

Fixed Income Allocations for 2025 and Beyond: A Playbook for Investors

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Executive Summary

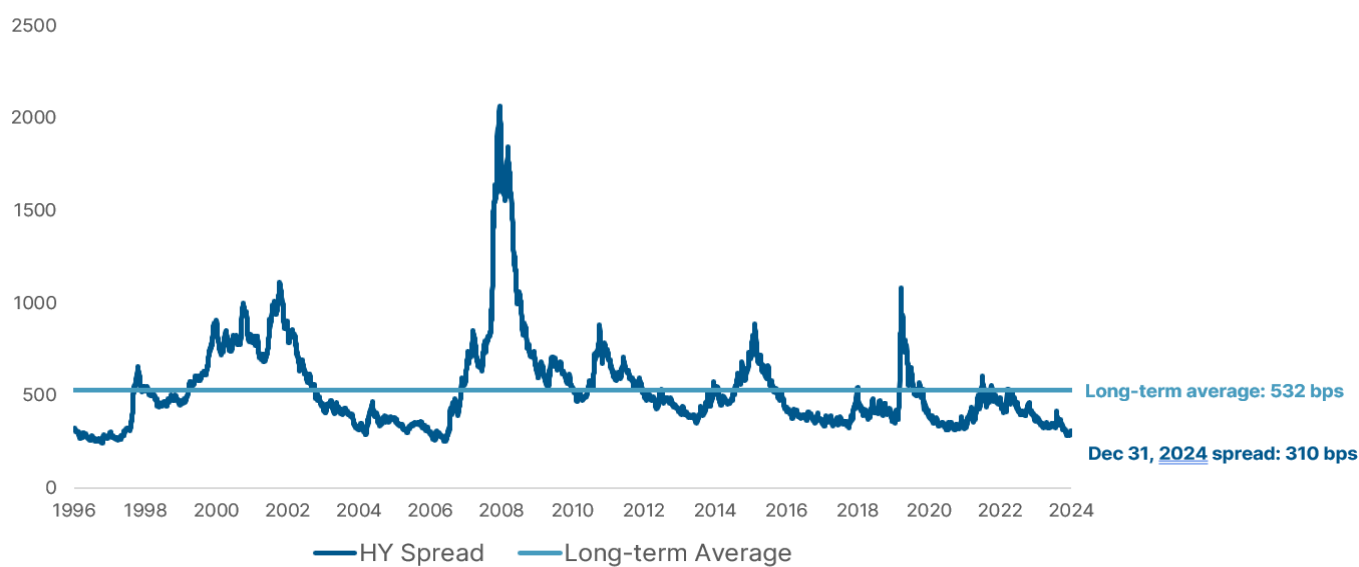
- Credit valuations appear elevated, global debt levels are high and rising quickly, and persistent fiscal imbalances risk undermining market confidence.
- Private credit has been all the rage of late, but potentially higher returns on offer come with many trade-offs versus public fixed income.
- Poor returns from traditional fixed income in 2021 and 2022 have caused some investors to reconsider the composition of their fixed income allocations.
- However, despite growing risks, rising bond yields over the past few years now provide compelling all-in yields in pockets of the bond market.
- Liquid global credit, in an unconstrained format seeks to provide investors with enhanced returns over active core and passive fixed income, without the primary trade-offs of private credit, while targeting positive returns in all market environments.
- There are benefits to making a strategic rather than tactical allocation to unconstrained global credit when constructing a well diversified portfolio.

What are some keys risks in today's fixed income market that investors must grapple with?

1. Credit Valuations

The chart below shows the average high yield spread (the incremental yield you earn for lending to a lower quality corporate with challenges, think: Bombardier in Canada or Boeing in the U.S) over the last 28 years. If you rarely look at credit markets, this is the only chart you need to get a sense of whether the market is tilted in favour of lenders or borrowers (it's a borrower's market today!). Also take note that these periods in favour of borrowers can last several years, but when the tide turns, it tends to do so abruptly and in extreme ways.

