



# Active Fixed Income

The choice among the five common types of strategies depends on the investor's risk tolerance, income and liquidity needs, and investment goals.

Investors' allocation to public fixed income is crucial, especially with uncertainty about the future direction of interest rates, inflation, and economic growth. While there are passive options, active strategies' objective is to outperform the benchmark, relying on the ability of the investment team to select securities, and potentially to adjust duration, yield curve exposures, and sector allocations. The choice of strategies materially affects funds' expected risk/return profile and performance.

The most common strategies for U.S. public market fixed income are Core, Core Plus. (Core+), High Yield, Multi-Sector, and Unconstrained. Each has different allocations to various segments of the market and offers different opportunities for portfolio managers to add value. This Viewpoint explores the key differences among the five common types of strategies, and how they fit into asset allocation decisions.



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## Types of Bond Strategies

**Core** is the most common strategy and tends to be a significant portion of the total fixed income exposure. The Bloomberg U.S. Aggregate Bond Index (the Agg) is the usual benchmark. It is a capitalization-weighted index. It is intended to reflect the U.S. dollar-denominated U.S. investment grade (IG) bond market.

**Core+** strategies hold predominantly investment grade bonds, but also include allocations to higher-yielding, lower quality and less liquid bonds. They include High Yield bonds, emerging market debt, and structured credit. The objective of reaching down the risk and liquidity spectrums is to enhance returns and only modestly increase overall risk, while maintaining low to moderate risk relative to the benchmark (typically the Agg).

**High Yield** bond strategies tend to be concentrated in below-investment-grade corporate bonds. Their investment objective is to generate higher returns by taking additional credit risk, which also increases the funds' correlation with equity markets. High Yield strategies provide less diversification to the overall portfolio as a result. As shown in **Appendix 2**, High Yield funds also tend to have shorter durations, which lessens their interest rate and overall risk. From an asset allocation perspective, relative to Core and Core+ funds, High Yield funds exchange interest rate risk for credit risk.

**Multi-Sector** funds employ a range of strategies, and have the flexibility to invest in a wide range of fixed income sectors. Actively managed, their investment objective is to outperform their benchmark, and their sources of excess returns can come from market timing, sector rotation and security selection. Each manager's strategy will employ a different combination. Because much of their risk comes from timing and rotation (e.g., increasing the allocation to mortgages, or moving from Investment Grade to High Yield bonds), their benchmark-relative performance is more dependent on the manager's sector allocation skill than are Core, Core+ and High Yield strategies.

**Unconstrained** bond strategies are intended to capture opportunities across the fixed income universe, and they tend to have an absolute return rather than a benchmark-relative focus. Their performance is highly dependent on the manager's skill. While they employ a range of approaches, they often have a flexible, "go-anywhere" mandate that allows the portfolio manager to invest across the full spectrum of fixed income sectors and instruments. This includes using derivatives (e.g., futures, swaps, options, etc.). These strategies tend to have lower correlations with the Agg than the other types of funds.

The choice among the five types of strategies depends on the investor's risk tolerance, income and liquidity needs, and investment goals. Core and Core+ strategies are more conservative and tend to perform in line with the overall bond market. High Yield takes additional credit risk. Multi-Sector and Unconstrained strategies can provide higher returns, but they require the investor to be confident in their ability to identify managers with the requisite skills.

## Types of Bond Strategies (cont.)

The table below shows the commonly held bond types by each type of strategy.

Table I: Types of Bonds Used within the Major Strategies

	Core	Core+	High Yield	Multi-Sector	Un-constrained
Treasuries	Yes	Yes	No	Yes	Yes
Agencies	Yes	Yes	No	Yes	Yes
Investment Grade Corporate	Yes	Yes	No	Yes	Yes
Mortgage Backed and other Securitized	Yes	Yes	No	Yes	Yes
Non-U.S. Sovereign Bonds	No	Yes	No	Yes	Yes
High Yield Corporate	No	Yes	Yes	Yes	Yes
Emerging Market	No	Yes	Yes	Yes	Yes
Syndicated Bank Loans	No	No	Yes	Yes	Yes

Table illustrates commonly held bond types / primary holdings. All strategies may use derivatives to manage curve exposures.

