Performance Drivers of your Fixed Income Portfolio

Featuring:

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As the saying goes, what gets measured gets managed? I guess that's what understanding performance attribution is all about. Here to share more. We have MSCI product management executive directors, Nancy Roth and Nick sharp. Nancy. Nick, it's great to have you with us. And I look forward to hearing your thoughts on some of the unique challenges of fixed income performance attribution the tradeoffs and priorities portfolio managers look for in a robust solution. And then, of course, the importance of communicating the results. Nancy, kicking off the conversation, could you provide some market context?

Nancy Roth

Thank you, Jana. Sure. You're correct. What gets measured gets managed and attribution really starts with measurement. But that's just the beginning. A high-quality attribution analysis can also contribute to a successful implementation of any portfolio strategy, whether active or passive. In particular, a daily analysis that accurately measures the impact of market movements, on your exposures and your active bets provides the guidance you need to adjust your positions in support of realizing your target outcome. This is especially useful in today's fixed income markets, it can be a real challenge to generate income in return when bond yields are so low. Portfolio Managers may be required to take more active exposures or higher risk positions in order to be competitive. These needs to be closely monitored as markets move. Of course, the big new topic in today's market is ESG and climate investing, opportunities and risks and arise from price distortions. Driven by changes in supply and demand due to new information, new tools and new regulations. The best signal we have for assessing relative value and changing sentiment is option adjusted, spread, or OAS. And the best way to manage OAS Based Investing is with analytics such as option adjusted spread duration or DTS. Fixed Income attribution captures the valuation history of your holdings, including spreads and durations, the amount of return generated from these exposures and the act of return due to allocation and select security selection strategies versus your benchmark.

Jenna Degenhart

Nick, turning to you anything you'd like to add?

Nick Sharp

Sure, thank you. Jenna said, capturing the performance impact for investment decisions is really only half of the story. Performance attribution reporting done well enables portfolio managers to communicate the success of their decisions to different stakeholders, an optimal level of detail. For example, communication with a team of portfolio managers requires very granular results to explain how many complex investment decisions paid off. Whereas risk managers require that the return drivers are reported in precise alignment with granular source of risk, and they don't necessarily align with investment decisions. Whereas reporting to the Investment Board, asset owners and private clients will require much more concise reporting.

Jenna Degenhart

And could you provide us with some examples?

Nick Sharp

Sure, I can give you a few examples of different fixed income specific investment decisions. It could include roll down decisions to position the portfolio to be exposed to steeper sections of the yield curve. And this is how you can profit as bonds roll down upward sloping yield curves as they approach maturity meaning that lower discount rates and these higher prices and then you've got term structure positioning a different key rates on the yield curve. For example, if you expect that the US 10 year, the US 10-year Treasury rate to decrease you need to be overweight the benchmarks 10-year key rate duration to make a positive active return as prices increase. And then for a final example, take an investment grade credit portfolio manager with a pure credit value strategy. They often make very specific relative value decisions to select bonds with highs spreads relative to other bonds within the same credit rating. And this is under the expectation that many of those high spread bonds w ill see their spreads tighten and prices increased by reverting to the mean spread of the group.

Jenna Degenhart

Ma'am Nancy, what are some of the unique challenges in fixed income portfolio management?

Nancy Roth

Well, there are a number of challenges unique to fixed income portfolio management, we tend to label it as a single asset class that distinguish from equities, but in fact, there are many sub asset classes, each requiring their own expertise and models. broad market portfolios are often manag ed by sleeve where experts and credit or rates or securitized product focused on their specialty. An implication of this is that these broad market portfolios and their associated benchmarks can be quite large. Now that's a challenge from a technical perspective, but it's also a challenge for investing. Bond markets are not as liquid as equities assets are not as fungible. one share of Microsoft is the same as another but, but their bond issues may not be interchangeable. Another factor is the lack of ex change-based pricing, making price discovery a big part of the job. Lastly, I would cite the fact that the bonds you might want to buy to construct your portfolio or strategy may not be available, you may need to use tools models and or derivatives to replicate the exposures those bonds would give you and accept some basis risk. These challenges ultimately impact attribution, there are no standard approaches systems just need to be scalable and flexible.

