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Better Together: How Unconstrained Bonds Can Help Enhance Fixed Income Portfolios

A modest allocation to a bond fund that invests across a wider array of sectors and isn't tied to the Bloomberg U.S. Aggregate Bond Index may help reduce risk and boost return potential.

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Key takeaways

- Pairing an unconstrained bond fund with a core fixed income strategy may provide a better overall investment experience than a core bond fund alone.
- Historical analysis shows that shifting 30% of a core fixed income portfolio to an unconstrained bond fund has improved portfolio efficiency while maintaining a minimum 0.80 correlation to the U.S. Aggregate Bond Index (the Agg).
- Unconstrained investing doesn't mean taking unconstrained risk: Our approach focuses strictly on public fixed income while aiming to avoid style bias, targets a risk level consistent with bonds, and uses duration posture to manage risk.

Benefits of unconstrained bonds

Core bond funds that invest primarily in U.S. Treasury securities, U.S. government agency mortgage-backed securities, and investment grade corporate bonds are the anchor for most any fixed income allocation. However, limiting portfolio exposure to these core sectors may mean missing out on a diverse universe of income and return opportunities in areas such as securitized credit, high yield and emerging market debt.

One approach is to add various single-sector funds and periodically revisit allocations to stay on track. A more opportunistic (and simpler) method is to move some core bond assets to an unconstrained (or "nontraditional") bond fund. These funds are called unconstrained because they typically have broad flexibility to invest across a variety of securities, with fund managers adjusting the portfolio based on where they see the best opportunities.

We believe this approach offers **three compelling benefits** that can lead to a better overall investment experience.

1. Improved portfolio efficiency

Using the Morningstar® Nontraditional Bond Fund category average as a proxy for a typical unconstrained bond fund, history shows that blending an unconstrained bond fund with a core bond fund has resulted in superior outcomes compared with a standalone core bond fund, as measured by the Markowitz efficient frontier of risk and return (Exhibit 1).

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A note about risk

All investing involves risks of fluctuating prices and the uncertainties of rates of return and yield inherent in investing. You could lose money on your investment and any of the following risks, among others, could affect investment performance. The following principal risks are presented in alphabetical order which does not imply order of importance or likelihood: Bank Instruments; Company; Convertible Securities; Credit; Credit Default Swaps; Currency; Deflation; Derivative Instruments; Environmental, Social, and Governance (Fixed Income); Floating Rate Loans; Foreign (Non-U.S.) Investments/ Developing and Emerging Markets; High-Yield Securities; Inflation-Indexed Bonds; Interest in Loans; Interest Rate; Liquidity; Market; Market Capitalization; Market Disruption and Geopolitical; Mortgage- and/ or Asset-Backed Securities; Other Investment Companies; Preferred Stocks; Prepayment and Extension; Securities Lending; Sovereign Debt; U.S. Government Securities and Obligations. Investors should consult the Portfolio's Prospectus and Statement of Additional Information for a more detailed discussion of the Portfolio's risks. The strategy employs a quantitative investment process. The process is based on a collection of proprietary computer programs, or models, that calculate expected return rankings based on variables such as earnings growth prospects, valuation, and relative strength. Data imprecision, software or other technology malfunctions, programming inaccuracies and similar circumstances may impair the performance of these systems, which may negatively affect performance. Furthermore, there can be no assurance that the quantitative models used in managing the strategy will perform as anticipated or enable the strategy to achieve its objective.

Glossary of terms

A **basis point** (bp) is a standard measure for interest rates and other percentages in finance; one basis point equals 1/100th of 1%, or 0.01% (0,001 in decimal form).

Correlation is a statistic that measures the degree to which two securities move in relation to each other.

Diversification is a risk management strategy that creates a mix of a wide variety of investments within a portfolio in an attempt to reduce portfolio risk.

A **drawdown** refers to how much an investment is down from the peak before it recovers back to the peak and measures the historical risk of different investments, compares fund performance, or monitors personal trading performance.

Risk-adjusted return is a calculation of the profit or potential profit from an investment that factors in the degree of risk that must be accepted in order to achieve it. There are several ways to evaluate risk-adjusted performance, such as the Sharpe ratio, the Treynor ratio, alpha, beta, and standard deviation, with each yielding a slightly different result.

The **Sharpe ratio** is a risk-adjusted measure calculated using standard deviation and excess return to determine reward per unit of risk. The higher the Sharpe ratio, the better the portfolio's historical risk-adjusted performance.

Index definitions

The **Standard and Poor's 500® Index** is an unmanaged capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. The **Bloomberg U.S. Aggregate Bond Index** is a widely recognized, unmanaged index of publicly issued investment grade U.S. government, mortgage-backed, asset-backed and corporate debt securities. Investors cannot directly invest in an index.FVR3 [illegible]

T he **Bloomberg U.S. Treasury Index** measures U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury with remaining maturity of at least 1 year. Treasury bills and STRIPS are excluded from the index by the maturity constraint. An investor cannot invest directly in an index, and index performance does not reflect the deduction of any fees, expenses or taxes. Index comparisons have limitations, as volatility and other characteristics may differ from a particular investment.

Morningstar® Categories: **Nontraditional Bond Fund:** Funds that pursue strategies divergent in one or more ways from conventional practice in the broader bond-fund universe. Many funds in this group describe themselves as "absolute return" portfolios, which seek to avoid losses and produce returns uncorrelated with the overall bond market; they employ a variety of methods to achieve those aims. Another large subset are self-described "unconstrained" portfolios that have more flexibility to invest tactically across a wide swath of individual sectors, including high yield and foreign debt, and typically with very large allocations. Funds in the latter group typically have broad freedom to manage interest rate sensitivity, but attempt to tactically manage those exposures in order to minimize volatility. The category is also home to a subset of portfolios that attempt to minimize volatility by maintaining short- or ultra-short duration portfolios, but explicitly court significant credit and foreign bond market risk in order to generate high returns. Funds within this category often will use credit default swaps and other fixed income derivatives to a significant level within their portfolios.

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