## Potential Sources of Alpha

Active fixed income strategies seek to generate alpha by identifying mis-priced bonds, forecasting interest rate movements, and anticipating changes in spreads (the difference between bond yields and the yields of comparable Treasuries). Potential sources of alpha include:

- **Security Selection / Credit Analysis:** Identifying mispriced bonds, typically by analyzing credit risk, issuer fundamentals, and potential for upgrades and downgrades. Individual bonds may also be mispriced due to short-term supply-demand imbalances or technical factors.
- **Duration Management:** Adjusting the portfolio's sensitivity to changes in the level of risk-free interest rates.



## Potential Sources of Alpha (cont.)

- **Yield Curve Positioning:** Shifting the allocation along the yield curve (e.g., short-term vs. long-term bonds) to capitalize on forecasts of changes in the slope or shape of the yield curve.
- **Sector Allocation:** Rotating between sectors (e.g., governments, corporates, mortgage-backed, structured credit, etc.) to capture relative value opportunities, or to take advantage of expected shifts in sectors' relative interest rates.
- **Currency Exposure:** Taking positions in bonds denominated in foreign currencies to benefit from changes in exchange rates.
- **Illiquidity Premium Capture:** Investing in less liquid securities and sectors to earn higher yields.

## Risk Exposures and Risk Management

Fixed income portfolios can carry multiple types of risk:

- **Interest Rate and Yield Curve Risks:** These relate to the sensitivity of the portfolio to changes in risk-free interest rates. Portfolio managers manage the risk by adjusting their portfolio's duration (how sensitive bond prices are to interest rate changes) and how the portfolio is positioned along the yield curve.
- **Spread Risk:** Spread risk arises because sector yields do not always move in tandem with Treasury yields. Also, the spreads of different sectors (e.g., agencies, corporates, etc.) do not always move together. Portfolio managers manage spread risk by allocating across sectors and securities.
- **Credit Risk:** Bonds have the potential for downgrades and defaults. This risk is managed by robust credit analysis and by diversifying holdings across issuers and sectors.
- **Liquidity Risk:** Portfolio managers hold less liquid bonds to earn higher returns (an illiquidity premium). However, because investors often rely on their fixed income allocation for liquidity, the portfolio manager must understand the potential need to raise cash quickly, and manage the allocation to less liquid securities accordingly.
- **Currency Risk:** Portfolio managers often opportunistically hold bonds denominated in foreign currencies. They can retain the risk if they believe the foreign currency will appreciate against the dollar, or they can hedge the exposure using currency derivatives if they believe the dollar will appreciate or are agnostic about the direction.



## Conclusion

The public market fixed income allocation is a crucial component of investors' asset allocations. There are strategies that offer investors a range of options along the risk-return spectrum. There is also a range of options to enhance returns. Each strategy (Core, Core+, High Yield, Multi-Sector, and Unconstrained) presents a different blend of risks, yield, expected return, and liquidity. Core strategies are lowest risk, and provide exposure to the broad U.S. investment grade bond market. Core+ adds modest credit risk. High Yield strategies provide higher expected returns by taking on additional credit risk. The objective of Multi-Sector strategies is to enhance returns by employing a wider range of opportunities. Unconstrained strategies have additional flexibility (and commensurate risk), but may not be appropriate for investors that prefer benchmark-aware strategies, or desire interest rate sensitivity in their asset allocation. Selecting the right mix of strategies will depend on the overall asset allocation, as well as the investor's risk tolerance (both absolute and benchmark relative), need for liquidity and confidence in their ability to identify superior active managers.

## Appendix I

Appendix 1 shows the composition of the U.S. and global bond markets.

