Transcript

PGIM FIXED INCOME

>> You're listening to All The Credits, a monthly Podcast Series brought to you by PGIM Fixed Income and active global fixed income investment manager. And now your host, Senior Portfolio Manager, Mike Collins.

>> Hello, I'm Mike Collins of PGIM Fixed Income and we're here to bring you all the credit. In this podcast we're going to delve into one of the key themes that drives our conviction that active fixed income managers can extract alpha across the global fixed income markets. That is the persistent market segmentation and preferred habitats of global fixed income investors create perpetual market dislocations and miss-pricings. Our two guests today recently wrote a paper on the subject in fact and titled, Capturing the Opportunity of Constraints, Tapping the Value Created by Market Segmentation. In fact, last year Savvy Investor awarded their research the Fixed Income Paper of the Year for 2019. Well congratulations and welcome to my colleagues at PGIM fixed income: Mike Peters and Tom McCartney. Greg is our head of multi sector portfolio management and strategy. Greg and I actually work together on all of our multi sector portfolios at PGIM Fixed Income. Tom McCartan is our head of liability driven strategies, or what some in the industry refer to as LDI. Greg, let's start with you. You're a relative newcomer in the scheme of things at PGIM Fixed Income celebrating your sixth anniversary with us, right?

>> Yeah, only six years.

>> Yeah, only six years. But you've had quite a storied career prior to joining us, give us give our listeners a quick synopsis.

>> Yeah, so I started out with the US Treasury Department, monitoring the thrifts back during the savings and loan crisis or the tail end. And then I moved to Wall Street, to Salomon Brothers and then ultimately Morgan Stanley, where I wound up being Global Head of fixed income research economics then also, I was a chief market strategist there.

>> Okay. Great. Welcome. And, Tom, you're also somewhat relative newcomer to PGIM Fixed Income. You've been here for about five years now.

>> Yep.

>> But you've held high profile positions on both sides of the Atlantic. Tell us about your career path. And what was our good fortune that brought you to the States?

>> Yeah. So I started doing asset allocation and liability hedging strategies for UK pension plans. So started out my career in the UK. And that was really when I got first introduction to this market segmentation because the UK Government had brought in monetary inflation increases for pension plans back in the mid-90s. Not realizing that that was linking the pension valuation to this sector of the bond market and what you've seen since then, UK real yield, the long term real yield is around 4%. It's now negative 2%. So really created huge captive demand. So I moved over to the US about five years ago. I was astonished to find similar parallels in other fixed income markets over here. Linking the pension valuations, to high quality corporate bonds has had similar effects on the prices of those.

>> So Greg, what is the genesis of the paper and it's significant in managing fixed income?

>> Yeah, so it all started with being asked to give a presentation to the CFA Institute on how do we manage fixed income portfolios. And so incorporating Tom's views and just our process, I wanted to provide, Tom and I wanted to provide a roadmap and how we think about the world and investing. And the thing about fixed income is that is a highly fragmented marketplace. There's lots of dispersions, lots of constraints. And so we wanted to put together a paper that details a process and how we kind of prosecute alpha and for multi sector investing, it's really about sourcing these different types of constraints in order to kind of create a much more efficient portfolio. And ultimately for us, the goal is repeatable alpha with a high information ratio. And so we wanted to detail how we go about it.

>> Great. So Tom, let's talk more about the fixed income, market segmentation and fragmentation and, and the associated constraints that you see, among primarily institutional investors.

>> Yeah, yeah. So there's really many examples of these. And, you know, I think the big thing is, the size of these constrained investors relative to the size of markets is quite large. So we mentioned already, pension valuations and how linking those particular sectors of our market impact demand. The other big ones are the accounting rules, the accounting conventions about when you hold fixed income investors when big financial institutions like banks and insurance companies, even corporations whole fixed income investors, how they have to account for those in their earnings every quarter, creates a huge focus on yield. And as we know, as accredited investors, yield is really not the primary thing you should be focusing on when thinking about investing in credit. It's about the risk premium. And is that enough compensation for the risks. Second big set of rules and constraints are the regulatory capital rules that have a lot of them which have been brought in post crisis. So think of solvency two, think of Basel three slash four, think of the NAIC ratings framework in the US. They direct demand towards specific asset classes based on how those regulatory capital rules have been written. And so for these very capital sensitive institutions, like banks and insurance companies, you have a big focus on trying to optimize yield per unit of regulatory capital. And really, you know, creating an objective function more focused on accounting than economics.

>> Right. So they're not necessarily focused on total return like we like we might be every day.