Historical High Yield Index Spreads (bps)



Source: ICE BofA data as of December 31, 2023

2. Political Machinations

With the recent change in White House administration, the purported policy agenda with a focus on higher tariffs, lower taxes, and reduced regulation has the potential to be favourable for U.S.-based companies over time. The majority of higher revenues, net income, and cash flow (if and when they transpire) will likely accrue to the benefit of shareholders over lenders given the upside potential accruing to equity holders versus the contractual return of fixed income. Think: mergers & acquisitions, share buybacks, and special dividends—it is not going to be in vogue to deleverage. If this environment plays out, protecting capital as a lender will be more important than ever.

3. Elevated Debt Levels

Incentives drive behaviour, and though debt serves a useful function in society, Canada, the

United States, and many other countries around the world are reaching alarming levels of indebtedness thanks in large part to years of easy monetary policy and government fiscal policy (i.e., growing deficits without the economic growth to eventually pay it back).

Chart 1: A plethora of fixed income sectors to chose from

Fixed income sectors	Key Characteristics
Global corporate bonds	Investment grade rated bonds issued by companies domiciled in developed economies.
Global high yield	Sub-investment grade rated bonds issued by companies domiciled in developed economies. Typically higher credit risk and offering higher interest rates than investment grade issuers.
Bank loans	Floating rate loans issued to sub-investment grade companies.
Convertible bonds	A bond that pays interest but can be converted into a pre-determined amount of common stock.
Asset-backed securities	Bonds and loans secured against auto loans, credit card receivables, mortgages, and other financial assets.
Private placements	Bonds and loans that are typically unrated and do not have a liquid secondary trading market.
Emerging market corporate bonds	Corporate bonds issued by companies domiciled in emerging markets. Tend to be sub-investment grade rated issuers.

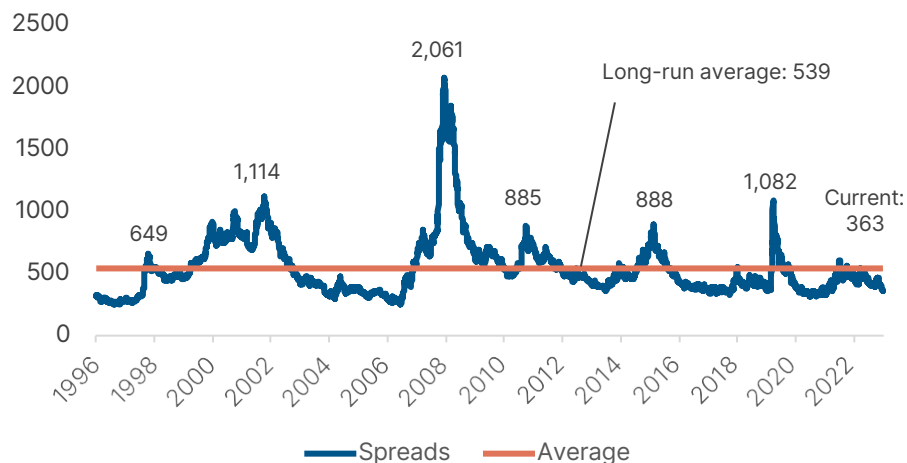
Large Canadian pension plans began moving away from concentrated allocations of Canadian securities decades ago and smaller institutional and high-net-worth investors are following suit. Diversification is the one free lunch in investing—a broader investment universe, all else equal, should lead to better portfolio outcomes over time.

Dynamic investment approach

Active management acknowledges and respects credit spreads can stay tight, and yields low, for long periods. Shifting to higher credit quality and shorter duration mitigates risk in expensive markets. When markets are cheap or distressed, a dynamic approach calls for taking advantage of the opportunity by rapidly and decisively shifting into lower credit quality positions.

