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Implications of the Fixed Income Evolution

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Key Takeaways:

- The fixed income evolution has delivered new opportunities for innovation.
- The increased depth and breadth of the fixed income infrastructure has unlocked more efficient implementation approaches.
- Prudent use of the expanded portfolio manager toolkit can provide a new range of portfolio construction techniques.
- Our suite of Fixed Income Efficient Beta strategies seeks to capitalize on these advances and systematically deliver competitive returns in less-liquid fixed income segments such as high yield, fallen angels, investment grade corporate, and emerging markets.

The fallout from the Global Financial Crisis set off a sea change in fixed income markets. The rise in electronic trading, a growing roster of liquidity providers, and efficient market completion tools are but a few of the changes that have positively impacted market structure, transparency, and liquidity. While the ensuing regulations were initially a headwind, market participants' creativity and resilience allowed for rapid adaptation to the new environment.

Perhaps nothing has been more important to the modernization than the growth of fixed income exchange-traded funds (ETFs). Once seen as a retail-oriented product, ETFs have become an institutionally accepted instrument as both a versatile portfolio management tool and as the centerpiece of new trading protocols.

We can now systematically capture returns and risk premia in less-liquid segments of the global bond market that were previously difficult to attain due to frictional headwinds; we describe how in this paper. With a suite of Efficient Beta solutions, investors now have more options to diversify their fixed income allocation beyond strictly active or passive approaches or introduce less correlated beta streams to their overall strategic allocation.

Innovative Implementation Methods

New Trading Protocols

Barriers to liquidity have dissolved over the past ten years. Data and technology have increased transparency, with electronic trading platforms now comprising 20-30% of fixed income corporate markets. We expect these trends to continue. Electronic trading platforms provide traders with a broader reach of clients and brokers and allow counterparties an easy platform on which to make markets and hedge risk. Automated data capture is another advantage of trading on an electronic venue, which helps to support post-trade execution analysis for the sellers, buyers and brokers.

As fixed income ETF assets have grown significantly, the depth and breadth of participants in the ETF market has grown along with them. A diverse group of market participants including institutional investors, liquidity providers, hedgers, options traders, broker-dealers and arbitrageurs are engaged at different levels within the ETF market structure. The increased utilization and engagement in the ETF marketplace by these participants has had a highly positive impact on liquidity conditions for the underlying bonds.

Nowhere has this effect been more pronounced than in the corporate market, and in particular the high yield market. The combination of data, technology, a critical mass of market participants, and the transparency of ETFs has resulted in a new trading protocol: credit portfolio trading. Equity portfolio managers have been doing program trading or basket trades since the 1970s, now after nearly 50 years, fixed income portfolio managers have a similar capability. Trading one bond at a time is not the only option anymore.

Credit portfolio trading, when constructed properly, lets us package hundreds of corporate bonds together, trade it within hours, in larger amounts, and at lower costs. Market makers prefer these diversified baskets of bonds because they can hedge them more efficiently and cost effectively. Market makers can utilize any combination of their bond franchises, ETFs, credit index derivatives, options, and electronic trading platforms to hedge these diversified baskets of bonds. With enough diversification, these trades can be viewed as hedgeable market risk exposures and traded less expensively than the cost of one bond at a time.

While the traditional method of trading one bond at a time is unlikely to disappear any time soon, credit portfolio trading offers many benefits to managers and clients such as lower transaction costs, enhanced liquidity, and immediate sourcing of bonds.

An Expanded Toolkit

In the contemporary fixed income market there are now harvestable opportunities—credit risk premia, structural alpha, and illiquidity risk premia—that were previously difficult to achieve. In addition to new trading protocols, there are more portfolio construction tools at our disposal to cost-effectively and efficiently harvest these risk premia for clients.

The US corporate market is a case in point. In addition to physical bonds, our portfolio managers can now employ a combination of credit index derivatives and ETFs to fine-tune portfolio exposures and to reduce costly turnover.

Credit index derivatives, comprised of a basket of single-issue derivatives, have become standardized and centrally cleared. They present a liquid and cost-effective instrument to manage beta exposures and reduce costly turnover in a portfolio. Further, increased availability of analytical data has resulted in a deeper understanding of credit index derivative return drivers and basis risks.

In our view, every fixed income portfolio manager should be utilizing ETFs either directly or indirectly in their portfolio construction. Not only are ETF assets and traded volumes growing, but the broader ETF ecosystem is expanding, reinforcing their presence and utility in the fixed income space. ETFs can be employed as a market completion tool, beta management tool, liquidity layer, or as an alpha strategy to capture returns during dislocations.

The expanding toolkit equips our portfolio managers with more efficient ways to manage liquidity, portfolio construction, and risk. Even though there are now more options at our disposal, it is crucial to understand when each works, their underlying strengths and weaknesses, and how to harmonize their use.

The Rise of an Efficient, Systematic Portfolio Solution

Years ago new data-centric equity and fixed income strategies labeled as smart beta began to emerge. Within equities, this approach has gained popularity due to observable and repeatable factors that are believed to improve risk-adjusted returns. Within fixed income, the aforementioned segmentation does not neatly lend itself to this approach, as seen by the tepid growth of smart beta fixed income strategies.