Jenna Degenhart

Noah one size fits all there. Now, Nancy, what are some of the choices and tradeoffs that should be considered?

Nancy Roth

Well, it often comes down to best of breed what is preferred by the front office, which would be analytic quality versus enterprise scale support a front to back use cases and I'd even throw in ad hoc communications with investor clients. Investment Managers need to streamline operations by meeting the performance and risk needs of both their front office and middle office teams. This will allow them to reduce their total cost of software ownership and transitioned the middle office risk function to an enabler of the front office portfolio managers. This requires Performance Analytics solutions that are both best of breed for the front office and capable of supporting enterprise wide reporting environments, as well as being integrated with risk analytics on the same platform. With this approach, tradeoffs don't necessarily need to be made and vendors are increasingly bridging the gap to to offer all of this in a single system.

Jenna Degenhart

Building off of that, Nick, what are the considerations that go into choosing a robust fixed income performance attribution solution?

Nick Sharp

Well, there are really a whole host of considerations but the number one has to be vendor stability. If your vendor is acquired by a larger institution, or worse still goes out of business. This creates huge operational risk. This affects continuity and reporting reporting which is needed to win business from investors. Then the PA solutions need to be set for the front office portfolio managers in terms of analytical qualities, which we'll come back to later. Reporting needs to be comprehensive and delivered in a timely fashion. Some of the more detailed considerations around reporting that the reporting for performance attribution needs to be integrated within a system that provides both performance attribution and risk reporting. And these two should really be integrated within the front to back investment management solution, which together could drastically reduce the total cost of software ownership. Ideally, Pa should be delivered as a service with the necessary system speed and scalability required by large asset managers to meet reporting SLAs. The system should be open access so to benefit from programmatic API workflows for operational efficiency. And then finally, you need interactive dashboards that are needed to investigate and communicate results. The implementation of these systems is very time consuming often, but this can be streamlined as much as possible if you've got vendors with dedicated implementation personnel. And then last but not least, you really need ongoing client service from your vendor, and this could be considered an integral part of a robust solution.

Jenna Degenhart

Finally, why is it critical to prioritize analytical quality when considering a fixed income pa solution?

Nick Sharp

I think simply put the analytical quality allows you to tell the right story. And this is needed to gain credibility with front office portfolio managers. Attribution needs to begin with the exact portfolio and benchmark return. Only after this can we expect to provide insightful attribution of performance from investment decisions. To do this, it requires extensive coverage of index then the benchmarks, including top level performance, asset level weights and returns and vendor classifications, which are necessary to ensure that the grouping schemes are aligned with the investment strategy. Otherwise, attribution results won't be insightful. The interest rate curves which are a fundamental aspect of six income need to be an extremely high quality with broad coverage and delivered in a timely fashion. And then you need asset volume, valuation models they are also very high quality. So, you can determine the exposures and granular components of return across various sub asset classes, like mortgages, mini bonds and complex securitized deals. Then you want finally the flexibility to tailor the performance attribution model to different investment processes. All of this is a prerequisite for portfolio managers to understand return, manage their portfolios, and ultimately to differentiate their investment strategies from the competition. And they can only achieve that If they can communicate insightful results for a range of stakeholders, an optimal level of detail.

Jenna Degenhart

Well, great discussion there on the importance of communicating the performance drivers of your fixed income portfolio. Nancy. Nick, thank you both for joining us.

Nancy Roth

Thank you.

Nick Sharp

Thank you. Bye bye.

Jenna Degenhart

And thank you very much for watching. Once again, I was joined by MSCI product management executive directors, Nancy Roth and Nick sharp. I'm Jenna Degenhart with asset TV

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