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Diversification in bond investing: the fund manager's dilemma

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Diversification and bond portfolio management often go hand in hand. There are two reasons for this: firstly, because the multitude and variety of asset classes underlying the bond market means there is a wide gap between the asset considered to be the safest in the world (Treasury notes) and the debt of financially fragile companies (high-yield bonds). Secondly, because at the "lower" level, i.e. within the indices, these asset classes contain hundreds of different securities.

This observation is more nuanced if we look back at the ultra-accommodative monetary policies of the last ten years, which have profoundly altered the correlation regimes within bond market asset classes. FOMO (Fear Of Missing Out) and “hunt for yield” behaviours have sidelined the traditional regime whereby “non-risky” and “risky” assets have negative to low correlations. During this recent period of managed markets – with the exception of the high-yield debt market, which retained this characteristic – the different segments of the bond market remained highly correlated. The high-yield debt market, where the majority of the yield comes from the credit spread, has thus escaped this phenomenon of homogeneous performance, which makes diversification difficult (or even ineffective) at the allocation level.

On the more specific point of the indices that represent the different asset classes of the bond market, nuance is also required. There is a high degree of concentration within these indices, as can be seen in the key bond indices illustrated below. So, for an investor looking for a specific allocation in one of the segments of the bond market, it is crucial to seek out active management, otherwise you will find yourself extremely concentrated in certain risks, sectors and issuers.

RATES	CREDIT
Euro Aggregate Index	**IG BEAC Index**
• Sovereign 56% • Quasi-Sovereign 10% • Covered 7% • Credit 27%	• 20 issuers / 680 = 20 % Benchmark • 18 issuers = 25 % DTSs Benchmark
Sovereign Index	**HY HEC4 Index**
• 4 issuers / 19 = 80 % de l’indice en poids • 5 issuers / 19 = 50 % DTSs	• 15 issuers / 328 = 25 % Benchmark

Source : Bloomberg Indexes Euro Aggregate, Bloomberg Euro Aggregate Corporates (BEAC), Bloomberg Euro Aggregate Treasury, ICE BofA Euro High Yield BB-B contraint (HEC4), data as of 30/08/2023. This information is simplified and schematic examples given for illustration and educational purposes. They are not exhaustive and do not represent specific views, portfolio or management process or investment recommendations.

The need for a policy on diversification in bond management is therefore clearly established. There are two opposing camps when it comes to developing such a policy: on the one hand, there are the advocates of so-called “super active” management, which would only be achieved by highly concentrating portfolios and for which diversification would only serve to mask a lack of conviction. Their main aim is to undermine the credibility of passive management by assimilating a whole part of the asset management landscape to it. On the other hand, there is another camp that continues to use Markowitz's(1) principles - admittedly, often in a rather uncreative way. In practice, this means piling quantitative constraints on portfolios and managing them in a way that ultimately resembles “basic” risk management.

Our role, as leading active managers in the bond market, is to distance ourselves from this sterile (and very marketing-focused) debate, in particular by building a unique philosophy of bond management and portfolio diversification.

There are several other issues:

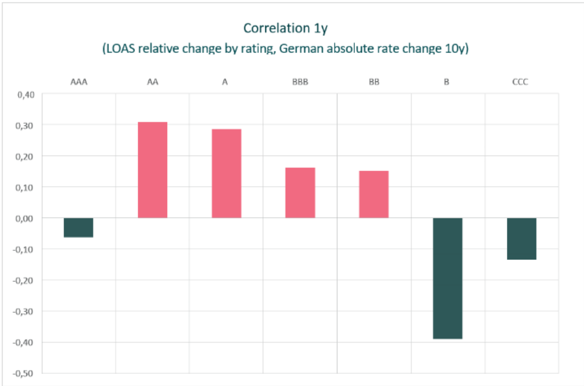
- In portfolio construction, negative views encourage the elimination of asset classes, issuers, sectors, instruments, etc. One consequence is the weakening of effective portfolio diversification. How can this be remedied?
- Additional expertise is therefore needed on the asset classes/issuers used, to diversify our allocations effectively and in an informed manner. This means it is crucial to be able to rely on a comprehensive and integrated platform of macroeconomic, strategy, credit and ESG research;
- What about diversification for certain so-called “risk-free” asset classes, which showed their extreme correlation – in terms of losses – during the European sovereign crisis?
- After a certain degree of granularity, diversification makes little or no contribution.
- In benchmarked management: Over-diversification bears the risk of replicating passive management. How can we maintain correlation with the benchmark while generating outperformance?

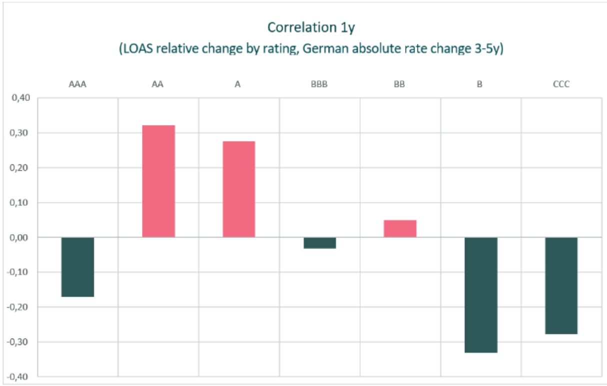
To respond to these different issues, we first provide a periodic response to the “fund manager's dilemma”, which can be formulated as follows: favour conviction-based management and concentration of exposures to extract outperformance, or favour a less aggressive style by diluting market risk and favouring the systematic reduction of “specific” risk.

