April 2018

Buy & Maintain

Highlights

- **Bond fund management with low portfolio turnover,**
  - suited to the market context,
  - in keeping with changes in IFRS,
  - traditional insurance management expertise.
- **Very diversified active fund management,**
  - allocation not based on issuers' outstanding debt,
  - quest for greatest possible diversification,
  - focus on default risk.
- **Specific performance measurement.**

Many bond investors have traditionally bought securities with the intention of collecting the coupons and holding the debt to maturity. Assets were only sold in the occurrence of a credit event. The aim was to build a portfolio and achieve regular returns, without necessarily looking for capital gains. Insurers in particular were the main proponents of this type of approach for accounting reasons. Furthermore, accounting and tax restrictions that hampered the disposal of these assets increased the appeal of holding them to maturity. This approach, which was initially known as "Buy and Hold", long suffered from a negative image, as it was considered to be a passive strategy, with the fund manager simply buying the securities and sitting tight until maturity.

However, in today's context, accounting changes on the one hand and current interest rates and spreads on the other have brought this type of "prudent person principle" fund management back into fashion, and it is now known as "Buy & Maintain" or "Buy & Monitor". As we will see, this type of approach is far from passive.

Why now, and for who?

Under the terms of IAS[i] 39, amortized securities could be classified as HTM or held-to-maturity investments. This enabled holders to use amortized cost for these assets and avoid any impact on profit and loss arising from interest rate fluctuations. However, this classification was highly restrictive and made it virtually impossible to sell the assets.

Accounting classification of investments has been reviewed under new accounting standard IFRS 9 and it is now possible to limit the impact of the market value volatility of most bonds on results, i.e. bonds that are deemed to have passed the SPPI test[ii]. In more practical terms, coupons net of amortization are booked to results; the difference between the market value and the amortized cost of financial assets is either booked to the balance sheet under 'other comprehensive income' (with no impact on profit and loss) or remains off-balance sheet.

Another factor has brought this type of bond management back in fashion: current low interest rates and spreads. At a time when transaction costs (bid/ask spread) are not so far from expected returns, it seems natural to look to a fund management approach with low asset turnover. This low turnover is also an advantage in addressing expected interest rate hikes: assets are not sold with capital losses, so this approach safeguards capital and follows interest rate rises by the reinvestment of the principal and coupons.

This strategy naturally appeals to investors who are looking for regular and relatively predictable income, and for whom asset liquidity is not a priority.

What is Buy & Maintain?

The principle

The aim of this investment method is to safeguard capital while optimizing the portfolio's book yield, and at the same time complying with the restrictions set by the client, particularly the credit risk budget and target duration. The aim of keeping portfolio turnover as low as possible is the result of accounting and tax constraints. It is a matter of selecting securities that are to be held to maturity, building the portfolio, then ensuring constant and active monitoring with two main goals in mind. The first aim is to take market opportunities via arbitrage moves aimed at improving the portfolio's yield, while the second is to remain particularly watchful in order to avoid default when possible, or at least anticipate default as early as possible. A rigorous approach to selling generally has a greater impact on a portfolio's yield than the best buy decisions: when purchasing assets, the yield/spread can be improved, with an impact for the portfolio's profitability that can be measured in basis points, while when selling investments, avoiding default often means warding off losses that can reach several per cent of the portfolio's value.
Active portfolio monitoring is therefore an intrinsic feature of this type of fund management approach, so it is a far cry from the passive approach required by the IAS 39 HTM category.

Variations

Buy & Maintain techniques cover three main categories of portfolio management. The largest in France is rolling maturity: contributions and portfolio inflows are (re)invested to maintain duration within pre-set limitations. The other two categories have a fixed timeframe/horizon: held-to-maturity and cash-flow matching.
The hold-to-maturity approach is used to lock-in interest rates and/or spreads over a certain period and for a defined maturity. The portfolio is then built in such a way as to minimize reinvestment risk, with maturities close to the required maturity date. This can lead to so-called HTM (Held to Maturity) funds with a limited subscription period and penalties for any early withdrawal.
Cash-flow matching is usually found in the United Kingdom. The aim is to build a portfolio in such a way that coupons and redemptions can back almost certain liabilities. These matched portfolios are particularly sought after by insurers under Solvency II as they enable them (under certain conditions) to benefit from the so-called Matching Adjustment mechanism: the option of discounting liabilities based not on the EIOPA risk-free rate curve, but on the actual yield of the underlying portfolio.

The rest of this document deals with rolling maturity.

