



THE BENEFIT OF ACTIVELY MANAGED BOND SEPARATE ACCOUNTS IN A PORTFOLIO

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We are undergoing a change in how investors view the concept of income. Historically, consultants and clients have laddered bond portfolios and clipped coupon income in order to satisfy their income needs. But increasingly, sophisticated investors are looking to active bond management, real estate investment trusts (REITS), preferred stock, convertibles, dividend-paying stocks and asset classes such as timber to serve as sources of income.

This trend of diversifying income will continue, so it is important to evaluate the most efficient vehicle for each and how to position that solution within a portfolio.

The following discussion focuses on the benefits of active bond management within a client's portfolio and the advantages of investment grade separate accounts over the traditional laddered approach and direct investment.

The Benefit of Actively Managed Fixed Income Separate Accounts

The Role of Fixed Income

The first objective in evaluating an income solution is to differentiate the characteristics of each approach. In the case of actively managed fixed income, that means defining the role of bonds in the asset allocation. This may sound simple, but recent history has shown that clients tend to flee to high quality fixed income when everything goes wrong but then tend to forget or look down on the asset class when times

are good. It is important to remember that the objective of a bond allocation is to not only provide income but also mitigate volatility over the long term. Financial crises provide a clear example of the correlation advantage of an investment grade bond portfolio versus several alternative income solutions. While other income solutions may provide higher yields cyclically, the role of investment grade bonds as a diversifier remains true.

Exhibit 1 illustrates how investment grade bonds provide an attractive correlation to equity compared to several of the other popular income solutions. While varied sources of income are valuable in a diversified portfolio, it is important to remember why investment grade bonds are an integral component of this allocation.

Can Investment Grade Bond Separate Accounts Provide Alpha?

In discussions with both advisors and clients, a common concern is whether hiring a fixed income money manager makes sense when the bond market is seen as fairly straightforward. In reality, the bond market is very complex and provides opportunities for institutional managers to provide attractive returns adjusted for risk.

When trying to identify value-added, most investors are really looking for alpha. While some equate it with performance over a benchmark, alpha is a risk-adjusted characteristic.

EXHIBIT 1: 5 YEAR ASSET CLASS CORRELATIONS (12/31/10)

	S&P 500	AGG	HY	MSCI EAFE	S&P PRE	S&P REIT
S&P 500	1.00	0.15	0.74	0.91	0.58	0.80
BARCLAYS CAPITAL AGGREGATE (AGG)	0.15	1.00	0.25	0.23	0.28	0.21
BARCLAYS CAPITAL HIGH YIELD INDEX	0.74	0.25	1.00	0.76	0.55	0.74
MSCI EAFE	0.91	0.23	0.76	1.00	0.61	0.72
S&P PREFERRED STOCK INDEX (S&P PRE)	0.58	0.28	0.55	0.61	1.00	0.51
S&P COMPOSITE REIT INDEX (S&P REIT)	0.80	0.21	0.74	0.72	0.51	1.00

Source: Barclays Capital

EXHIBIT 2: PERCENTAGE OF FIXED INCOME UNIVERSE PROVIDING POSITIVE ALPHA

Manager Universe	Benchmark	% with Positive Alpha (# of Managers in Universe)	
		5 Year	10 Year
PSN Core Fixed Income	BC Aggregate	82% (318)	80% (270)
PSN Investment Grade Fixed income Intermediate	BCGCI	84% (335)	86% (270)

Source: Informa Investment Solutions. As of 09/30/2010

In other words, how much risk did it take to produce superior returns? If you beat the benchmark by 0.5% but take twice the risk, is that a good proposition when risk doesn't pay? This is a question that is illuminated in a period of market turmoil. In fact, actively managed fixed income separate accounts can provide alpha as a function of their attention to both risk and return, with risk management typically being a primary concern when hiring a bond manager.

Exhibit 2 illustrates that over 80% of investment grade bond separate account products provide alpha over a ten year period. As you can see, the results illustrate that actively managed bond separate accounts should be worth considering in developing an investment grade income solution. Ladders, on the other hand, typically place more emphasis on coupon income than either total return or risk management, creating a portfolio that is static in its view of risk and return.

Once it is understood that value can be created within actively managed bond portfolios, it is important to understand the sources of value-added: active bond management and institutional bond management.

The Value of Active Bond Management – Exploiting Inefficiencies

Various sectors and maturities within the bond market can be influenced by cyclical, monetary and market pressures to create mispricing in fixed income sectors and securities. These potential inefficiencies in valuation result in opportunities for bond managers to provide attractive risk-adjusted yields. An analysis of these strategies provides further evidence of the benefit of fixed income separate accounts.

Sector Management

Sector selection is a primary tool used in active bond management given the cyclicity of performance across various sectors. While each sector has different historical return potentials and risk characteristics, there are opportunities throughout the economic cycle to provide risk-adjusted value to a portfolio through identifying undervalued sectors.