Chart 2: Valuations are highly cyclical in credit markets

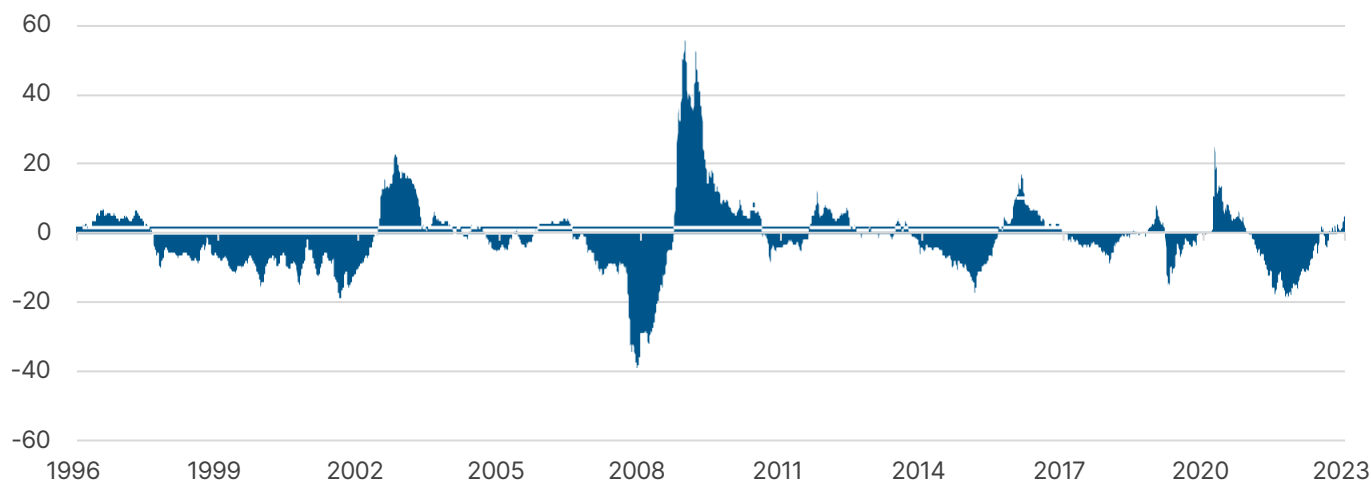
U.S. High Yield Spread History



Source: ICE BofA data as of December 31, 2023

Chart 3: Valuations are highly cyclical in credit markets

U.S. High Yield Rolling 12-Month Price Returns (%)



Source: ICE BofA data as of December 31, 2023

Credit exposure must be actively managed as there are times when spreads rapidly increase (e.g., the Great Financial Crisis of 2008 and COVID-19 in March 2020). These periods lead to substantial short-term losses but offer the potential to reap significant long-term recoveries, rewarding investors that dynamically increase exposure and risk after credit selloffs and patiently hold on during the recovery phase of the cycle.

Absolute return focus and benchmark agnostic

Absolute return focus is defined by the goal of generating positive returns regardless of market environment, independent from a benchmark return.

Benchmark agnostic means portfolio characteristics, including credit exposure and duration, are a byproduct of the individual credit determinations driven by bottom-up analysis, not a result of trying to be within plus/minus of a benchmark.

An absolute return, benchmark agnostic investment approach builds a resilient portfolio of best ideas, not necessarily the highest yielding ideas. The approach targets positive returns in all markets. Free from the typical constraints of a benchmark-relative mandate, the strategy has the license to capitalize on market dislocations whenever and wherever they occur.

Risk aware

There are layers of risk management embedded in a UGC. Some are in common with traditional fixed income strategies such as bottom-up security analysis and minimum diversification requirements at the issuer level.

Traditional funds “constrain” risk by mandating relatively close adherence to a benchmark. These constraints target tight tracking error but often increase risk with poor investment outcomes. It is not always an effective way of managing downside risk, the risk that a strategy has negative absolute returns.

For example, a traditional bond strategy may be allowed to deviate from a benchmark which has eight years duration by one or two years. Being two years short the duration of a benchmark would be a bold call by a portfolio manager managing a benchmark-relative bond mandate. However, the reality is that if bond yields rise by 1 percent, the portfolio manager will outperform their benchmark by 2% but still lose 6% in absolute terms². Hardly an ideal outcome for investors!

UGC strategies are unconstrained with respect to credit and duration positioning. To be clear, it’s not that UGC strategies won’t take on risk. Assuming risk is a necessity when trying to generate returns above the risk-free rate. However, UGC can be selective about when and how much risk it takes on and can avoid certain risks entirely if the compensation is deemed insufficient. Many traditional fixed income strategies do not have this flexibility.

