Quoniam
QUANTITATIVE INVESTMENT ENGINEERING

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(English translation of original text)

Credit investments: active solutions are more important than ever

The monetary policy of the ECB is melting yields, driving European investors (because of the investment crisis) into eve n riskier investments. At the same time, in order to save costs passive concepts are favoured - an obviously critical mix.

Based on the current yield levels, it is unlikely that bond investors will "get rich overnight" again. A fact which significantly differentiates a bond investor from an equity investor. Of course, the expected stock volatility is on average at least five times higher, but in contrast to the fixed income side, this volatility can also "go positive in performance". Because of this difference, it is clear why bond investors must actively analyse risks. However, low yields tempt many bond investors towards supposedly cost saving passive or index-tracking approaches in the face of certain to be expected turbulence a risky strategy. In particular the combination of riskier assets and naive implementation create an almost "explosive atmosphere".

Active Management

Dealing with turbulence and challenging situations is a pilot's raison d'être – the same can be said for an active fund manager. The autopilot or the benchmark is more than capable of guiding the "plane", but who wants to rely solely on the autopilot during a turbulent landing? The pilot in the cockpit is instrumental in determining the safety of a landing and so too is a dynamically adept manager when facing turbulence in the future. Historically, with returns of more than 5%, an additional 1% from active management was "nice" but not considered crucial. When it came down to it, the benchmark had essentially delivered. Due to this many investors hardly thought about the efficiency of the chosen active management approach, let alone the benchmark. However, given returns of less than 1%, the effects of an inefficient benchmark or manager can be comparatively colossal.

Status Quo

What still stands: irrespective of all risk considerations, there is no passing up an opportune bond investment for institutional investors. Concepts which are capable of delivering adequate returns even during more volatile market phases are in high demand.

Duration versus Spread

Previously, the benefit attained by a simple increase in duration could rarely be beaten. However it is clear that this ship has sailed. "Less duration and higher credit spreads" is the typical mantra of return orientated investors, along with a focus on diversified investments in corporate bonds of all sorts. Important to acknowledge though is that the current investment crisis is effectively driving down yields. This is particularly true for Euro denominated corporate bonds. Many investors have consequently shifted their focus to the USD investment space.

Market Structure

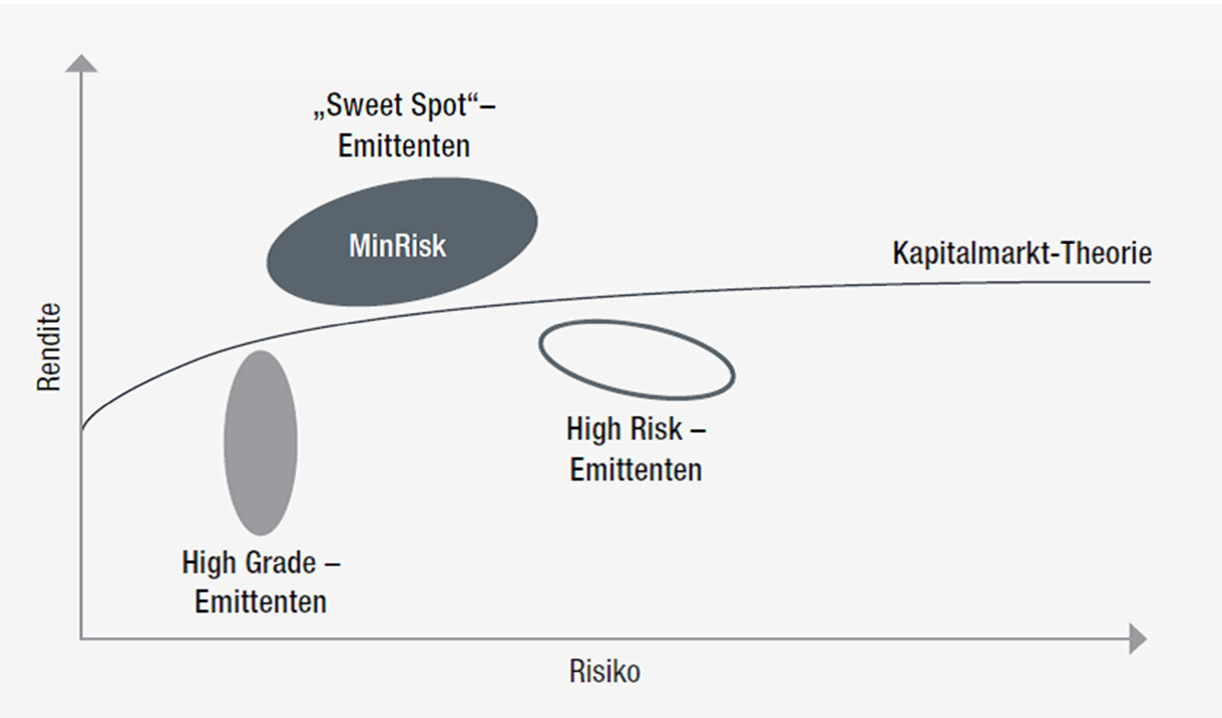
With an eye on the global structure of the market for corporate bonds, the before mentioned decision is only logical, because 6500 USD titles make up more than 60% of the total market alone. Only 24% is made up of the 1900 Euro denominated bonds, and the rest (only 16%) is made up of GBP, CAD and others. The targeted yields are in any case clearly higher in the USD space compared to those in the Euro space, even after full currency hedging. The combination of steeper interest rate curves, higher spreads, and an investment universe that is three times larger, makes the US market attractive. Currently, yields from USD credits lie notably above the level of Euro corporate bonds.