As with any other well diversified portfolio, a bond portfolio can produce a very attractive risk/return pattern when the

allocation has the flexibility to access different sectors and do so when they are undervalued. Just look at the cyclicity of investment grade bond sector returns in Exhibit 3. As you can see, Treasuries (often a primary component of a laddered portfolio) were the top performer (indicated by the yellow boxes) in two of the previous ten years ending in 2010. On the other hand, BBB-rated credits, while producing a more volatile return pattern, provided the best return in five of the last ten years. As you can see in 2009, the BBB-rated credit sector provided 3,130 basis points of excess return vs. a similar duration Treasury!

A common concern for individual investors in laddering a bond portfolio or direct investment is to exclude sectors such as credit securities at the lower end of the investment grade spectrum or mortgage-backed securities (MBS) due to the lack of access to supply or lack of understanding of the market. Unfortunately, this approach can dramatically reduce both the income and return potential to the end client. While laddering is ideal for specific client needs, it does not look to add return by finding relative value in the bond market. As you can see in Exhibit 3, the variance in returns of different bond sectors can be dramatic and professional bond management attempts to take advantage of these opportunities by continuously looking to optimize risk-adjusted income. In a market environment with very large levels of spread, it can be very additive to explore the risk-adjusted attractiveness of these sectors.

Interest Rate Management

The concept of duration is an extremely important one in fixed income management. Duration in its simplest terms explains the interest rate sensitivity or magnitude of the change in price of a security (or an overall portfolio) to a 1% change in interest rates. For example, if interest rates were to rise (fall) parallel across the yield curve by 1% and the duration of the portfolio was 4.5, the portfolio would decrease (increase) in price by approximately 4.5%. This is an important concept to understand and convey to clients as "...NASD surveys, for example, showed only 40 percent of investors understood that bond prices fall as interest rate rise" (NASD, 10).

EXHIBIT 3: INVESTMENT GRADE SECTOR EXCESS RETURNS vs. TREASURIES (2001 - 2010)

Manager Universe	2010	2009	2008	2007	2006	2005	2004	2003	2002	2001
Treasury (Total Return)	5.87	-3.57	13.74	9.01	3.08	2.79	3.54	2.24	11.79	6.75
Excess Returns*										
Agency	0.77	2.88	-1.52	-0.56	0.76	0.17	0.78	0.30	1.00	0.78
AAA	0.64	1.68	-4.58	-1.42	0.50	-0.13	0.67	1.23	0.98	1.20
AA	0.95	11.47	-11.58	-4.17	1.08	-0.17	0.68	2.12	1.29	2.65
A	1.70	19.12	-20.18	-5.45	1.14	-0.28	1.44	3.91	-1.52	3.17
BBB	3.05	31.30	-23.95	-5.16	1.54	-1.77	2.19	9.34	-4.49	2.74
MBS Fixed Rate	2.30	4.82	-2.55	-1.85	1.22	-0.37	1.42	0.11	1.73	-0.75

Source: Barclays Capital.

*Excess returns under Exhibit 3 is the difference between total returns of the security and an implied Treasury portfolio matching the term-structure profile of that security. Total returns can be compounded. By separately compounding these two series of monthly total returns, we arrive at the two periodic total returns. The difference between them is the periodic excess return.

Managing the level of interest rate sensitivity provides managers ample opportunity to add value as interest rates are fairly cyclical. In other words, in environments where the economy is growing at an above average rate and inflation concerns begin to increase, the Fed has historically increased interest rates to curb potential inflation expectations. Conversely, when economic growth concerns are stronger than inflation expectations, interest rates tend to move downward.

From a bond manager's perspective, if the expectation is that inflation concerns will increase, the manager can add value to the portfolio by shortening duration, taking a defensive posture and reducing interest rate exposure. On the other hand, if growth is slowing and economic turbulence seems to signal interest rates moving lower across the yield curve, the manager can extend duration or take on more interest rate exposure in order to produce more attractive total return for the client. A laddered portfolio, on the other hand, typically staggers maturities regardless of the opportunity set or potential direction of interest rates.

Yield Curve Positioning

An additional tool available to active fixed income managers is yield curve positioning, which refers to how a portfolio is structured along the yield curve. A buy and hold investor will typically stagger or ladder maturities regardless of opportunity set, but active managers have the flexibility to utilize a bullet or barbell structure depending upon the expected change in interest rates at different points along the yield curve in order to emphasize those portions of the curve with the best risk reward.

A bulleted structure concentrates maturities in one part of the yield curve, while a barbell emphasizes shorter and longer

maturities if the intermediate portion of the yield curve is unattractive. For example, if the yield curve is expected to steepen with long rates increasing more than short rates, an active manager can structure a bullet in the short-intermediate portion of the yield curve to protect against rising long rates and potentially provide excess returns vs. the market. This active management tool can provide additional opportunity to add value relative to a static yield curve approach.

Credit Risk Management

While most investors view all bonds equally, turmoil in the financial markets provides plenty of evidence that credit research is very important to providing stability within a portfolio. With a financial crisis in full swing, credit research is at the forefront. A primary benefit to fixed income separate accounts is the credit research and diversification that can be achieved compared to direct investment or laddering, both of which prove very important in environments where credit risks increase.