>> Exactly. Yeah. You know some of the when you when you think of solvency too, that has been really punitive on an asset class and we actually think economically is very cheap. So certain high quality structured product are pure are punished a huge amount. So Triple-A CLOs, for instance, they're doing --

>> Collateralized loan obligations.

>> Collateralized loan obligations, the triple A CLOs, received three times higher capital waste than the actual collateral, the leveraged loans, double B leveraged loans, which are underneath them, despite having 40% credit enhancement on that collateral pool. Really doesn't make sense. It's very non intuitive.

>> Right. And I've also noticed talking to a lot of investors around the world that there are other biases too. Some of them are behavioral biases. I know a lot of retail investors and their advisors are so worried about the short term mark to market volatility of your portfolios, that they err on the side of holding really short duration, bond portfolios. And it seems like that creates an opportunity with steep spread curves, steep term structure. What do you what do you think about that?

>> So I think it's important to emphasize what Tom was saying about yield and the separation of risks. And so for us, yield doesn't really tell you anything, right. So embedded in the yield is the option cost is the risk free rate is the credit spread. And so for us, it's really important to separate all those different risks to understand the value of the security. And the classic example is just mortgage backed securities, right? So agency mortgages, where if you look at the yield, it doesn't tell you anything because of the prepayment option. And so using OAS is a much better measure, but even OAS particularly for credit is a flawed measure. So I think oftentimes what investors use is just kind of a starting OAS as expected future return. But what's missing in that calculation is credit migration. And so it's really important to incorporate what the expected loss through credit migration is. And so using OAS doesn't really get you to an expected return. And so examples like that is why we think it's really important to separate duration risk from spread risk to FF risks.

>> All right, and, Tom, I know another major trend we're seeing in the fixed income markets and we actually Michael Liller [assumed spelling] and I talked about this on our on our last podcast is the trend toward passive management away from active management, particularly in the equity market, but it's also happening in the fixed income market. We've seen a big proliferation and exchange traded funds that focus on fixed income indices.

>> Yeah, and there's a huge amount of this I think is being driven by what's happening in the retirement market in the US, this big shift away from defined benefit towards defined contribution. And what we see is in those 401k, or defined contribution plans, a huge amount of the contributions going on in its projected to get to 80% of new contributions are going to target date funds.

>> And target date funds are largely index based?

>> So within target date funds, there are active and passive however, the net contributions in target date funds are all going into the passive target date funds. So think of Vanguard and BlackRock, these huge big players that have a big footprint in the target date markets. And all of that is creating this big bid into passive replication of the indices.

>> So Greg, what does that what does that do for valuations in fixed income?

>> Yeah, so the valuations and fixed income are being driven by this passive flow, but I think it's important to understand that there's a continental divide between the equity community and the fixed income community around passive investing. For example, on the equity side, you invest in a single security, a single equity. If you have the same capital structure on the fixed income side, there might be 15, 20, 40 different securities to choose from. And so it's much more complex. And the point of this paper actually is to highlight that fixed income is a much more segmented complex marketplace than equities. I also think it's important to note that the index on the fixed income side is is somewhat arbitrarily constructed. So missing in the toolkit from a passive side, no 144 As, for example. No structure products, other types of limitations and so you're limiting your alpha capabilities just by passively managing to an index. So I think that is very, very different than the equity side.

>> Right. And just by the nature of a market capitalization weighted bond index just seems like a bad idea. You're, you're forced to allocate more capital to the entities that have the most debt, right? That just seems like a fundamentally flawed thesis. So Greg, to follow up with you about the these trends we're seeing in these dislocations in the market segmentation. Is there actual empirical evidence, you can point to that supports the theory that the global bond markets are, are riddled with inefficiencies?

>> Absolutely. So all you have to do is just plot excess returns versus volatility, right. And so what you typically should see is a linear slope. On the fixed income side, though, it's scattered, right? And so it's very much of a shotgun blast. So it just highlights how segmented the marketplaces and information ratios are very different as well across. And a great example is short single B's for has a almost a one info ratio, sharp ratio, whereas long corporate single As have zero or negative. And that just kind of highlights just the dispersion in the market.

>> Tom, is there a reason to believe that these miss-pricings would persist? I mean, you know, market theory would lead you to think that eventually the free markets will price these inefficiencies out of the market. But why would they persist?

