is unconstrained fixed income, which is managed against some benchmark, often the Barclays Aggregate, but with substantial tracking error against that benchmark. It is a go-anywhere strategy that involves a substantial risk budget. The other is absolute return fixed income, which differs from unconstrained in that the benchmark is cash – LIBOR or Treasury bills. The objective is expressed as cash plus some return objective. In addition, some risk level or profile is targeted over a market cycle. It's also

continued on page 8

NEUBERGER | BERMAN

INSIGHT FROM INDEPENDENT INVESTORS

We are hands-on, active investors and passionate about asset management.

Our 43 investment teams are time tested with portfolio managers averaging 28 years of industry experience.

With a focus on long-term results, Neuberger Berman is proud that 77% of our fixed income assets under management have outperformed their benchmarks for the most recent 10-year period.[1]

Our relationship with clients is a partnership and we have structured our business so that both our interests are aligned. We are honored to be invited to manage assets in strategic relationships by some of the world's most sophisticated investors.

Serious Investing for 75 Years™

[1] As of December 31, 2013. AUM outperformance data is asset-weighted and based on the gross of fee performance of the firm's traditional fixed income strategies against their respective benchmarks and peer categories. Individual strategies may have experienced negative performance during certain periods of time.

This material is provided for informational purposes only and nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation to buy, sell or hold a security. Investing entails risks, including possible loss of principal.

Neuberger Berman LLC is a Registered Investment Adviser and Broker-Dealer. Member FINRA/SIPC. The "Neuberger Berman" name and logo are registered service marks of Neuberger Berman Group LLC.

©2014 Neuberger Berman LLC. All rights reserved.

go-anywhere, but importantly also involves going both long and short."

WIDE DURATION BAND

"For plan sponsors, the absolute level of rates makes it a tough time to invest in fixed income from a risk perspective," says Wellington's Coleman. "An unconstrained fund can be a way to generate a core return with less risk using a wider range of instruments. These can include investment grade, high yield, mortgages, structured credit and a wide duration band. These funds typically have a portfolio objective of beating the Barclays Aggregate over the long term – a five- to seven-year market cycle."

Even bearing in mind these distinctions, opportunistic fixed income can be a fairly individual strategy, different in every investment shop. Thinking about the objective and the ability of the manager to reach that objective is another way to consider the varieties of opportunistic fixed income out there. "We've been discussing opportunistic investing for two or three years," says Slocum's O'Neill. "It's about fitting the right managers to the right clients. This is not just one strategy, but a range of strategies with a wide range of return and correlation expectations. Among the managers we track closely, the returns ranged from -2% to +6% in 2013. When you take away the beta of the benchmark, it adds more manager-specific risk. We often pair managers that do things differently to diversify that risk."

Again, benchmark or lack of benchmark is a key consideration here. "Neutral duration and therefore the choice of benchmark are important," says Neuberger Berman's Johnson. "Unconstrained fixed income is benchmarked against the Barclays Aggregate, which has a duration of 5½ years, while absolute return fixed income has zero duration. Each will give different outcomes, so it's critical to understand what the plan sponsor wants to accomplish."

Those investors with specific return objectives and few constraints may approach the choice of opportunistic fixed income as a way to garner the best ideas of a fixed income manager. "Public pension plans and E&Fs are saying, if we give you a large tool set, what would you do with it?" says Prudential's Alt. "I would say most fixed income investors in these categories are looking at opportunistic strategies as a way to deal with concerns about the potential impact of rising rates."

One of the reasons that investors consider opportunistic fixed income as a strategy for this moment in time is the perception of uncertainty. Opportunistic fixed income, as the name implies, is nimble at its heart. "All opportunistic strategies have tactical management as a core component of the mandate," says T. Rowe Price's Austin.

Being fleet of foot does make some investors – and some consultants – nervous. Managers point out that opportunistic or unconstrained strategies are not all-or-nothing solutions. How opportunistic or how unconstrained is a matter of negotiation between investor and manager. "Unconstrained funds sound like a good idea," says Wellington's Coleman. "But consultants and plan sponsors are a bit hesitant. An unconstrained, 'go-anywhere' fund sounds like a hedge fund. It can go deeply into distressed credit, emerging markets etc... It's a definition that has broad appeal. Yet it is also possible to manage it more narrowly. It can have a risk/return profile that is more like a core or core-plus fund, but have risk that is more asymmetric than benchmark-relative strategies."

