INTRODUCTION

Mercer continues to support the role of growth fixed income assets as part of a well-diversified and balanced growth portfolio. The focus of this paper will be on absolute return fixed income, which can act as a useful diversifier within growth-fixed income portfolios. Specifically, this paper will re-introduce the strategy and its investment rationale, provide an overview of the different investment approaches/styles adopted by managers in the universe, and consider the case for absolute return approaches in the current environment; it concludes with thoughts on how investors might access these strategies.

WHAT IS ABSOLUTE RETURN FIXED INCOME?

Absolute return fixed income strategies invest in a wide variety of global fixed income assets in a flexible and dynamic way with the aim of generating positive returns above a cash benchmark rather than a traditional fixed income market benchmark. To accomplish this, the strategies will opportunistically access a variety of (global) return sources, such as government bonds, interest rates, credit, currencies, and emerging markets, taking both long and short positions.

Managers will often market these strategies by arguing that they “aim to achieve positive returns in all market conditions,” including credit-spread-widening and interest-rate-rising environments (which negatively impact traditional fixed income assets). Although many strategies fail to deliver on such ambitious goals, the returns of absolute return fixed income strategies tend to be much less dependent on the overall direction of fixed income markets and more dependent on manager skill. The better strategies have a focus on capital preservation as well as robust risk management frameworks. Given their absolute return focus, an ability to identify managers that are able to consistently add value (or generate “alpha”) is of critical importance.

Returns of absolute return fixed income strategies tend to be much less dependent on the overall direction of fixed income markets and more dependent on manager skill.
EXPECTED LEVELS OF RISK AND RETURN

In general, absolute return fixed income strategies seek to achieve annual returns of cash plus 2%–4% (gross of fees) with expected volatility in the range of 3%–6% per annum. We believe that this is a reasonable outperformance target given that alpha is scarce and these strategies rely heavily on manager skill. It is important to note that the return and risk expectations of individual strategies can vary and some managers offer higher return versions of their core strategy by “dialling up” the risk taken in each of their risk buckets (typically done by increasing leverage). At the same time, there are a number of strategies in the universe that are targeting lower returns of cash plus 1%–2%.

Figure 1 below shows the rolling three-year returns (annualized) of the median manager. As the chart shows, the return profile is stable, although the three years ending September 2015 have seen lower returns than the previous rolling averages. A big driver of this was weaker performance in the fourth quarter of 2014 when many managers implemented a short duration view in government bond markets, expecting to profit as yields rose. Instead, yields fell further, pushing returns for the median manager into negative territory for the quarter. One-year returns to 30 September are −0.8% for the median manager, whereas the upper quartile manager posted positive returns of +0.6% over the same period.

FIGURE 1. ROLLING THREE-YEAR ANNUALIZED RETURNS OF THE MEDIAN ABSOLUTE RETURN FIXED INCOME MANAGER

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>ABSMed</td>
<td>4.1 (12)</td>
<td>3.8 (12)</td>
<td>2.8 (11)</td>
<td>3.0 (14)</td>
<td>1.5 (13)</td>
</tr>
<tr>
<td>USTB3M</td>
<td>0.1 (22)</td>
<td>0.1 (22)</td>
<td>0.1 (21)</td>
<td>0.1 (25)</td>
<td>0.0 (20)</td>
</tr>
<tr>
<td>95th percentile</td>
<td>11.1</td>
<td>7.1</td>
<td>4.9</td>
<td>6.5</td>
<td>2.9</td>
</tr>
<tr>
<td>Upper quartile</td>
<td>6.7</td>
<td>5.5</td>
<td>3.5</td>
<td>4.2</td>
<td>2.0</td>
</tr>
<tr>
<td>Median</td>
<td>4.1</td>
<td>3.8</td>
<td>2.8</td>
<td>3.0</td>
<td>1.5</td>
</tr>
<tr>
<td>Lower quartile</td>
<td>3.2</td>
<td>2.6</td>
<td>2.1</td>
<td>2.3</td>
<td>0.3</td>
</tr>
<tr>
<td>5th percentile</td>
<td>1.0</td>
<td>0.1</td>
<td>0.9</td>
<td>−0.1</td>
<td>−3.1</td>
</tr>
<tr>
<td>Number of funds</td>
<td>22</td>
<td>22</td>
<td>21</td>
<td>26</td>
<td>25</td>
</tr>
</tbody>
</table>