The answer is first and foremost a choice of management style, based on a historical and prospective study of market systems. By finely analysing the correlations between asset classes in the bond market, as illustrated below, we identify market segments with decorrelated power and/or potential which may be the subject of allocation. At the very start of our investment process, we choose a diversification/concentration framework. This is periodically reassessed.

CORRELATION		L-OAS										YIELD
		LECPTREU	HEC4	BEYHTREU	AAA	AA		BBB	BB	B	CCC	All 3-5y rates
L-OAS	LECPTREU	1.00	0.61	0.45	0.42	0.93	0.97	0.57	0.73	0.10	0.62	0.17
	HEC4	0.61	1.00	0.68	0.12	0.47	0.57	0.44	0.82	0.75	0.68	-0.23
	BEYHTREU	0.45	0.68	1.00	-0.21	0.30	0.38	0.44	0.61	0.29	0.59	-0.16
	AAA	0.42	0.12	-0.21	1.00	0.31	0.34	0.50	0.27	-0.17	0.23	-0.17
	AA	0.93	0.47	0.30	0.31	1.00	0.98	0.36	0.60	0.05	0.34	0.32
	A	0.97	0.57	0.38	0.34	0.98	1.00	0.44	0.67	0.13	0.46	0.28
	BBB	0.57	0.44	0.44	0.50	0.36	0.44	1.00	0.57	-0.07	0.63	-0.03
	BB	0.73	0.82	0.61	0.27	0.60	0.57	0.57	1.00	0.32	0.53	0.05
	B	0.10	0.75	0.29	-0.17	0.05	0.13	-0.07	0.32	1.00	0.38	-0.33
	CCC	0.62	0.68	0.59	0.23	0.34	0.46	0.63	0.53	0.38	1.00	-0.28
YIELD	All 3-5y rates	0.17	-0.23	-0.17	-0.17	0.32	0.28	-0.03	0.05	-0.33	-0.28	1.00

(1) Modern portfolio theory, developed by Harry Markowitz in the 1950s, defines the process of stock selection to create the most efficient portfolio possible, that is, that has the maximum profitability for a minimum level of risk.





Source: Ostrum Asset Management, data as of 30/08/2023. This information is simplified, and schematic examples given for illustration and educational purposes. They are not exhaustive and do not represent views, a portfolio or a management process or investment recommendations.

Once this choice has been made, we use multi-dimensional portfolio construction to implement it.

The choice of fund manager is made on a strategy-by-strategy basis, taking into account the performance prospects and objectives of the portfolio concerned, the characteristics of the types of process (focus on allocation or stock selection) and the eligible asset classes. Obviously, a High Yield bond strategy will naturally seek greater concentration than a pure Investment Grade strategy, for example. A 'Long/Short' strategy will, by its very nature, have less market risk, but could be subject to greater diversification in terms of themes and possible styles (Event Driven, Arbitrage, Directional, Carry trade, Curves, Normalisation, etc.).

Next comes the allocation stage. We construct model and actual portfolios, allocating risk budgets by diversifying bond “assets” or “themes” within each strategy. This is why our fund managers often use “non-benchmark” or “non-core” assets, with the aim of reducing risk and optimising performance.

We then apply our philosophy on a finer scale and a step which consists in fundamental research and financial analysis. This enables us to lock in the effective level of portfolio diversification. So, within the sectors/securities in which we invest, we study the level of business risk caused by the activity of the bond issuers in the portfolio.

We measure this risk at portfolio level and study the effective correlation of our investments from this angle. For example, the issue of exposure to semiconductor shortages has been a focus of attention in terms of diversification. We are also thinking about the impact of artificial intelligence on our choice of sectors/securities and how this issue should be taken into account in our “business risk” diversification work.

The last stage of our process consists in analysing technical market factors and finalising stock selection and allocation based on criteria such as secondary and primary flows, positioning, valuation and performance. These indicators and factors must also be approached through a diversification prism. For example, if a portfolio is overexposed to market segments with excessive primary financing requirements, this may jeopardise its long-term performance. The same applies to positioning – market segments that are heavily or “over” invested can only perform marginally and offer significant potential for underperformance. Investments should therefore be diversified from this perspective.

In essence, managing a bond portfolio involves balancing the expression of strong convictions with a view to generating performance and sufficient resilience to ensure that this performance is sustainable and stable. To achieve this, diversification must be integrated into all aspects of management, from idea generation to portfolio construction and stock selection. In addition to seeking “decorrelated” strategies, we provide diversification through strategies in which the fund manager has sufficient expertise to include controlled risk/return combinations. Diversification needs to be approached from different angles – asset classes, sectors, themes and styles – and then refined by analysing the underlying risks involved, particularly in credit asset classes.

Diversification in bond management is therefore not incompatible with a search for pure performance, but rather focuses on the quality and resilience of that performance.

Finally, to Warren Buffet's famous quote, “Diversification is protection for ignorance.. .”, we could have added “... and protection for 'unknowns'”.

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