It's also possible to use more traditional guardrails as well. "Most plans that use opportunistic fixed income put guidelines in place around the go-anywhere condition," says Neuberger Berman's Johnson. "Typically each mandate is bespoke, with bandings around how much the manager can go short and a maximum percentage of market value by sector. We also find it useful to have an understanding with the investor of the tail risk (expected shortfall) that the portfolio will be exposed to. Expected shortfall is one of the best ways to estimate a portfolio's downside risk. For instance, an objective might be described as LIBOR plus, with 5% expected risk and expected shortfall to be no more than 15%."

BROAD TOOLKIT

"The move from core into more unconstrained mandates has been gaining momentum," says Cutwater's Fogarty. "The more flexible approach can be a challenge for asset owners to understanding the risk they are taking. Unconstrained mandates are like snowflakes – no two are alike. This product is a recent phenomenon and many don't have long standing track records which can provide a framework for how they will perform in different market scenarios."

"What I see as the most interesting development in fixed income today is the many different ways that people attack opportunistic," says Neuberger Berman's Johnson. "Some use credit only. Others use a broader toolkit. We want as many tools in the toolkit as possible so that we can create portfolios with the same expected return with less risk."

Although there has been talk about less constrained fixed income mandates for years, it is only recently that a significant amount of money has been moved into these strategies. In general, the assets have come out of core or core-plus allocations into other wider mandates. "In general, the amount of money invested in core and core-plus fixed income has shrunk," says Slocum's O'Neill. "Investors are moving to more opportunistic and unconstrained strategies. They are concerned about the level of interest rates, and are looking to build flexibility and diversification into their portfolios."

"We do see large U.S. institutional investors shifting out of core U.S. into more global opportunistic mandates," says T. Rowe Price's Austin. "But there is also some interest in consolidating single sector mandates into a multi-sector mandate. This is happening both in the U.S. and with institutional investors in Europe and Asia."

There are some exceptions. "Many plan sponsors choose to maintain direct control over below-investment-grade and international allocations, so they award standalone mandates for those sectors as opposed to adding them to multi-sector mandates," says Prudential's Alt.

For larger investors, who might have had discrete sector mandates, some as Austin says, have been bringing those together into mutli-sector mandates with the expectation that the sectors would be managed tactically. In other cases, funding for newer fixed income mandates has also come from equities, thanks to the extraordinary performance some investors have seen recently. "We see public pension clients moving money from core or core plus to unconstrained mandates," says Prudential's Alt. "They are typically restructuring their fixed income allocation to minimize duration risk.

"Typically pension plans have some form of core in their fixed income allocation," says Neuberger Berman's Johnson. "It could be active core or passive core. Then they might look to add absolute return fixed income, rather than a hedge fund, to increase return. The strategy is very attractive to those who are more concerned about interest rate risk, because it is LIBOR-plus and the benchmark has zero duration."

TRACKING THE CREDIT CYCLE

Investors know the party ain't over yet, but it may be time to be a bit more wary

Fixed income investors have been crowing about credit for the past few years. As conservative corporate managements hoarded cash, balance sheets became attractive. A turn in the economic cycle saw profits rise. Credit was a good place to be. But now doubts are creeping in.

"The credit cycle, until recently, felt like 2003 or 2004," says Michael J. Collins, Senior Investment Officer and Portfolio Manager for Core Plus Fixed Income and Absolute Return Strategies at Prudential Fixed Income. "Now it feels like 2005 – late in the 5th or 6th inning. Companies are starting to lever up. The quality of underwriting is beginning to deteriorate. You can see this most starkly in the leveraged loan market, where lots of retail money is flowing in and collateralized loan obligation (CLO) issuance has surged. As a result, for leveraged loans, it's an issuers market, with looser covenants and more limited investor protections. M&A is also picking up again, though LBOs haven't increased markedly yet, probably because cheap financing in the bond market is readily available."