Source: Mercer Insight MPA
LIQUIDITY

Absolute return fixed income products typically offer daily dealing terms. They are able to do this because the assets they allocate to are among the most liquid in the world; for example, currencies and government bonds. Corporate bonds, which may form part of a manager’s allocation, also typically trade daily but actual liquidity conditions are more susceptible to changing market sentiment.

Figure 2 below summarizes the key characteristics of absolute return fixed income strategies.

FIGURE 2. KEY CHARACTERISTICS OF ABSOLUTE RETURN FIXED INCOME STRATEGIES

<table>
<thead>
<tr>
<th>RETURNS DRIVEN BY ALPHA</th>
<th>TARGET RETURNS</th>
<th>DAILY LIQUIDITY</th>
</tr>
</thead>
<tbody>
<tr>
<td>No static beta allocations</td>
<td>Range from cash + 1%-2% to cash + 3%-5%</td>
<td></td>
</tr>
<tr>
<td>Relative value focus</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Security selection and asset allocation drives returns</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>DIVERSIFIED SOURCES OF RETURN</th>
<th>ABSOLUTE RETURN FIXED INCOME</th>
<th>SOPHISTICATED RISK MANAGEMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rates</td>
<td>Generating returns in different ways</td>
<td></td>
</tr>
<tr>
<td>Currencies</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Credit (IG, HY, ABS, converts)</td>
<td></td>
<td></td>
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<tr>
<td>Emerging markets</td>
<td></td>
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</tbody>
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<thead>
<tr>
<th>SIGNIFICANT UTILIZATION OF DERIVATIVES</th>
<th>SEEKING TO DELIVER A POSITIVE RETURN IN ALL MARKET ENVIRONMENTS</th>
<th>DIFFERENT INVESTMENT STYLES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government bond futures, swaps, and options</td>
<td>Low volatility</td>
<td>Generating returns in different ways</td>
</tr>
<tr>
<td>Currency futures and options</td>
<td>Focus on protecting capital by limiting drawdown</td>
<td></td>
</tr>
<tr>
<td>Credit default swaps</td>
<td></td>
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</tbody>
</table>

SEEKING TO DELIVER A POSITIVE RETURN IN ALL MARKET ENVIRONMENTS

Low volatility

Focus on protecting capital by limiting drawdown

DIFFERENT INVESTMENT STYLES

Generating returns in different ways
INVESTMENT RATIONALE

Since the global financial crisis of 2008, asset classes across major markets have delivered exceptionally strong returns. “Traditional” bonds, for example, have benefited greatly from expansionary monetary policy as policymakers acted to bolster their economies, pushing bond yields to historic lows. Low absolute yield levels, coupled with the potential for interest rate rises (particularly as the US Federal Reserve considers its path to “normalization”), means that going forward, traditional fixed income is unlikely to provide the same expected level of returns and risk profile that it has achieved in the past. Therefore, absolute return fixed income strategies may be an attractive component of a diversified growth fixed income allocation, especially for those investors who are concerned about the impact of rising yields.

In addition, absolute return fixed income can also serve as a useful portfolio diversifier. For example, absolute return fixed income has historically been lowly correlated with global equities (around 0.5 correlation, see Figure 1). Importantly, the correlation has not been static and does indeed shift depending on the market environment. In fact, over the last 15 years to September 2015, the correlation has been as low as −0.1 and as high as 0.7.

FIGURE 3. CORRELATION OF THE ABSOLUTE RETURN FIXED INCOME UNIVERSE MEDIAN WITH GLOBAL EQUITIES

Traditional bonds have benefited greatly from expansionary monetary policy as policymakers acted to bolster their economies, pushing bond yields to historic lows.
As can be seen from Figure 4 below, the correlation to investment grade credit also varies and over the last 15 years has been as high as 0.8 and as low as -0.2.