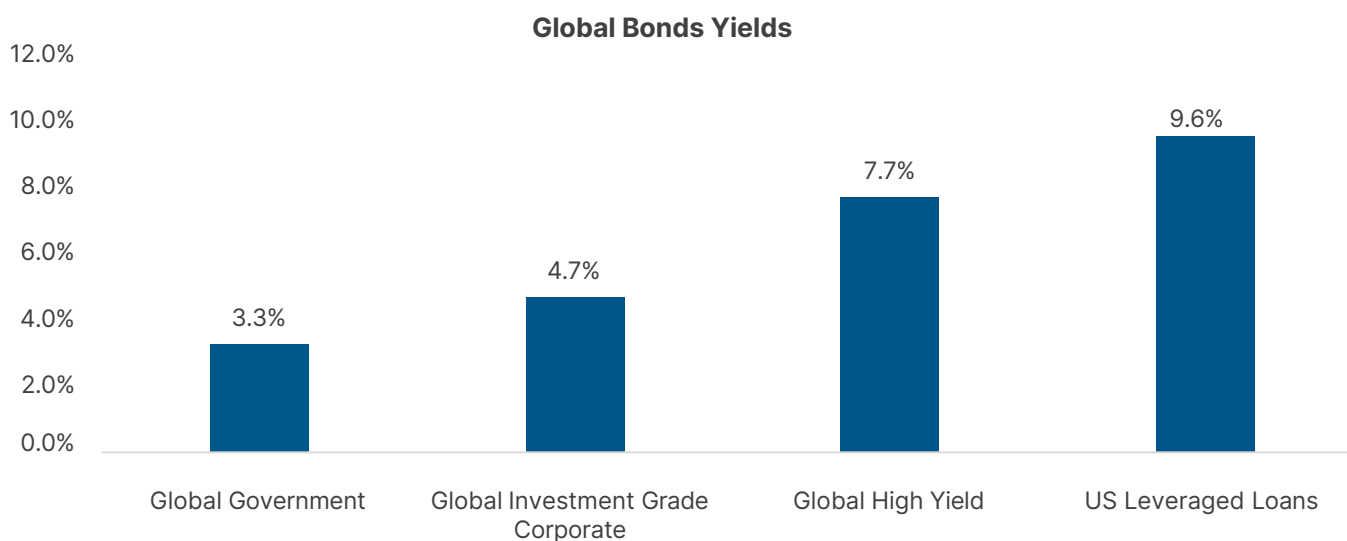
² We are outlining a highly simplified scenario where things such as credit spread and yield curve changes and running yield are ignored to isolate the impact of the duration positioning decision.

Why investors should consider investing in unconstrained global credit

UGC aims to retain the key benefits of fixed income while enhancing and smoothing out returns.

- **Diversification.** Fixed income is a diversifier and a risk mitigator versus other asset classes including equities or real estate which tend to dominate many investors' portfolios.
- **Income.** Fixed income can provide meaningful portfolio cash flow. Corporate bonds can provide return over and above government bonds.
- **Capital Preservation / Capital Appreciation.** Fixed income can and should act as a preserver of capital but can also, in periods of market dislocation, provide substantial capital appreciation potential.

Chart 4: An attractive yield pick-up from diversified global credit



Source: ICE BofA and S&P Global data as of December 31, 2023.

How to allocate

A core fixed income substitute: Some investors commonly see UGC as a substitute for a large portion of an existing traditional fixed income allocation. UGC strategies can target a more attractive expected return profile than traditional fixed income without a commensurate increase in risk.

A fixed income satellite: For investors that want to maintain a traditional core fixed income exposure (for example pensions that want duration exposure to hedge liabilities), a satellite allocation to this strategy can be a return-seeking credit focused compliment.

An equity substitute: Some investors use UGC strategies to reduce the equity concentration risk in their portfolios without materially sacrificing return potential. UGC strategies also target a smoother return profile than equities. In other words, the long-term destination may be similar but the experience along the way can be more comfortable in a UGC strategy.

Conclusion

Fixed income remains an important part of a well diversified portfolio, especially after the recent normalization in bond yields. An UGC provides diversified exposure to a breadth of credit sectors through opportunistic positions. Ideally, well compensated risks are assumed, poorly compensated risks are avoided.

Ultimately, UGC provides a way for investors to lessen the home county bias in their portfolio while either enhancing the return potential of existing fixed income allocations or de-risking equity allocations. In either case, it's another potential tool in investors' toolkits to help meet their long-term objectives.

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