Retail money flow is typically a leading indicator, in this case of a possible turn in the cycle. "We believe corporate credit peaked 18 to 24 months ago and the best is behind us for this credit cycle," says Jesse Fogarty, Managing Director, Portfolio Management at Cutwater Asset Management. "That said, we remain comfortable with where we are based on still strong fundamentals against an improving global macro backdrop. At this point there simply are not the animal spirits that generally accompany the end of a cycle. While years away, we are keeping our eye on the beginning of the maturity wall, beginning in 2016 that will likely coincide with the beginning of an increase in the interest rate cycle. This could be cause for concern down the road considering the historical correlation between the end of a cycle and the Fed raising rates."

Others think the cycle has a bit longer to run up. "We are not at the end of the credit cycle," says Andy Johnson, Managing Director at Neuberger Berman. "It will mirror the economic cycle, which is just starting to gain momentum. Rates will stay relatively low for one to two years, without the fiscal drag from the Federal government. We don't expect to see any catalyst for change until 2017 or 2018."

QUALITY CONCERNS

The notes of caution, though, are heard from those that are following bond issuance closely. "What we don't see yet, but expect to see over time, is increasing concem about the quality of new issues," says Peter Austin, Head of Fixed Income Solutions at T. Rowe Price. "Will managers have to sacrifice some quality for supply? Fundamentals are strong and no credit concerns are looming, either in the investment grade or high yield spaces. But it is important to be highly aware of both supply and quality trends."

Those that are adventurous credit investors are looking farther afield. "We do see the markets evolving," says T. Rowe Price's Austin. "Five years from now, European high yield will be much bigger than the $600 billion market it is today. As European banks shrink their balance sheets, the high yield market will take on some of that role. That's an opportunity for U.S. investors."

Less attractive prospects for equity markets also hang in the balance. "The Fed has said it is unlikely to raise rates within the next year and that they expect the Fed funds rate to be at a more normalized 4% level in about four years," says Thomas Coleman, Fixed Income Product Manager at Wellington Management. "This will help the credit cycle run. On the other side, the equity markets have seen a massive rally, so the total return prospects here going forward are less positive."

Investors have several routes into credit with the most obvious being high yield. In recent years, the bank loan sector, which offers similar exposure, has become a popular way to access credit. "From a historical perspective, bank loans have been more attractive than high yield," says Wellington's Coleman. "They offer a bigger liquidity premium and are higher up the capital stack and benefits from a broader investor base, including more institutional investors in addition to the retail and CLO buyers of pre-2008. It is our largest credit bet in multi-sector strategies at the moment."

COUPON ADJUSTMENT LAG

Wellington is not alone in their interest in the sector. "The inflows into bank loans are staggering," says Nolan O'Neill, Senior Research Associate at Slocum. "We have funded some mandates this year, but remain cautious. There are certainly opportunities here, though we would suggest using both high yield and bank loans, because we feel many investors misunderstand the reset mechanism on bank loans. The LIBOR floor present in most loans means there will be a lag in coupon adjustment as interest rates normalize. Investors also have to compare the lost carry versus traditional high yield when comparing the two."

Bank loan mandates are generally funded out of other fixed income allocations. "We see a lot of demand for bank loans, with investors moving money out of core or core-plus into these," says Neuberger Berman's Johnson. "This is usually because they have higher return potential and are insensitive to rate rises because they are floating rate."

THE TRIALS AND TRIBULATIONS OF GLOBAL INVESTING

Emerging markets have had a turbulent 12 months.
Peripheral Europe may have calmed down.
But tapering will change the global bond landscape in the months to come

FIXED INCOME OFFERS OPPORTUNITY. THAT'S the overwhelming message coming from investors and managers alike. It doesn't matter if the aim is to hedge the liabilities of a corporate pension plan or to increase the return of an endowment. But where is the greatest opportunity? The message here is think global.

It's a path long trod by institutional investors outside the U.S., largely of course because they often only have access to much smaller domestic bond markets. "Another way to generate more return from a fixed income portfolio is to create a more global portfolio," says Thomas Coleman, Fixed Income Product Manager at Wellington Management. "Clients outside the U.S. have long used global bonds to get more diversification – more diversification of government credit and sovereign risk."