Building and managing using the Buy & Maintain approach

Building, or buying

The crucial stage in the Buy & Maintain process involves determining the portfolio's characteristics, starting off with the investment universe i.e. geographical regions, sectors, ratings-related restrictions, combined rating/maturity rules, restrictions based on issuers or even issues, and lastly the ramp-up period.
The book yield expected from the portfolio will be significantly restrained by these criteria and by the investment period. In addition to the investment universe, other decisive criteria will be the target duration and/or the profile of the liabilities to be matched.
Securities are purchased complying with the criteria set, while seeking to maximize book yield and hence the purchase yield. The credit analysis process has a particularly important role to play here. It must provide a different view to that required for standard benchmark-based fund management or very dynamic portfolio management such as the total return approach. The difference lies in the analysis timeframe.
In the case of benchmark portfolio management, the fund manager can look at securities where he/she expects spreads to narrow in the short term, even if the longer-term analysis throws open some questions. He/she needs to look at projections for a change in the issuer's rating, whether upgrade or downgrade, and the impact this may have on the securities' market value and yield. He/she can then take positions aimed at generating outperformance over a short period. For the Buy & Maintain fund manager, the most important point at the outset is the likelihood that the issuer will not default before maturity.

Monitoring, or maintaining

Once invested, the portfolio must be monitored: coupons and principal must be reinvested, the portfolio adjusted to changing markets/liabilities, issuers monitored, arbitrage opportunities taken, etc. Once again, there are fundamental differences with a benchmark approach, particularly when securities are downgraded. When an issuer is downgraded, the analyst must continue to assess it on a longer-term basis: the key question is whether we can be reasonably sure that the bond will be redeemed at maturity or not. Remaining in or exiting the Investment Grade category is a secondary consideration when analyzing from a Buy & Maintain standpoint. And this point in particular increases the importance of setting clear rules via an extensive discussion between the client and the fund manager. In general, it is better to avoid a forced sale, or at least wait long enough for those who have no other choice but to cut down their position (ETFs, index tracker, etc.) to sell if the analysis is not conclusive.

	Benchmark	FI Insurer Portfolio
Philosophy	Each position is relative to the benchmark and can be offset at will	Long-term building; each sale has accounting consequences
Allocation	Debt-weighted	Liability-driven
Evolution	Downgraded securities and maturities shorter than a year are sold	Usually hold to maturity
	New bonds to enter the benchmark on a monthly basis	New bonds often bought on primary issuance
Rebalancing	Systematic, monthly	Non applicable

A classic market benchmark cannot represent the management of a fixed income portfolio within an Insurer's balance sheet. A "Buy and Maintain" approach is more suitable

Comparison between benchmarked and Insurer approach

Characteristics of the Buy & Maintain approach

This type of approach is naturally effective in taking advantage of the illiquidity premiums offered by some issuers. Liquidity is not an absolute requirement, so the fund manager can focus on achieving the best possible yields.

Most securities are held to maturity, so portfolio turnover is low, and transaction costs are therefore also naturally low. As mentioned above, this feature is particularly sought after when absolute spreads are close to the order of magnitude of the bid/ask spreads[iii]. Avoiding forced sales also helps restrict portfolio turnover. In benchmarked funds, securities that exit the index are almost systematically sold, whether due to rating downgrades or due to remaining maturity of less than a year. Similarly, by construction, new bonds are added to the benchmark after their issuance. The Buy & Maintain fund manager can buy them on the primary market, generally with a more attractive yield than when demand increases.

As we have seen, it is vital to have access to proprietary credit research that covers the largest possible universe if risk is to be managed in an optimum way. The focus for this analysis (and portfolio management) is to minimize default risk, not minimize tracking error[iv]! Another way to minimize this risk involves using the greatest possible diversification in the fund management universe. The largest portfolios managed using a Buy & Maintain approach can have several hundreds of different issuers. It is even a necessity when it exceeds one billion euros. The portfolio's low concentration helps minimize the effects of a potential default that had not been expected.

Furthermore, when building the portfolio, fund managers are not restricted by the benchmark's exposure, which is generally weighted by the proportion of issuers' debt. The portfolio can therefore be balanced differently, based on balanced sector exposure, not too much of a focus on one corporate, etc. It can also benefit from the greatest possible diversification and include real asset debt, ABS, infrastructure debt, etc.

Expertise required to manage using the Buy & Maintain approach

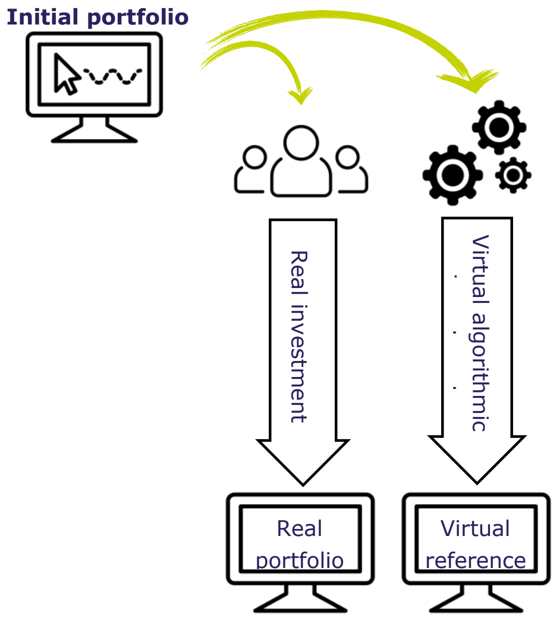
To manage a Buy & Maintain portfolio as efficiently as possible, a number of areas of expertise are required in addition to having experienced bond fund managers.