	<i>Bloomberg U.S. Aggregate</i>	<i>Bloomberg U.S. Universal</i>	<i>Bloomberg Global Aggregate</i>	<i>Bloomberg Global Multiverse</i>
Number of Issues	13,702	20,442	30,511	34,104
Total Market Value (\$billion)	\$28,916	\$33,777	\$70,372	\$73,528
Yield to Worst	4.25%	4.48%	3.33%	3.53%
Years to Maturity	8.31	8.08	8.46	8.33
Effective Duration (Years)	6.16	5.96	6.67	6.54
<u>Quality</u>				
AAA	3.4%	3.5%	11.8%	11.3%
AA	72.7%	63.7%	42.5%	40.7%
A	11.5%	12.8%	31.5%	30.1%
BBB	12.5%	13.7%	14.2%	13.8%
BB		3.1%		2.4%
B		2.3%		1.3%
CCC		0.8%		0.4%
Lower		0.1%		0.1%
Not Rated		0.1%		0.0%
<u>Issuer Type</u>				
Government	43.6%	37.4%	53.5%	51.9%
Agency	0.8%	3.6%	8.2%	8.1%
Corporates	24.7%	30.2%	18.3%	20.2%
MBS	26.1%	21.9%	12.6%	12.1%
CMBS	0.8%	1.3%	0.6%	0.6%
ABS	0.5%	0.4%	0.2%	0.2%
Other	3.6%	5.3%	6.5%	7.0%
<u>Geography</u>				
U.S.	93%	85%	40%	40%
Non-U.S. Developed	6%	9%	44%	43%
Emerging Market	1%	6%	16%	17%

Source: Bloomberg LP  
As of September 30, 2024

## Appendix II

Appendix 2 shows the average characteristics of each of the types of strategies

	Core	Core+	High Yield	Multi-Sector	Unconstrained	
<b>Number of Funds</b>	239	74	92	54	30	
<b>Total AUM (\$ billion)</b>	\$1,548	\$793	\$568	\$362	\$82	
<b>Credit Risk</b>						
<b>Fund Averages<sup>5</sup></b>	Quality	AA	A+	B+	BBB+	A-
	Yield to Worst	5.30%	5.68%	7.64%	6.90%	6.12%
	% HY + EM	1%	7%	79%	26%	14%
	Beta vs S&P 500	0.21	0.25	0.40	0.32	0.22
	<b>Market Risk</b>					
	Duration	6.27	6.51	3.34	4.59	3.88
	Volatility	6.85%	6.68%	6.03%	6.97%	5.72%
	Tracking Error vs Agg	1.33%	2.19%	7.48%	6.06%	5.20%
	Correlation with Agg	0.98	0.95	0.56	0.68	0.66

### Credit Risk:

- Core Bond funds tend to have the highest average quality (an average rating of AA). That is not surprising since their benchmark (the Agg) includes a significant portion of Treasury Bonds (rated AAA by Moody's and AA+ by S&P & Fitch), and excludes High Yield bonds (rated less than BBB). The average quality of High Yield bond funds is B+. The average quality of Multi-Sector funds is BBB+. They have more high yield bonds than Core+ funds, but still have a significant allocation to investment grade bonds.
- The differences in credit risk also show up in the funds' yields and their betas relative to the S&P 500.

### Market Risk:

- Duration (sensitivity to interest rate risk): High Yield funds have the shortest durations. There are two reasons. Companies with lower quality ratings tend to issue debt with shorter maturities. Also, high yield bonds' higher coupons shorten their duration a bit. Multi-Sector funds tend to have shorter durations than Core and High Yield. That is because they often hold structured products and employ strategies that hedge interest rate risk. Because they tend to have an absolute return focus, and often use derivatives to hedge various risks, Unconstrained strategies had lower risk than the more traditional Core, Core+ and High Yield.
- Total Risk (5-Year Volatility): The average volatilities of the funds in each category were similar. That is because the fund types with less credit risk tended to have more interest rate risk.
- Benchmark-relative risk (5-year tracking error versus the Agg): Tracking error is relevant to investors that benchmark their public fixed income strategies to the Agg, and that are also sensitive to underperforming the benchmark. Core strategies had the lowest tracking errors. Core+ had slightly more. High Yield, Multi-Sector and Unconstrained funds had relatively high tracking errors versus the Agg. High Yield funds are typically managed to a High Yield index. For the most part, Multi-Sector tend to be benchmark-agnostic, and Unconstrained Funds tend to have an absolute return objective. The funds' correlations with the Agg is another way to evaluate benchmark-relative risk.