"Investors outside the U.S. see opportunities in international and emerging markets more clearly than those in the U.S.," says Peter Austin, Head of Fixed Income Solutions at T. Rowe Price. "A T. Rowe Price study of the largest 25 U.S. public DB plans showed that their fixed income portfolios tend to be heavily weighted to high-grade, U.S.-centric assets. Given these plans' appetite for other kinds of return-seeking assets, it's a natural question whether these plans should be accessing the global fixed income markets to generate better risk-adjusted returns. We see many public plans taking action and diversifying their fixed income allocations. Many are accessing this global fixed income opportunity set and ceasing to think of fixed income as simply a natural hedge to U.S. equities."

The diversification argument convinced some investors early in the game. "Public funds and Taft-Hartley funds are way past the beginning stages of investing internationally," says Wellington's Coleman. "They have been using global bonds via core-plus for 20-plus years, and following 2008, as disaggregated core. Now with credit concerns in developed Europe and the U.S., these investors are much more interested in global fixed income with a total return orientation."

For those that have stayed home so far, the tumultuous last year in bond markets has heightened interest in global fixed income. "For those investors relying on core U.S. fixed income, the link between tapering and. higher U.S. interest rates means they need to look beyond – they need to look globally to find fixed income solutions that meet their objectives," says T. Rowe Price's Austin. "Where they will look depends on the focus, which may involve a targeted return, target risk or both, with the objective dictating what components will be used."

Global and international bonds, for those that maintain distinct domestic allocations, do still offer attractions. "We do use international bonds in both unconstrained and absolute return fixed income," says Andy Johnson, Managing Director at Neuberger Berman. "In unconstrained, we look for opportunities to overweight and underweight assets. In absolute return, because we can short, we make pure bets for and against assets. At the moment, we are short Japan and Germany, and long the U.S., U.K., and New Zealand."

CRISIS HOTSPOTS

It isn't just developed market bonds that are attracting institutional investors. "I see huge opportunity in the bond markets of both developed and emerging economies," says T. Rowe Price's Austin. "There are 23 important elections scheduled in 2014 in the emerging markets, with most occurring in the first half of the year. So 2014 in the emerging markets will be defined in part by volatility, but that also means there will be pockets of opportunity. The second half of the year will see more stability, as politicians take their places and the post-election markets stabilize."

Emerging market bonds have garnered a growing amount of interest from U.S. investors, notwithstanding some of the issues apparent in the last year. But specialists aren't predicting a full-blown crisis in the sector. "We don't see a full blown emerging markets crisis," says Gorky Urquieta, Managing Director at Neuberger Berman. "There are certain crisis hotspots, like the Ukraine, Argentina, Venezuela, or even Turkey, but it's not a systematic problem, not a balance of payments problem. Argentina is a very, very specific, self-inflicted issue, not a country that had been reliant on capital inflows. The Ukraine too is an idiosyncratic story."

Emerging market bonds haven't been positive contributors to returns in the last year, so what will need to change. "What do we see as catalysts for a turnaround?" asks Neuberger Berman's Urquieta. "It will be a slow process. Positive real rates, which we have, will provide an anchor for these currencies. These countries need to find a level of stability between growth and currency weakness. It is possible that local interest rates will still need to undergo adjustments before they find a bottom."

The global macroeconomic environment has particular influence on the behavior of many emerging markets, so managers keep a close eye on the big picture. "China is a source of concern and risks," says Neuberger Berman's Urquieta. "In our view, emerging markets are not reliant on Chinese growth of 10% anymore. The world has now adjusted to

continued on page 12

PRUDENTIAL FIXED INCOME

OUR ABSOLUTE RETURN STRATEGY CAN GO ANYWHERE FOR ALPHA.

SEE WHERE IT CAN TAKE YOUR FIXED INCOME PORTFOLIO.

With the Absolute Return Strategy from Prudential Fixed Income, finding opportunities in an uncertain market environment is a challenge we can meet — no matter where in the world those opportunities may be.