In this new world of transparency and data, we believe that combining market insights and intuition from fundamental fixed income management with risk management and value preservation techniques from index management to implement quantitative, systematic portfolios will produce a competitive solution. However, designing the strategy is only half of the battle. In illiquid fixed income markets, the other half of the battle is implementation. We thus complement forward-looking portfolio design with innovative trading techniques.

We believe there is a better, more efficient way for investors to access less-liquid fixed income segments that have historically generated attractive return profiles. We expect investors to gravitate to strategies that capitalize on the benefits of the fixed income evolution: enhanced liquidity, an expanded portfolio manager toolkit, and the ability to implement portfolios with broad diversification.

Experience Counts

Our implementation, portfolio construction, and risk management expertise draws on our three decades of experience as a manager of fixed income index strategies. Mellon was also an early adopter of the ETF ecosystem and pioneered credit portfolio trading after recognizing its efficacy in potentially overcoming the transaction cost hurdle and meeting the unique liquidity demands of beta strategies. We have the ability to trade large buy or sell orders in a matter of hours that provides a unique liquidity profile to less-liquid fixed income sectors.

Pioneering Portfolio Implementation

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A. Individual Bonds	B. Fixed Basket of Liquid Bonds	C. Custom Basket of Diversified Bonds
$$$$	$$$$	$$$$
Traditional Approach	Mellon (2012)	Mellon (2017)
Trading in cash markets is very costly (50-70 bps)	ETF Create/Redeem feature contains hidden liquidity (25-35 bps)	Custom Baskets offers precision and liquidity (25-35 bps)

Transaction costs presented above are hypothetical, do not represent actual trading results, and are based on Firm estimates for commission charges, taxes and fees, and market impact charges, which are based on a hypothetical initial all cash investment of $100 million. Actual results may vary. Hypothetical results have certain inherent limitations and should not be relied upon. Determinants of transaction costs are shown for illustrative purposes only.