The credit sector tends to be cyclical, so there are periods when taking risk is rewarded and those when taking risk is clearly not rewarded. Professional bond managers have broad research capabilities which assist in constantly evaluating securities through turbulent times to ensure those companies' balance sheets and business models are capable of servicing the debt and avoiding defaults and downgrades.

A brief look at the cumulative default rates on corporate bonds is reviewed in Exhibit 4. As you can see, there can be significant credit risk in the corporate bond market over the long term. Managing this credit risk and opportunistically taking advantage of credit inefficiencies gives managers an additional tool in attempting to provide more attractive risk-adjusted returns. The evolution of

EXHIBIT 4: GLOBAL DEFAULT RATES, % (1983 - 2008)

Average Cumulative Issuer Weighted

Rating	Year 1	Year 5	Year 10	Year 20
Aaa	0.00	0.09	0.19	0.19
Aa	0.02	0.25	0.41	2.13
A	0.03	0.68	1.71	5.10
Baa	0.18	1.89	4.14	11.15
Ba	1.15	10.48	18.74	34.46
B	4.33	24.47	41.45	57.46
Caa	13.73	43.75	64.78	81.05
Investment Grade	0.07	0.92	2.00	5.43
Speculative Grade	4.35	20.69	32.52	47.20
All Rated	1.57	7.12	10.54	15.47

Source: Moody's Global Credit Policy, February 2009

bond separate accounts has also seen the development of completion strategies to provide greater diversification in certain credit sectors that offer attractive returns with increased security specific risks.

Lastly, the development of unified managed account platforms has provided the ability to access additional bond sectors such as high yield, international and emerging market debt via diversified vehicles such as mutual funds and ETFs, which provide an attractive complement to an investment grade separate account and may further improve the potential risk-reward for the client.

The Value of Institutional Bond Management

Bond Trading Costs

Bond managers have historically referenced the benefit of institutional trading in discussing the advantages of using a manager and to address the fee issue. We hope to illustrate some of the "costs" to trading that have so often been discussed but not widely acknowledged empirically. This is an important discussion given that many clients believe that bond ladders are "free" and thus a fee on a fixed income account seems unreasonable. A NASD survey revealed that "Thirty-four percent either thought: (a) there was no fee for buying or selling a bond or (b) they did not know whether they were paying a fee" (NASD, 10). Insight into this key issue can be very helpful in describing the advantages to institutional bond management.

Bond pricing is an advantage of institutional bond management versus direct investment or bond ladders that

invest in higher yielding securities such as corporate bonds. This advantage in execution is very well illustrated in a study completed by Lawrence Harris, Amy Edwards and Michael Piwowar. They studied TRACE reported corporate bond trades to see if the increased transparency in trading provided any cost benefit to the end client. In doing so, they also provide some tangible costs of trading corporate bonds.

"The estimated transaction costs decrease with trade size. The average round-trip transaction cost for a representative retail order size of \$20,000 is 1.24% of price (62 bps \times 2), while the average round-trip cost for a representative institutional order size of \$200,000 is only 0.48% (24 bps \times 2)." (Edwards, 18).

This is revealed in the study to be exacerbated in larger order sizes - a \$5 million institutional trade demonstrated estimated average costs as low as 0.06% roundtrip vs. the 1.24% roundtrip for a \$20,000 retail trade." (Edwards, 20) This fundamental pricing mechanism is an advantage to institutional bond trading that is often not recognized by individual investors.

An analogy is the concept of shopping at a wholesale discount store such as Costco. Institutional bond managers are buying in bulk and getting advantageous pricing per unit versus smaller orders. An understanding of bond trading costs is important in understanding the value that institutional managers can provide vs. laddering or direct investment.

The Availability of Supply

In addition, most clients are unaware that the majority of bonds are held by institutions. This is an important factor because it provides institutions with greater access to inventory. Both pricing and availability of supply become increasingly important in turbulent market times in order to maximize the value-added in this asset class.

Conclusion

In summary, the idea of income generation is currently evolving and will continue to undergo changes as more instruments become available to clients. While investment grade bonds may play a slightly lesser role in an income generation strategy, they will always hold a special place given their attractive non-correlation to equities and role as a "safe haven" when times get tough.

While laddering bond portfolios is still very prevalent and

appropriate in certain situations, actively managed bond separate accounts provide a very attractive client solution based on the value that can be provided over the long-term through both institutional and active bond management. Just as in the equity markets, there are inefficiencies that can be exploited to provide more attractive income levels per unit of risk. A client that is looking to mitigate volatility and has a longer term time horizon should consider bond separate accounts as an attractive core holding within a diversified income strategy.

SOURCES:

Edwards, Amy K., Lawrence E. Harris, Michael S. Piwowar, "Corporate Bond Market Transaction Costs and Transparency", The Journal of Finance, Volume: 62, Issue: 3, Published: June 2007

NASD. "Report of the Corporate Debt Market Panel" September 2004.

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Definition: Excess Return - Returns in excess of the risk-free rate or in excess of a market measure.



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