Our Absolute Return Strategy is unconstrained, providing the flexibility to invest across all global fixed income sectors and currencies. It also:

- Mitigates downside risk by actively adjusting allocations as market conditions change[1]
- Locates diversified alpha sources and reduces interest rate risk[1]
- Offers a timely alternative to traditional fixed income strategies

To learn more about Prudential Fixed Income's Absolute Return Strategy, call Miguel Thames, Head of US Sales and Global Consultant Relations, at **973-367-9203,** or email **fixedincome@prudential.com**

Download our Quarterly Fixed Income Market Outlook at **prudentialfixedincome.com**

Prudential Fixed Income

- *$405 billion in global fixed income AUM*
- *More than 200 globally based investment professionals*
- *Research-driven, top-down sector allocation and bottom-up security selection*
- *Deep discipline in risk management, credit research and quantitative research*[1]

Prudential
Bring Your Challenges®

[1] **No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment. Does not imply low risk.**

© 2014. All data as of 12/31/13. Prudential Fixed Income is a unit of Prudential Investment Management, Inc., a registered investment adviser and a Prudential Financial company. Prudential, the Prudential logo, the Rock symbol and Bring Your Challenges are service marks of Prudential Financial, Inc., and its related entities, registered in many jurisdictions worldwide. 2014-0241

China growing at something closer to 7%, but a deeper slowdown, to say below 6% would be problematic. There are also shadow banking issues and the need to deleverage, which add to the risks around China."

NO CLEAR DISTINCTION

For those investors with interest in global bond investing, it's important to remember that this is not a homogeneous single market. Just a quick look at the market composition shows the changes. "Over the past 20 years, emerging markets have become a meaningful asset class, the sector has benefitted from structural changes, which has resulted in nearly 60% of the investable emerging markets debt being rated investment grade," says Jesse Fogarty, Managing Director, Portfolio Management at Cutwater Asset Management.

"It can be tough," says Michael J. Collins, Senior Investment Officer and Portfolio Manager for Core Plus Fixed Income Strategies at Prudential Fixed Income. "There isn't always a clear distinction between emerging market and developed market debt. Is South Korea emerging or developed? Their sovereign debt is investment grade."

The differences in markets are a source of investment opportunity. "Some U.S. investors have a tendency to consider emerging market debt as one market, analogous to the U.S. debt market," says T. Rowe Price's Austin. "Obviously that is inaccurate, starting with the fact that there isn't one central emerging market bank. Emerging market debt offers a huge opportunity to capture value. It represents a range of opportunities that vary by country and are driven by some combination of central bank policy, yield curves, credit spread, the stability of income and potential for capital appreciation."

Global benchmarks don't always provide a road map for investors. "The lines do become blurred between developed and emerging markets," says Neuberger Berman's Urquieta. "There are plenty of single- and double-A credits in emerging markets. It reflects the still relatively arbitrary way that emerging market debt is defined. The benchmarks identify different countries as emerging in equity and fixed income, and even sometimes within fixed income. South Korea sovereign debt is considered developed, while corporate credit is in the emerging market index. This creates opportunity."

Some managers advocate throwing out the developed/emerging distinction altogether. "Many emerging markets are investment grade today – they've emerged – and it no longer makes sense to think of emerging market debt as a monolithic asset class," says Wellington's Coleman. "So to build a portfolio, you will want to look at the growth prospects and balance sheets of each country, because it's a continuum, not a distinct difference between developed and emerging markets. Investors need to look across the globe without traditional biases. It could be best to think of this as global, not emerging market debt."

At the riskier end of this continuum, investors may find some interesting opportunities, particularly from a total return perspective, that are unavailable in the world's largest bond markets. But these deals come with a health warning. "Most emerging market issues are investment grade with positive stories from either a yield or a yield and capital appreciation standpoint," says T. Rowe Price's Austin. "But it is important to have a clear understanding of how emerging market debt behaves, as in both the near and distant past there have been periods of high volatility and poor liquidity."