Firstly, it is vital to have strategists and macroeconomists who look at a longer horizon than usual: it is key to build scenarios and market views on 12- to 18-month timeframes at least. The other core skill required is credit analysis. As mentioned previously, it is important to monitor as many issuers as possible and analyze their ability to redeem their issues at maturity. Position-keeping systems must be adapted as it is important to monitor both the market value for investments and their amortized book value on an FIFO basis, at least in France: not security by security but purchase by purchase. Lastly, execution capabilities and access to the primary market are vital.

What performance measurements can be used in the absence of a benchmark?

In the Buy & Maintain approach, as set out above, the main risk is default risk, as a decrease in the market value of the portfolio would generally be absorbed by a fall in the value of the liabilities. The performance, from an investor's perspective, is the accounting profit generated by the portfolio on a YoY basis. An obvious "performance" measurement is obtained by dividing accounting revenues by the average accounting book value[v].

As obvious as it may be seen, it is an absolute measure; it does not allow for any relative judgment and does not help in deciding how good the performance is. The consequences of the historical accounting principles are that book yields are mainly driven by the insurer's asset allocation and the historical portfolio ramp-up. Two portfolios that are identical from a mark-to-market perspective can generate very different accounting performances, depending on when the securities were bought and the level at which the book yield was locked.



Performance measurement algorithm:

1. Future cash flow is determined from the Initial Portfolio projection,
   production hypothesis (other inflows) can be added at this stage
2. Flows are invested
   - By the portfolio manager implementing its market views
   - By the "robot" determined ex ante without any market anticipation
3. Performances of both the Real Portfolio and the Custom Benchmark are measured

The portfolio manager's performance is the difference between the two

Performance measurement algorithm

Building the customized reference

A customized fair reference must be built. This reference must deal with all the insurer's specific requirements: the reference portfolio must be invested at the same time and for the same amount as the real portfolio, for the same maturity and with the same risk budget constraints. Both the reference portfolio and the real portfolio must have the same inflows and contingencies (outflows, sells realizing gains/losses for accounting adjustment…).

To avoid a back-trading construction of the reference portfolio, it should be set up as a clone of the real portfolio at the beginning of the period under review. This allows a direct comparison between both portfolios by ignoring the consequences of past investments: investments made before the period under review will have the same impact on the real and the reference portfolio. When done so, a critical point is: what would a "portfolio-manager neutral" investment policy be. Could we build a "robot" manager which would invest the portfolio completely independently of the market? This is key to constructing a credible reference. Assuming the existence of such a "robot", the algorithm can be easily described as in Figure *Performance measurement algorithm*.

This "neutral" algorithm must be adjusted to the insurer specifics as mentioned above: Asset Allocation, limits and constraints. The algorithm must include issues on the primary market as they are usually a major part of real investments.

Compare, go further

The portfolio's book yield is an initial assessment that can be used for comparison purposes: portfolio accounting revenue divided by its average amortized value over the year, a figure that has the advantage of being known and published in the various reporting data. However, it is an instantaneous measurement, whereas accounting revenues depend on investments made over several years and on yields at the time of purchase. Measuring revenues for one year can overshadow the fact that they are primarily a result of past periods that are not being analyzed. Multi-year timeframe and a suitable measurement should be planned as a secondary measurement.

Conclusions

Buy & Maintain is a traditional area of expertise in bond fund management. It has been brought to the fore again as a result of accounting changes such as IFRS 9 and in particular due to very low interest rates and spreads. Contrary to misconceptions about this type of approach being passive, it actually requires resources to ensure active monitoring of positions and an in-depth analysis of the widest possible range of issuers. Lastly, the measurement of the value-added provided by this type of approach is not as immediate as the out/underperformance to a benchmark, but it is accessible to clients who have a clear idea of their investment strategy.

Text completed on 12th April 2018

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[i] IAS: International Accounting Standard
[ii] So-called SPPI or "solely payments of principal and interest i.e. "the contractual terms of the financial asset give rise to specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding" (IFRS 9 paragraphs 4.1.2.b and 4.1.2A b)
[iii] Bid/ask spread: difference between purchase and sale offered price
[iv] Tracking error: relative risk measurement
[v] Book value: accounting value of the portfolio

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