

MANAGING BOND PORTFOLIOS

In this chapter we turn to various strategies that bond portfolio managers can pursue, making a distinction between passive and active strategies. A *passive investment strategy* takes market prices of securities as fairly set. Rather than attempting to beat the market by exploiting superior information or insight, passive managers act to maintain an appropriate risk–return balance given market opportunities. One special case of passive management is an immunization strategy that attempts to insulate or immunize the portfolio from interest rate risk. In contrast, an *active investment strategy* attempts to achieve returns greater than those commensurate with the risk borne. In the context of bond management this style of management can take two forms. Active managers either use interest rate forecasts to predict movements in the entire fixed-income market, or they employ some form of intramarket analysis to identify particular sectors of the fixed-income market or particular bonds that are relatively mispriced.

The boxed article that follows discusses the advantages and pitfalls of active fixed-income portfolio management.

Because interest-rate risk is crucial to formulating both active and passive strategies, we begin our discussion with an analysis of the sensitivity of bond prices to interest rate fluctuations. This sensitivity is measured by the duration of the bond, and we devote considerable attention to what determines bond duration. We discuss several passive investment strategies, and show how duration-matching techniques can be used to immunize the holding-period return of a portfolio from interest-rate risk. After examining the broad range of applications of the duration measure, we consider refinements in the way that interest rate sensitivity is measured, focusing on the



ACTIVE MANAGEMENT PAYS OFF: INDEXING SHOWN AS THE WRONG ROUTE FOR FIXED-INCOME FUNDS

Tim Hicks and Harry Marmer, both with the pension consulting firm Frank Russell Canada, have a simple message to the country's pension funds: Don't join the crowd rushing to index their fixed-income investments.

Instead of trying to boost performance of assets, the managers should consider alternatives such as buying securities issued by corporations and/or investing in foreign bond markets—and they should be patient.

"There is a case for active fixed-income management," said Mr. Marmer, who along with Mr. Hicks recently produced a paper entitled "Beating the Canadian Fixed Income Market" that will soon be published in the *Canadian Investment Review*.

"We believe that fixed-income managers can significantly improve their alpha potential by looking at different types of bets across sectors. This means not increasing duration strategies but considering and implementing alternative innovative styles and strategies to significantly increase the odds of beating the market," the two wrote.

The two believe opportunities will arise from two sources: a broadening out of the local fixed-income market with the rise in corporate bond issuance (including asset-backed securities); and growth and diversification in the global arena. They make that conclusion after determining that "standard fixed-income styles and strategies are insufficient alone to beat the market."

The two define the five major fixed-income strategies or styles: pricing anomalies (which involves rich/cheap analysis); bond swapping (sector rotation); yield curve forecasting; interest rate anticipation; and indexing—where the manager's portfolio matches the bonds included in a financial market index to duplicate the general performance of the market in which it invests.

The paper then shows rate anticipation has generated the best returns in four years but has also generated the worst results in five years. Yield curve forecasting has generated the best results for the past five years but generated the worst results in four of the decade's first five years.

"The market rewards different styles over time without any predictable pattern. In addition, the return differential between the best- and worst-performing styles can be enormous," they say.

Mr. Marmer added the case for indexing fixed-income securities has arisen for a couple of reasons:

- First, the relatively small gap between the return generated by the top-quartile managers and the bottom-quartile managers. The gap between the first- and third-quartile performance is about 50 basis points, or about one-third of the similar gap for equity managers. In essence, the return among fixed-income managers tends to be far more concentrated than for equities.
- Second, the gap between the top-performing managers and the benchmark (typically the Scotia Capital Universe index) isn't that substantial. "Over the past five years, the payoff for very good fixed-income performance has been relatively small compared to superior Canadian equity results, albeit in a less volatile asset class," the two write.

Thus the question: Why pay for active management, which involves higher fees, when the returns aren't there? Why not opt for an indexed style and receive the benchmark return?

Mr. Marmer, the director of investment funds at Frank Russell Canada, and Mr. Hicks, a portfolio manager, insist their research isn't self-serving.

"We are a research company. If our research concludes that we can't find strategies or managers to beat the market, we will [recommend indexing] but we feel we can find those strategies to beat the market and the managers to do it," said Mr. Marmer.

Added Mr. Hicks: "Our own bond fund has over the past year outperformed the benchmark, in part because we employ a multi-manager structure and because we own more corporate bonds than the benchmark. Accordingly we generate higher returns." ...

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concept of bond convexity. Duration is important in formulating active investment strategies as well, and we next explore several of these strategies. We consider strategies based on intramarket analysis as well as on interest rate forecasting. We also show how interest rate swaps may be used in bond portfolio management. We conclude the chapter with a discussion of financial engineering and derivatives in the bond market, and the novel risk profiles that can be achieved through such techniques.