Allspring

Riding the Curve: The Power of Security Selection

+ High-quality fixed income offers historically attractive yields in both nominal and real terms.
+ The recent increase in bond market volatility creates dispersion across sectors and securities.
+ Dispersion allows prudent security selection to enhance value in fixed income portfolios.

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It's been well documented that fixed income yields have risen astonishingly from very low levels amid efforts by the Federal Reserve and other global central banks to reverse over a decade of accommodative policy as they tackle high inflation. By reviewing the long-term historical yield of the Bloomberg U.S. Aggregate Bond Index—a high-quality liquid benchmark—we can see how dramatic this shift has been (Figure 1). The index shows that high-quality, investment-grade yields have risen to more than 5.00% over the past two years—an increase of about 400 basis points (bps; 100 bps equal 1.00%).

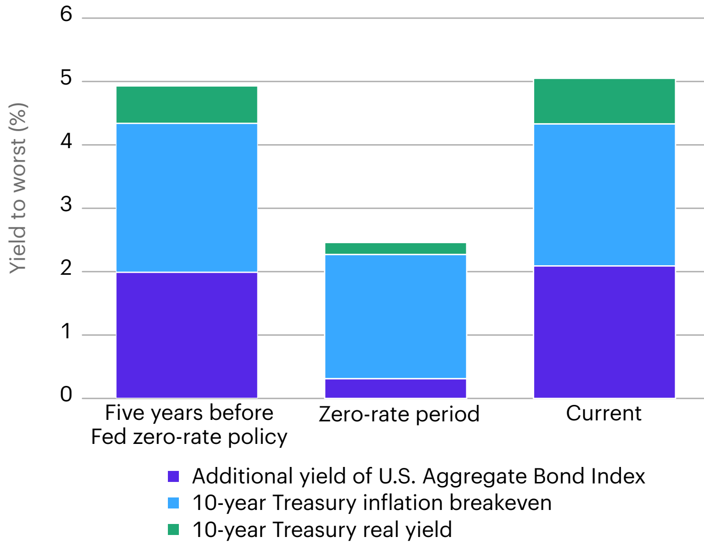
FIGURE 1. YIELD TO WORST: BLOOMBERG U.S. AGGREGATE BOND INDEX

Sources: Allspring and Bloomberg Finance L.P.

Yield to worst is a measure of the lowest possible yield that can be received on a bond that fully operates within the terms of its contract without defaulting.

The most significant driver of this development is the return of real yields. The long period of zero/very low interest rates that began after the Global Financial Crisis resulted in depressed real yields, which have now recovered to attractive levels. At 200+ bps, we believe the real yield offered by the broad investment-grade bond market (represented by the Bloomberg U.S. Aggregate Bond Index) could more than compensate investors for inflation risk over the coming years (Figure 2).

FIGURE 2. COMPONENTS OF U.S. AGGREGATE BOND INDEX'S YIELD TO WORST



Five years before Fed zero-rate policy = 01-Nov-03 to 16-Dec-08

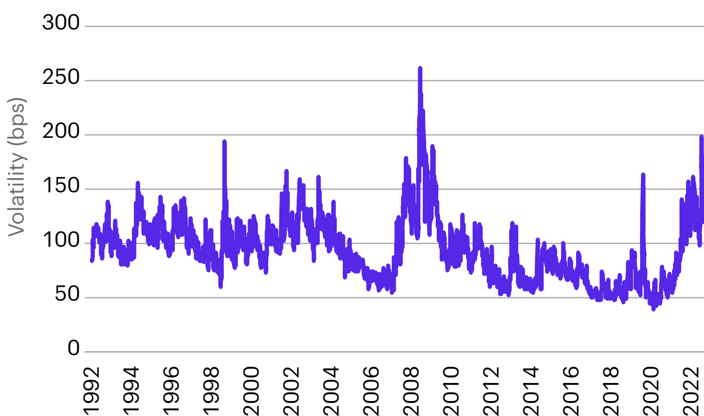
Zero-rate period = 16-Dec-08 to 15-Feb-22

Current = 16-Feb-22 to 30-Nov-23

Sources: Allspring and Bloomberg Finance LP.

Many investors have remained on the sidelines, however, because this rapid increase in yields has been accompanied by a significant and sustained increase in volatility—as seen in the recent performance of the ICE BofA MOVE Index, which reflects the level of volatility in U.S. Treasury futures (Figure 3).

FIGURE 3. U.S. TREASURY VOLATILITY (PER ICE BOFA MOVE INDEX)



Sources: Allspring and Bloomberg Finance L.P.

After years of quantitative easing and accommodative monetary policy, many investors have been somewhat shocked by this paradigm shift. But markets are simply returning to more normalized, historical levels. The economic outlook remains highly uncertain, with risks balanced between positive and negative—suggesting this will be persistent. For investors, the key is to take advantage of the newly attractive yield environment using an active strategy that views volatility as an opportunity to exploit, not a risk to fear. A core bond strategy focused purely on security selection does just that.

Active management in core bond strategies works

Over time, active managers have demonstrated their ability to deliver consistent alpha in the core bond space. Bond markets remain relatively inefficient, with many trades still handled by phone. The complexity of the bond market—where one issuer typically has multiple issues with different maturity dates and structural features—doesn't lend itself to simple trading strategies. This characteristic can lead to pricing anomalies that nimble managers can use to their advantage.

New bonds are issued daily, often with valuation discounts, providing further opportunities to add value. The diversity of bond market participants who have significantly different objectives—from central banks perhaps purchasing bonds for noneconomic reasons, to banks that may buy specific bonds for regulatory reasons, to international investors who may be pursuing value through a currency lens—can also create dislocations for active managers to exploit.

