



The Potential to Maintain Investment Returns with Fixed Income

Clearly defined risk tolerances, not specific return targets, are most important when approaching today's challenging fixed income markets, Voya Investment Management's **Matt Toms** argues. To discuss his views on current opportunities in the space—and to share what still scares him as the fixed income markets continue their unsteady jaunt—Toms sat with *Chief Investment Officer's* **Kip McDaniel** in early March.

CIO: Bonds are a big topic—perhaps the biggest in institutional investing. So let's start with the current fixed income environment.

Matt Toms: Broadly speaking, we are very cognizant of a global macroeconomic environment lacking in demand growth.

The three-plus decades preceding the financial crisis were marked by debt-fueled overconsumption in developed markets. Since the crisis, however, we've seen those over-levered economies rush to de-lever, and that's created a general lack of demand in global markets. Central banks have responded to the sluggish

demand with aggressive rate cuts, and we've reached the point where we must step back and question the long-term efficacy of monetary policy in changing the demand function. As monetary policy reaches some point of exhaustion, you actually *increase* the risk to the markets because policy can no longer provide downside protection and upside cap to the growth cycles, at least to the same extent it has in the past.

In short, post-financial crisis monetary policy should be viewed as a necessary painkiller. But painkillers only treat the symptoms of a disease and not the

cause, which by analogy in this case is lack of demand growth. Fiscal policy is the treatment necessary to drive demand to the level necessary to support the global growth engine and to spark a turn in emerging market economies that borrowed heavily into this low-rate environment spawned by developed market central banks.

CIO: Let's turn to the solution. Is fixed income even an answer for investors at this point?

Toms: While the short answer is yes, the long answer is more nuanced. Historically, a good portion of fixed

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income return has been derived from the real interest rate plus the inflation embedded in a bond yield curve. With inflation continuing to run at low levels, your compensation from that component of return is now in the relatively unattractive 0% to 2% range.

Ultimately, however, it's best for investors to differentiate between return-seeking fixed income and fixed income that is meant to *keep* you rich. The vast majority of fixed income strategies can help maintain your wealth, particularly in a yield environment in which it's hard to create much wealth with fixed income.

Most fixed income sub-segments on the investment grade side were never really built to deliver returns 5% or 6% above inflation. They were built to deliver inflation plus 0% to 2%, and it is still possible to achieve this in the current environment. On the other hand, investors with a fixed income return target of 7% to 8% will have to take on a good amount of risk to get there, including such vehicles as senior bank loans, high-yield debt, perhaps some non-dollar bonds and emerging-market debt, or other levered, securitized instruments.

CIO: Let's first focus on staying rich: What can Voya bring to allocators in this regard, and in this environment?

Toms: We believe that maintaining wealth and achieving a return—albeit perhaps not in the double-digit range—is about avoiding downside risk. We look for asymmetries in markets, beginning with a wide array of potential solution sets—or risk-return parameters—to find sectors of the market that provide all the upside potential of other segments with less downside risk.

For example, we've been very defensive within high-yield bonds and emerging-market bonds, which were weak for much of 2015 and the early part of 2016 before rebounding of late. We saw that corporations, not consumers, caused the recent increase in debt, so we understood that emerging-markets and

high-yield issuers would need nominal growth to service that debt. And that's why we believed that high-yield and emerging-market debt would suffer first in this malaise of growth—but would eventually have an upside, as they are now demonstrating.

We also urge all investors to establish their risk tolerances before return expectations. We believe clients are much better served over long periods of time by identifying the risk they can bear and then adjusting their return expectations in each market for that given level of risk. For example, consider that cash was earning interest at a rate in excess of 5% before the financial crisis. With rates currently at around 0.38%, investors whose return expectations remain anchored to pre-2008 market conditions will be challenged to meet these outlooks, to say the least. Risk tolerance, on the other hand, can—and should—remain more consistent through a cycle.

CIO: So what are the opportunities—areas that you really like—even in this bad environment?

Toms: We've perceived—over the prior three years in particular—a relative strength and persistence in the US economy, a repair of the consumer's balance sheet and a growth trajectory that's limited by an aversion to debt in the United States.

The US mortgage market (or non-agency loans) and plays on housing and a healthier consumer have been largely insulated from the headwinds bedeviling emerging-market, high-yield and investment-grade corporate markets, which are struggling as a stronger dollar impairs corporate profits. These investments have provided a nice sanctuary for mid-single digit returns—more in the 4% to 7% range—that can still be garnered without taking undue risk.

We'd also look to the senior bank loan market, which had been quite resilient up until the last quarter. There has been a meaningful selloff over the last half-

year, to the point where senior bank loans have declined to a weighted average bid price below 90, and now have caught up with high yields. We believe this is a brilliant opportunity because you're still in a market where loans are generally senior in the capital structure and have covenants that allow higher and sooner recovery than most high-yield bonds. We also like private credit bonds for many of the same reasons: their generally senior status in the credit structure, protective covenants, flexible term structures, and high recovery rates.

CIO: But there must be some fixed income area strategy product that scares the hell out of you right now...

Toms: The biggest abuser from a product category standpoint that we've seen is the unconstrained bond space.

We launched a product a little more than three years ago and have been very successful versus our peer group—which is admittedly not very homogeneous. But there are products being created to meet clients' short-term needs or expectations, and unconstrained bonds became the darling for, "I will protect you if interest rates go up." We have seen managers promising to protect against rising interest rates even if they no longer believed rates would go up; we've seen products that would actually lose money if rates stayed low or went lower through negative duration positions. In our view, this more short-term orientation toward a product can ultimately hurt clients.

Our approach is aimed more toward trying to achieve a stated risk on either side of LIBOR with a volatility assumption that could benefit either from a falling or rising rate environment—but one that is not specifically tied to interest rates either moving up or down. We think unconstrained bond funds are meant to protect when rates go up but also earn an income and provide downside cushion when they go down. That's a lofty goal, but ultimately we think that's what clients want. ■