UNWELCOME VOLATILITY

For most institutional investors, emerging market debt is still a specific allocation. Corporate pension plans often include it in their return-seeking portfolios, while in public plans and E&Fs, it's a part of the overall fixed income allocation. So the volatility in these markets in the last year has been unwelcome. "We see opportunity in emerging markets debt, but we are hesitant to add aggressively due to the amount of risk involved," says Prudential's Collins. "These bonds exhibit a lot of volatility regardless of whether they are sovereign or corporate hard currency bonds or local currency debt. Recently we've seen significant currency depreciation in some countries even in the face of rising rates. Once the dust settles, we expect that there will be a good total return opportunity, but it won't be without risk and volatility. Right now valuations are compelling and we are nearing a good entry point, but a long term time horizon is key."

"Valuations are more attractive in emerging market debt, relative to a year ago," says Wellington's Coleman. "The recent news on tapering highlighted the differentiation across markets. From a policy perspective, these markets aren't all as predictable as many people hoped they were. Through 2008 and right up until 2012, emerging economies looked strong and stable relative to developed markets, but now we're looking at things country by country."

Consultants suggest it isn't yet the right time to go into emerging market debt, if an investor isn't already involved. "We are cautious on emerging market debt," says Nolan O'Neill, Senior Research Associate at Slocum. "As U.S. interest rates continue to normalize and the dollar becomes stronger, we will see increased volatility in emerging market debt. Eventually, we expect to see differentiation between markets, but not yet. Once that starts to happen, we will start scaling back in, but for the moment, we are still fairly cautious."

The changed macroeconomic picture leaves investors in uncharted territory. "The notion of higher rates or more normal rates in the U.S. poses a problem for emerging market investors," says Neuberger Berman's Urquieta. "We don't have much history with episodes of monetary tightening in the U.S. and their impact on emerging market debt. You could go back to 2004, but at that point, correlations in emerging markets were high. Subsequently they dissipated. Ultimately we would expect spreads come back in emerging markets debt."

INFLECTION POINTS

This is an investment for those with a long-time horizon. "For investors involved in these markets, long term volatility is to be expected," says Neuberger Berman's Urquieta. "This will be especially apparent at inflection points and with the Fed saying that it will be removing liquidity going forward, there will be more of these and they will exacerbate outflows."

One reason for the long time horizon is that it isn't easy to get out of these markets. "The emerging markets are obviously less developed than sovereign markets," says T. Rowe Price's Austin. "But notwithstanding its relative youth, the emerging market corporate sector is larger than the U.S. high yield market. But liquidity can at times be quite challenging."

Currency fluctuations and currency returns play a large part in the outlook and prospects for emerging market bond investors. For some, though, it's a layer of volatility too much. "Our client base has the ability to allocate to emerging markets," says Cutwater's Fogarty. "We look for a variety of ways to get this exposure with emphasis on economies with sustainable growth and a growing middle class."

"There's a change in dynamics in local currency emerging market debt," says Wellington's Coleman. "It's more developed and

continued on page 14

How do we uncover **fixed income** opportunities that others may miss?

T. Rowe Price's collaborative approach is integral to our fixed income management process. Across sectors, regions and asset classes, our portfolio managers and analysts work together — identifying attractive sectors and capital structure opportunities, developing independent credit ratings, selecting securities and managing risk. These multiple perspectives provide our experienced investment team with insights to identify diversified sources of alpha that others may overlook.

To find out more about how we manage over US$155 billion* in fixed income assets, visit troweprice.com/uncoverfi

Asia • Australia • Europe • Middle East • The Americas

*The combined fixed income assets of the T. Rowe Price group of companies as of 12/31/13. The T. Rowe Price group of companies includes T. Rowe Price Associates, Inc., T. Rowe Price International Ltd, T. Rowe Price Hong Kong Limited, T. Rowe Price Singapore Private Ltd., and T. Rowe Price (Canada), Inc.

offers more opportunity today. But traditionally pension investors have more hard currency emerging market debt than unhedged local currency debt."

The last year has made the currency element more contentious. "Volatility in local currency has been high in the last eight or nine months," says Neuberger Berman's Urquieta. "The sell-off after the interest-rate movement last May made certain countries' vulnerabilities obvious. The Fed's talk about tapering hit an already struggling emerging market asset class that was facing a slowdown in economic growth. Those countries that were reliant on currency flows to fund their current account have seen a pretty significant correction – Indonesia, India, Turkey, Brazil and South Africa. The correction earlier this year was a bit of replay of last year's, though each bout is a bit more selective, with Turkey and South Africa, for example, under more pressure this time while India and Indonesia held up well."