## Appendix III

Appendix 3 is a glossary describing types of bonds.

**Agencies:** Bonds issued by U.S. government-sponsored enterprises (GSEs) or federal agencies, such as the Federal National Mortgage Association, (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac). They are not fully backed by the U.S. government, but have a strong implied backing.

**ABS (Asset-Backed Securities):** Bonds backed by specific assets such as auto loans, credit card debt, or equipment leases. Their cash flows are derived from the payments of the underlying assets.

**CLOs (Collateralized Loan Obligations):** Structured products that pool together leveraged loans and slice them into tranches with different risk / return profiles.

**CMBS (Commercial Mortgage-Backed Securities):** MBS backed by commercial real estate loans.

**Convertible bonds:** Corporate bonds that can be converted into a specified number of shares of the issuing company's stock.

**Emerging Market Debt (EMD):** Bonds issued by governments or companies in developing economies. They may be issued in hard or local currency.

**Fallen Angels:** Bonds that had an investment-grade rating when issued, but have since been lowered to junk bond status.

**High Yield bonds:** Corporate bonds rated below investment grade (BB+ or lower). (Also known as "junk bonds.")

**Investment Grade (IG) Corporate bonds:** Bonds issued by corporations with a credit rating of BBB- or higher.

**MBS (Mortgage-Backed Securities):** Bonds backed by pools of mortgages. Investors receive payments from the principal and interest payments of the underlying mortgage loans.

**Municipal bonds:** Bonds issued by states, cities, or local governments. They are often tax-advantaged.

**Non-U.S. Sovereign bonds:** Debt securities issued by national governments other than the U.S. They may be denominated in local or foreign currencies.

**RMBS (Residential Mortgage-Backed Securities):** MBS backed by residential mortgages.

**Structured Products:** Complex securities that combine bonds and derivatives. They are used to create customized risk-return profiles. These can include mortgage-backed securities and collateralized debt obligations.

**Syndicated Bank Loans:** Loans provided by a group of lenders to a single borrower. They are structured, arranged, and administered by one or several financial institutions. (Also known as Levered Loans.)

**TIPS:** U.S. Treasury bonds designed to protect against inflation. Their principal and interest payments adjust with CPI inflation.

**Treasury Bonds:** U.S. government debt securities, issued by the U.S. Treasury, and are backed by the full faith and credit of the U.S. government.





## Endnotes

1. This discussion does not address investing in global fixed income strategies. Also, it does not address narrower strategies such as cash, short-term or long-term bonds, sector-specific or absolute return strategies.
2. This discussion focuses on active strategies, but there are also passive strategies. Index funds benchmarked to the Bloomberg Aggregate Bond Index are Core strategies, and funds benchmarked to the Bloomberg Universal Index are considered Core+. There are also index funds benchmarked to High Yield indices.
3. The weight of each bond in the index is its market value (total par outstanding multiplied by its price) divided by the total market value of all bonds.
4. Duration describes a bond's sensitivity to changes in interest rates. If interest rates were to rise by 1%, the price of a bond with a 5-year duration should be expected to fall by 5%.
5. The table shows average fund characteristics for subsets of strategies in the eVestment database. The selection criterion for inclusion in the calculations include: The eVestment primary universe meets the appropriate classification. The fund: Has an appropriate benchmark and AUM. Does not have special objectives such as ESG or tax-aware. Has portfolio characteristics (e.g. duration, tracking error, etc.) were not outliers. Has a limited percentage of non-U.S. bonds.

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