These features of fixed income markets have, over time, created an environment for active managers to thrive (Figure 4). Given that these features are likely to persist, we believe investors should consider what type of active approach may offer the greatest opportunity for success going forward.

FIGURE 4. ANNUALIZED ACTIVE CORE BOND MANAGER RETURNS VERSUS BENCHMARK

	3 YEAR	5 YEAR	10 YEAR
Median core bond manager annualized returns	-4.71%	0.61%	1.63%
Bloomberg U.S. Aggregate Bond Index annualized returns	-5.21%	0.10%	1.13%

Sources: Allspring, Bloomberg Finance L.P., and eVestment as of 30-Sep-23

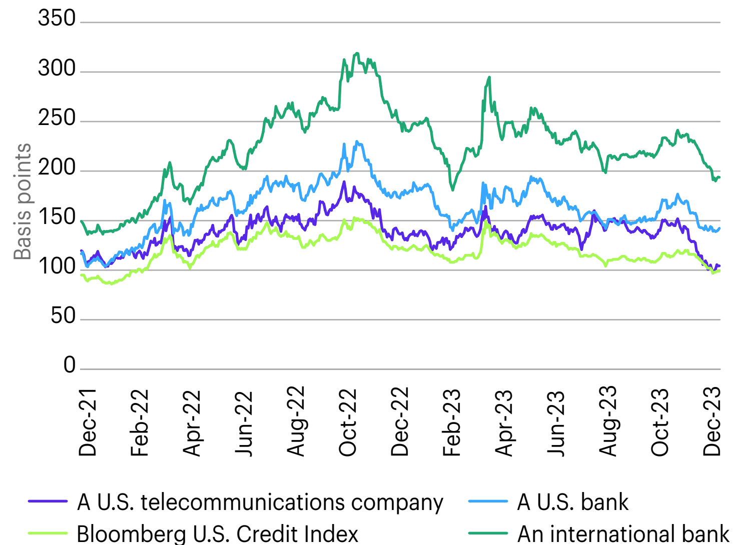
Benefits of nondirectional returns: Use security selection to enhance returns

Top-down asset allocation is necessary to achieve portfolio diversification—but as an investment tool, it's a blunt instrument for portfolio managers that's laden with directional risk. Exposure to macroeconomic factors—especially in an environment of greater up and down volatility—can lead to large performance shortfalls and negative surprises that may offset the benefit of attractive yields. In contrast, a diversified portfolio composed of dozens of security selection decisions based on fundamental research can potentially deliver more consistent outperformance. Within this type of portfolio, individual securities that are mispriced relative to one another are selected while robustly controlling overall portfolio risk. Many small decisions made over time may drive consistent outperformance with a more predictable risk profile than one big decision made at one point in time.

Increased dispersion is the primary way that volatility creates security selection opportunities. Valuations of similar securities begin to diverge from one another, with relationships between them adjusting more rapidly. A nimble portfolio manager can exploit these changes in relative value repeatedly, creating a source of alpha that's consistent, replicable, and uncorrelated with macroeconomic developments. In fact, while it may become more challenging to implement directional portfolio tilts in times of heightened volatility, the opportunity set of attractive security selection opportunities actually tends to expand significantly.

Figure 5 shows an example of similar securities within the high-quality, investment-grade corporate bond market. During the low-interest-rate environment that prevailed in December 2021, these securities traded at similar and stable valuations relative to each other without significant dispersion compared with their broader benchmark. As interest rates rose and markets became more volatile, these relationships diverged, changing quickly in both directions. An active manager can adjust accordingly by rotating positioning based on what's relatively attractive at any given time. The manager also can express these security-level views across multiple sectors and subsectors simultaneously without taking a directional view on the overall market—keeping risk contained.

FIGURE 5. CORPORATE BONDS' YIELD SPREADS RELATIVE TO U.S. TREASURIES



Sources: Allspring and Bloomberg Finance L.P.

An investment process that's focused on this type of security selection and active rotation, with robust risk controls, can potentially deliver positive excess return in just about any environment—but it shines in more volatile markets. In a normalized volatility and yield environment, this kind of process may thrive, enhancing the performance of what's already an attractive yield profile.

A performance formula: Active management focused on security selection

In recent years, low yields, low volatility, and low dispersion created a difficult environment for investors in high-quality fixed income—especially those focused on security selection. Today, yields are attractive again, and returns can be further enhanced by successful active management.

We believe markets are in the midst of a paradigm shift, categorized by a return to normalized levels of volatility where bottom-up portfolio construction—with a focus on security selection—allows investors to create high-quality fixed income portfolios with efficient risk/return characteristics. The crowded macro opportunities of recent years, such as carry trades and shortened duration, can't be relied upon to consistently drive performance going forward. We believe investment managers who focus on bottom-up security selection within a tightly controlled risk framework have a good opportunity to win in this regime.

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The Bloomberg U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment-grade, U.S.-dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, mortgage-backed securities (agency fixed-rate and hybrid adjustable-rate mortgage pass-throughs), asset-backed securities, and commercial mortgage-backed securities. You cannot invest directly in an index.

The Bloomberg U.S. Credit Index contains publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be registered with the U.S. Securities and Exchange Commission. Each qualified issuer's exposure is then capped on a market-weighted basis at 3%, and the residual is allocated on a pro-rata basis to all remaining constituents. You cannot invest directly in an index.

The ICE BofA MOVE Index is a measure of U.S. interest rate volatility that tracks the movement in U.S. Treasury yield volatility implied by current prices of one-month over-the-counter options on 2-, 5-, 10-, and 30-year Treasuries. You cannot invest directly in an index.

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