>> It should right, you know, that's what a lot of the theory is kind of thought is what is seems to be exhibiting in the equity markets, right, where active managers and an aggregate are having a hard time beating the indices. It's not the case in the bond markets. And, you know, that's not to say that we think this is an easy task to identify that relative value that Greg mentioned earlier, but we do think part of these rules and constraints and regulations are persistent and potentially even growing. Like think about financial regulation of those, those institutions. Those capital regimes aren't going anywhere. In fact, you know, they still seem to be continuing. Think of that really big, strong bid in passive investing, that's only growing as these target date funds grow. And then you have, you know, other factors like, you know, pension risk transfer, transferring more of the DB corporate defined benefit plans over to the insurance universe, where again, there is, you know, a lot of regulation on how they invest. So, so we do see some persistence in these inefficiencies.

>> Right. Well, this sounds all good for active managers, and obviously a PGIM fixed income that is our focus. So Greg, how should a fixed income manager that is presumably not constrained by a lot of these types of regulatory capital and behavioral biases, construct portfolios?

>> Yeah. So you basically are allowed to build an efficient frontier to capture the constraints. And so we can build a portfolio with the highest possible information ratio. And we're not limited by the various constraints that Tom talked about. And so at the end of the day, we're up and out the efficient frontier where we'll build, we can build a portfolio with less volatility and a higher expected return. So the irony is we write this paper about constraints, but it's actually a really big opportunity for us to take advantage.

>> Great. And, Tom, you're the LDI expert. And you worked very closely with many of our pension clients who focused on, focused on liability driven investment matching their long term liabilities and cash flows. How do we think differently or similarly about managing that type of portfolio versus the multi sector portfolios that Greg discussed?

>> Yeah, so it's, it's following a very, very similar process exactly as, as Greg outlined, but we're starting off from that point of, of helping the clients identify this issue that because the accounting has linked the pension valuation to this one sector of the bond markets, risk adjusted returns in that sector have become pretty challenged. And so what we want to do is, is use all of the evaluation of relative value right across the fixed income spectrum, like Greg mentioned. Use broad guidelines, use healthy tracking our budgets to we think improve the overall outcome and expected excess return of the portfolio. We think it's pretty well rewarded, you know, by using that risk budget.

>> You think that's a much better process than buying a bunch of high quality, industrial investment grade corporate bonds, which a lot of these plans end up being forced to do.

>> I think there's a balance and there's a balance between we all know the you know, people are always looking at the accounting ability and they want to manage risk over the short term relative to that. We think there's a long term or optimal portfolio construction, and it's trying to find a balance, strike a balance somewhere in between those two.

>> Okay, so we covered a lot today. Thank you. Let's wrap up by sharing with our listeners what some of our best ideas. So you have all these efficiencies, all these opportunities, all these miss-pricings. What are they? You know, Greg and Tom, I'll throw it out to both of you. What are some of our favorite bonds and sectors that that you know could benefit from these dislocations?

>> The first sector that we continue to really value is securitized products, right? So that is the epicenter of where the constraints affect the valuations. So triple A CLOs, triple A CMBS, those types of securities, we continue to really see a lot of value. The second is what I call the Fallen Angel gap. So the constraint of investment grade versus high yield kind of creates this great opportunity around triple B and double B's. And so we have a preference for triple B's. And then typically we have a preference for double B's as well. So those are two of the main areas. But then in addition, you know, reverse Yankees is an area that fits, once again, not in the index are lots of different indices. And then we continue to have this underweight in long duration, high quality industrials, as we think that is where the credit migration is most severe, and you're not getting paid for the yield or the OAS.

>> Right. And those are exactly the types of bonds a lot of our constrained, investors are forced to participate in. I know even last year, a lot of our clients were afraid to buy low triple B rated bonds just under the fear that they would go to below investment grade and I know we were pretty active and actually looking for opportunities in lower rated triple B's that were indeed leveraging mode. So that was an interesting nuance.

>> So on the triple B's, I think that identifies another of the market segmentations Mike, where there's this very arbitrary line drawn between investment grade and sub investment grade and the fear of triple B's or getting downgrades that you allude to and how a lot of those bonds cheapened up is as a result of that segmentation between the two markets. So, I think it relates back to the point that Greg was making about that opportunity in the triple B double B space to capitalize on that fear and that that fear of this relatively arbitrary demarcate demarcation between the two segments.

>> And then some investors would be forced sellers if they go to double B and they don't want to be in that position.

>> Exactly.

>> Okay. Well, that's a wrap. Thank you very much to my guests, Greg Peters and Tom McCartan, and thanks to all of our loyal listeners. Please subscribe to our podcast, All the Credit. And if you're interested in taking a closer look at that award winning paper, you can find it on PGIMfixedincome.com Thank you.

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