"U.S. investors are wary of currency," says T. Rowe Price's Austin. "Given the recent experience with Turkey and Argentina, that's not surprising. But these are risks that can be mitigated."

This level of currency fluctuation is scaring some investors away from the sector. "We see the fragile five – Brazil, India, Indonesia, Turkey and South Africa – as subject to runs on their currencies because of fiscal and external current account deficits," says Prudential's Collins. "So they are raising rates to attract capital. Yields have gone straight up as the currencies have gone down. Given this situation, some people are moving out of emerging markets debt and into European peripherals."

BLENDED MANDATES

For those with strong stomachs, managers underscore the advantages that emerging market debt provide in contrast to developed market bonds. "One key theme that emerging market debt offers is the ability to blend the stability of income with capital appreciation," says T. Rowe Price's Austin. "You don't have this opportunity in developed markets."

Just like other bond sector, the emerging market debt market is not monolithic. This sector includes sovereign and corporate hard currency debt, and debt issued in local currencies. The dynamics of a single country portfolio changes depending on which elements are used. "Emerging markets debt is a changing asset class, but it generally has broad underlying characteristics," says Neuberger Berman's Urquieta. "It's increasingly a growing discrete allocation for institutional investors. Now the approach is for products that blend across all segments in emerging markets debt – credit, corporates, local currency and sovereigns."

The rise of these blended mandates is partly a result of the deepening of individual country bond markets. "There's been an evolution in emerging market debt investment," says Slocum's O'Neill. "First, it was just a small part of core-plus. Then plans moved to separate mandates in hard currency only. One to two years later they might add some local currency. Now there are blended mandates including hard and local currency, and corporate debt. These mandates are often also operating on a total return basis, where they will seek to limit emerging market beta by using longs and shorts, and sometimes carrying up to 40% in cash. This way they can cut off the volatility, relying less on beta and more on alpha."

> To build a portfolio, look at the growth prospects and balance sheets of each country, because it's a continuum, not a distinct difference between developed and emerging markets

Blended mandates offer a more comprehensive risk management component that is attractive to plan sponsors without those skills in-house. "Small- and medium-sized plans generally opt for these blended strategies in emerging markets," says Neuberger Berman's Urquieta. "Larger plans tend to be more specific in their mandates. They often already have a sovereign allocation, but now want local currency exposure or corporate credit for example."

There are three fixed income drivers: rates, spread and currency," says T. Rowe Price's Austin. "Some U.S. investors do want global, but don't want currency, so hedge the portfolio back into dollars. For those that want currency exposure, it can be tactically managed within a defined risk budget.. For some investors that are migrating from core to global opportunistic, it is easier to do it without the currency component. As managers, we have some emerging markets where we do like local currency and some markets where we don't. But we realize it is difficult to explain. Year-to-date local emerging market debt is off 3.38%, with 3.13% of that loss attributable to currency. Last year, emerging market local debt was off 9%, with 8.72% of that loss attributable to currency. When U.S. rates rose in May, emerging market currencies were hard hit."

Partly because of the risks and partly because of the recent return experience, take-up of local currency debt is not high among pension investors. "When plan sponsors look at emerging market debt, about half think about using local currency bonds," says Jeffrey Alt, Principal and Head of North American Institutional Sales at Prudential Fixed Income. "But it's a small allocation within the overall emerging market debt bucket. Local currency bonds are more volatile than hard currency bonds, and may or may not be correlated to other fixed income or equities."

"For higher quality emerging market sovereigns and corporates, spreads and yields are already very attractive," says Prudential's Collins. "We are selectively adding dollar-denominated spread product."