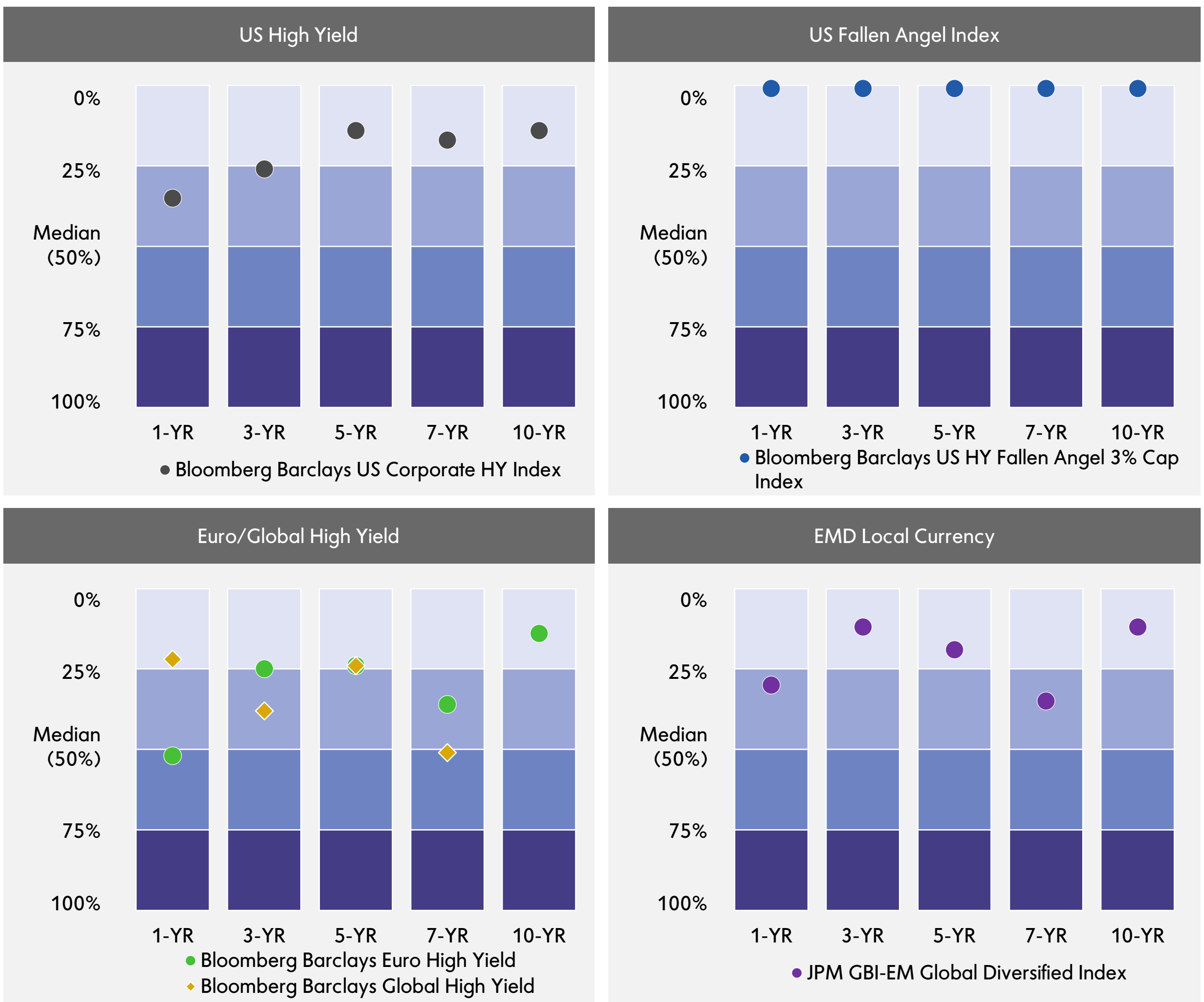
Efficient Beta

At Mellon, we have developed a suite of solutions that is designed to address investor frustration with fixed income performance, both passive and active, in certain inefficient market segments. We refer to this suite as Efficient Beta. Not to be confused with smart beta, Efficient Beta aims to deliver building blocks representing specific fixed income beta exposure to investors.

Our Efficient Beta strategies seek index-like returns in fixed income asset classes where the index has generated top-quartile performance. Specifically, we focus in sectors such as high yield, fallen angels, investment grade credit, emerging market, and other less-liquid fixed income segments.

Focus on Market Segments Where Active and Passive Struggle

Net of Fee Peer Ranking | As of June 30, 2020



Source: eVestment. eVestment statistics are subject to change based on the number of universe constituents reporting. US High Yield and US Fallen Angel are the eVestment US High Yield Universe; Euro High Yield and Global are the eVestment Euro High Yield Universe and eVestment Global High Yield Universe respectively; EMD Local Currency is the eVestment Emerging Markets Universe. Composite expenses, including management fees and other expenses were deducted from these returns. Performance for EMD Local Currency is expressed in EUR.

In our view, Efficient Beta represents a new model of fixed income management at the intersection of passive and active. Our suite of strategies has integrated all dimensions of the fixed evolution as it has progressed. We believe that as the evolution continues our strategies can achieve their objectives more efficiently and at lower cost.

Efficient Beta Potential Benefits

- Potential for competitive outright returns versus peers, both active and passive
- Designed to achieve efficient risk-adjusted returns
- Diversification
- Competitive fees that reside between passive and active

Breaking Down Barriers

The fixed income market has evolved to provide more transparency, depth and opportunity to generate competitive returns. The old active-or-passive paradigm no longer needs to dominate investment manager offerings. In our view, the new fixed income market dynamics allow us to create better portfolio designs in formerly illiquid segments and the ability—if done correctly—to implement them more efficiently. We believe the coming years will be marked by further transformation in fixed income. In this new environment investors will be challenged to think differently about their fixed income allocation. Welcome to the brave new world!

Manuel Hayes

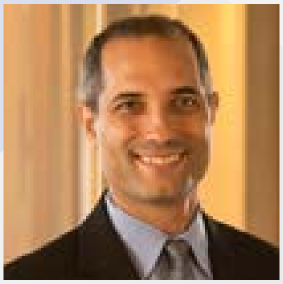
Director, Senior Portfolio Manager

Manuel is a senior portfolio manager responsible for managing investment grade and high yield cash strategies. He actively works with credit researchers to develop new investment grade and high yield strategies. Additionally, Manuel has pioneered innovation in bond trading with “bond basket” trading to enable lower transaction costs, scalability and enhanced liquidity in the credit space.

Previously at the firm, he served as the primary credit trader on all Global Investment Corporate, High Yield, Emerging Market Hard Currency, Sovereigns and Municipal bonds.

Manuel has been in the investment industry since 2004. Before joining the firm in 2009, he was a credit portfolio associate with Pacific Investment Management Company (PIMCO). Prior to that, he was a fixed income trading associate with Metropolitan West Securities (Wachovia, now Wells Fargo).

Manuel earned a BS in economics from the University of California at Berkeley.



Paul Benson, CFA, CAIA

Managing Director, Head of Fixed Income Efficient Beta

Paul is the head of fixed income efficient beta, responsible for managing the firm’s quantitative, factor-based fixed income strategies, including the High Yield Beta strategy. Previously at the firm, Paul was a senior portfolio manager responsible for the yield curve arbitrage strategy within global asset allocation portfolios. Additionally, he engineered and built the process to automate fixed income portfolio rebalancing and improve operational risk control.

Prior to joining the firm, Paul was a senior fixed income portfolio associate at PIMCO, where he analyzed portfolios, and implemented and managed active US and global fixed income portfolios. Previously, he was a trader at Westdeutsche Landesbank Tokyo, where he built the interest rate swaps trading desk, and a trader at Bankers Trust Tokyo, where he ran the Japanese government bond book. Both positions included market making and proprietary trading. Paul has been in the investment industry since 1994.

Paul received a BA from University of Michigan at Ann Arbor. He holds the CFA® designation and is a member of CFA Institute.

Disclosure

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