Fortify portfolios with unconstrained fixed income

The Franklin Templeton Multisector Bond Fund looks for economic imbalances where it can generate alpha for income and capital appreciation.

There are many ways investors can integrate unconstrained fixed income investing into their core portfolios, and each approach may be considerably different from the next.

The Templeton Global Macro team, led by Dr. Michael Hasenstab, says the mechanisms for which to invest in unconstrained fixed income, however, generally fall into either single-sector or multi-sector approaches.

The single-sector approach usually involves allocating a portion of a fixed income portfolio to various individual investment vehicles that focus on non-index assets, such as an emerging market debt fund, for example.

The multisector approach, on the other hand, typically invests in unconstrained, benchmark unaware, fixed income strategies investing in assets opportunistically across multiple types of securities in order to generate risk-managed absolute returns. The Franklin Templeton Multisector Bond Fund is one example of this approach.

Why active management matters

An unconstrained approach to global fixed income investing allows the Templeton Global Macro team to run independent of benchmarks and hold the positions they believe have the best potential to maximise risk-adjusted returns.

Traditionally investors have employed a strategic asset mix that is based around or resembles a common core index such as the Bloomberg Barclays Global Aggregate Bond Index. However, Templeton Global Macro notes the current interest rate environment demonstrates how investors taking this approach may be left especially vulnerable to interest-rate risk, i.e. when low interest rates combine with long-duration characteristics of several common core indices.

Templeton Global Macro chief investment officer, Dr. Michael Hasenstab, says that taking an unconstrained approach to global fixed income investing essentially provides the team with the ability to position defensively with regard to interest-rate risk while capitalising on opportunities around the world.

As an example, in the final quarter of 2016, the team's active and unconstrained approach shone because of its contrarian view that US Treasury yields would begin to rise with or without action from the Federal Reserve.

Throughout 2016 the Franklin Templeton Multisector Bond Fund had maintained duration of close to zero (a position which is still held within the fund) and absorbed losses on net-negative positions in US Treasuries, the yen and the euro as they rallied.

The strong performance of several local currency emerging-market bond positions and a healthy overall yield component meant the fund's performance was only slightly down for the first three quarters.

Come October 2016, 10-year US Treasury yields rose as markets began to incrementally trend towards the team's view that inflation was rising largely due to almost full employment and increasing wage pressures in the US.

By November, a sharp correction in US Treasury valuations was underway, and by the end of the fourth quarter, the Franklin Templeton Multisector Bond Fund had closed what was once a sizeable performance gap and had significantly outperformed its benchmark.

To further highlight the role of unconstrained and active management, Templeton's Multisector Bond strategy, has a track record going back to 2003 and has outperformed its benchmark 93% of monthly rolling three-year periods over the past decade.

Where to be long and short

Hasenstab says he continues to position the Franklin Templeton Multisector Bond Fund for rising rates by maintaining low portfolio duration and aiming at a negative correlation to US Treasuries. It's his view that one of the biggest risks over the next several years will be rising US interest rates.

The US Fed's reticence to lift rates has left it "way behind" the curve and investors are being "complacent" about the impact of the upcoming unwind of the Fed's bloated balance sheet, according to Hasenstab.

The fund remains focused on three key macroeconomic investment themes: Profound value in specific emerging markets; the short of US Treasuries in a rising rate environment; and the flexibility to manage currency markets whether it is long or short positions.

Templeton Global Macro believes several emerging markets have improved resilience over the last decade and have increased external reserve cushions. This has brought accounts into surplus or close to balance, improved fiscal accounts, and reduced US-dollar liabilities.

The manager holds positive outlooks for several local-currency exposures in emerging markets it sees as undervalued including Mexico, Brazil, Colombia and Indonesia.

When it comes to currency the Franklin Templeton Multisector Bond Fund is positioned to benefit from currency depreciation tied to policy measures from the European Central Bank (ECB) and Bank of Japan (BOJ). It is positioned with a long on the US dollar against a short euro, and a long on the US dollar against a short Japanese yen.

The numbers

93%

Templeton's Multisector Bond strategy has outperformed its benchmark 93% of monthly rolling three-year periods since September 2006.

Demystifying risk

As mentioned earlier, Templeton believes fixed income portfolios with allocations too close to core indices become vulnerable to rising interest rates, especially in the current uncertain rate environment.

The manager says generally for a fixed income security or portfolio, the longer the duration the more sensitive it is to fluctuations in interest rates. When rates go up, more often than not the value of fixed income securities goes down more if they have longer-duration characteristics.

There is an argument among fixed income investors that sectors such as emerging markets offer better potential returns but at the expense of increased risk, especially when compared with a portfolio that mirrors the index.

However, Hasenstab's team have put together research identifying which countries are most resilient to rising interest rates, as well as to shocks in global trade, such as in China, and the geopolitical landscape. Countries that depend on capital inflows, have large current account deficits and have high debt levels are very vulnerable – the team point to Turkey as an example. Mexico, Malaysia and Indonesia, on the other hand, score high for their resilience.

The team's view is that while index-based asset allocations can still play a vital part in an investor's fixed income portfolio, shifting towards an unconstrained strategy can better position investors against the pitfalls. This means being less vulnerable to rising rates, an increase in yield potential and an improvement in the overall level of diversification. FS

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