TACTICAL TRADE

One bright spot in emerging market debt: the recovery of peripheral Europe. "We do see opportunity in traditional government debt in Europe and Asia, particularly peripheral Europe," says Prudential's Collins. "There is still opportunity in the debt of PIIGS (Portugal, Italy, Ireland, Greece and Spain) despite the recent outperformance of those markets. We are getting more comfortable with the economic cycle in Europe, which is turning positive. Although the economic outlook is improving, the fiscal outlook remains challenging. External balances have also recently improved in Spain and Greece for example and are now showing a balanced current account."

With their economies on the up and more overall European stability, the PIIGS offer opportunity to U.S. dollar-denominated investors. "We generally see value potential versus U.S. corporate credits or lower rated sovereigns like Italy, Ireland, Spain and Portugal, for example," says Neuberger Berman's Urquieta. "Emerging markets sovereigns have lower levels of indebtedness and have lower issuance requirements as a result."

Attractive as it is, some see peripheral Europe as a short-term opportunity. "We do see opportunities in Ireland, Italy and Spain as tactical trades," says Slocum's O'Neill.

Where's the income in fixed income?

Creative solutions across all fixed income sectors for plan sponsors.

- LDI
- Core/Core Plus
- Global Bond
- High Yield/Bank Loans
- Fixed Income Alternatives

For the Midwest
Danny Sharp
312-845-1404
rdsharp@wellington.com

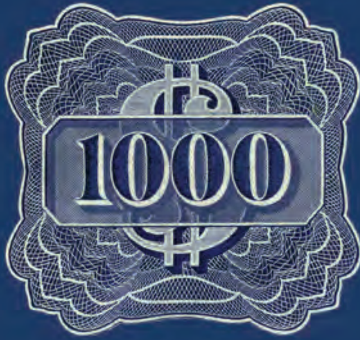
For the East Coast
Jed Synnestvedt
617-951-5638
jasynnestvedt@wellington.com

www.wellington.com

©2014 Wellington Management Company LLP. All rights reserved.

WELLINGTON MANAGEMENT®

REGISTER NOW



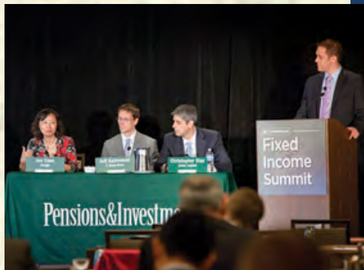
P&I | CONFERENCES

Fixed Income Summit

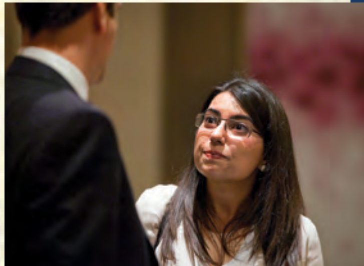
Chicago: May 13 | New York: May 15

WHY ATTEND?

"The best day of fixed income training anywhere!"



"Practical take-away information and peer experience. Best ideas in the space!"



"Very upbeat and different from what I would've expected from a fixed income event. It was great!"

Increased credit risk is at the forefront of bond investors' minds with expected interest-rate hikes likely to take place in the near future. With so many portfolios focused on preserving capital over the past several years, fixed income allocations have been on the increase despite low returns.

Is it time to rebalance before the shift in fixed income occurs?

Should fixed income still play a part in the majority of portfolios?

These are crucial questions that P&I's Fixed Income Summit will address where top industry experts will weigh in on key areas for creating robust risk-adjusted returns.

Topics to be discussed within fixed income will be:

- Emerging market debt
- ETFs
- LDI strategies
- Fixed income alternatives
- Absolute return
- Core allocation

Register today to learn about the latest trends in fixed income aimed at finding the right balance within a diversified portfolio which can withstand today's market volatility.

Complimentary registration* at **www.pionline.com/fis2014**

sponsored by:

NEUBERGER | BERMAN

WELLINGTON MANAGEMENT®

Questions? For more details please contact Elayne Glick at (212) 210-0247 or pi-registration@pionline.com

*Registration is only open to pension plan sponsors, endowments, foundations and a limited number of investment consultants.

All registration requests are subject to verification. P&I reserves the right to refuse any registrations not meeting our qualifications. The agenda for the Fixed Income Summit is not created, written or produced by the editors of Pensions & Investments, and does not represent the views or opinions of the publication or its parent company, Crain Communications, Inc.