Efficient Benchmarks?

For many investors, the structure of the benchmark and thereby, the targeted diversification of the portfolio, is equally as important as the choice of investment universe. Considering this, common fixed income indices exhibit significant weaknesses: Companies which are above average in an economic sense are automatically granted a higher weight in equities indices (market capitalisation defines the weight). On the other hand, with fixed income indices the ability to generate debt is the determining factor (outstanding debt defines the weight). The largest companies within a fixed income benchmark are therefore by no means the most economically successful issuers. Consequence: in essence debt laden issuers and sectors are over represented in corporate bond indices; dangerous concentration risks are the logical outcome. Thus approximately 50% of an index's weight typically consists of just 10% of all issuers. For sectors the picture is similar; three highly indebted sectors (financials, utilities, telecommunications) hoard approximately 55% of the index between them (Barclays Global Aggregate Corporate Index). Indices thereby put the 'wrong' issuers and the 'wrong' sectors into the spotlight.

Yield = Return?

Another important point which should be deliberated: do higher yielding investments actually go hand in hand with higher returns? Unsurprisingly, the results of empirical research conclude in most instances that this is not actually the case. Investors obtain the highest returns with issuers which are positioned in the middle of the risk spectrum (the so called 'sweet spot' – see graph).



(Source: Quoniam Asset Management)

MinRisk-Concept

For this reason Quoniam identifies issuers within the sweet spot using its 'MinRisk' approach. Issuers which are too expensive or excessively high yielding (risky) are largely avoided. An intelligent weighting scheme is crucial, and an intelligent weighting scheme is one which allocates weight according to risk contribution ("duration times spread" or DTS). DTS enables the active avoidance of benchmark-typical concentration risks. The resulting portfolio is clearly more evenly distributed in terms of risk compared to a standard index. This equates to a reduction of industry typical risk metrics (including duration) by up to 50%. Nonetheless: the combination of superiorly diversified allocation and well informed active title selection elicits a remarkably better risk-return profile (Sharpe ratio). A MinRisk portfolio's risk profile lies (depending on the market phase) well under that of a typical market indices'. Last but not least, remarkably the strategy delivers market similar returns, whilst simultaneously achieving a marked reduction in total risk (as calculated over a full market cycle).

Soft Landing

Given an investment scenario which denotes global corporate bonds and full currency hedging, a Global MinRisk portfolio currently achieves approximately a yield of 1.7% with just 2.4 years duration. Even under full duration hedging, yields of 0.9% are realistic. Those not stuck in a perfect liability matching corset have smarter trading alternatives over a naïve benchmark investment. The MinRisk concept enables a comparably more secure return landing in turbulent market environments.