**FIGURE 4. CORRELATION OF THE ABSOLUTE RETURN FIXED INCOME UNIVERSE MEDIAN WITH GLOBAL CREDIT**

Source: Mercer Insight MPA
WHY NOW?

In general, we believe that the current landscape offers few attractively priced asset classes for the longer-term investor. At the start of 2015, Mercer identified five key themes that we believe will help investors address the challenges presented by the current market environment.\(^1\)

Absolute return fixed income delivers on two of these key themes:

1. **Tilting portfolios from “beta” to “alpha.”** Absolute return fixed income strategies are, by their very nature, largely driven by alpha (or manager skill) and are much less reliant on beta (or broad market returns). Given the low yields available, accessing manager skill can make sense in environments where there is a scarcity of cheap beta. As global dynamics shift and as countries adopt increasingly divergent monetary policies (e.g. the US Fed and UK’s MPC looking to tighten while Europe and Japan continue to loosen), fixed income markets may experience increased volatility and dispersion. Instead of being a victim of market volatility, the better absolute return fixed income strategies can indeed benefit from rising volatility as they are able to access a larger number of potentially rewarding relative value trades. As such, well-managed absolute return fixed income strategies should perform well in environments characterized by higher volatility and broader dispersion within markets.

2. **Accessing inexpensive defensives.** Since most absolute return fixed income strategies are designed with the aim of achieving steady positive returns over time while delivering low levels of volatility, an element of defensiveness is usually part of their DNA. This level of defensiveness is important within an overall portfolio context, especially if volatility leads to negative returns elsewhere in investors’ portfolios.

In addition to offering defensiveness, fees for absolute return fixed income strategies tend to be relatively attractive and typically start from about 0.3% for the lower-returning strategies and go to around 0.8% for strategies targeting higher returns. In addition, many strategies offer performance-based fees that typically consist of a lower base fee, in addition to a performance fee of 10%-20% over cash or a certain hurdle. The decision regarding which fee structure to choose is dependent on investor requirements; however, we have a preference for flat fees given that return targets are typically moderate. For the highest-returning strategies, performance-related fees may make more sense.

RISKS

It is important to recognize that there are inherent risks within absolute return fixed income investing. Most importantly, the success of these strategies is heavily reliant on manager skill and the ability to make the right calls on markets at the right time. For example, during the fourth quarter of 2014, we know that some absolute return fixed income managers were caught off-guard through their short-duration positions as yields unexpectedly fell further. However, we believe that better absolute return fixed income strategies should be sufficiently diversified in order to safeguard against one trade dominating the entire risk budget, thereby jeopardizing return targets. Also, investors should be aware that due to the nature of the investment strategies employed, absolute return bond funds tend to make greater use of derivatives than traditional fixed income strategies for both return generation and risk management purposes.

The success of absolute return strategies is heavily reliant on manager skill and the ability to make the right calls on markets at the right time.
TYPES OF ABSOLUTE RETURN FIXED INCOME MANAGERS

The absolute return fixed income universe consists of managers that deliver returns in a range of different ways. Broadly speaking, the styles can be summarized as “directional” and “idiosyncratic relative value.” The exhibit below summarizes these two styles:

**STYLES OF INVESTMENT WITHIN ABSOLUTE RETURN FIXED INCOME**

**IDIOSYNCRATIC RELATIVE VALUE**
- Limited directionality from beta.
- Focused sources of risk and return.
- Healthy level of idea diversification within focused areas.

**DIRECTIONAL**
- Beta rotation and security selection skill.
- Broad sources of risk and return.
- Sophisticated users of volatility.

*Blending of different approaches offers enhanced specialism and diversification.*
Directional strategies derive their returns from accessing a broad global opportunity set and tend to be very well diversified across a range of return sources. This typically includes interest rate decisions, credit decisions (including both investment and sub-investment grade), and active currency decisions within developed markets but may also include emerging market exposure. The reason for both a broad geographic remit as well as an ability to invest in sub-investment-grade credit is because directional strategies will look to cast the widest possible net in order to opportunistically access areas that offer the best value. In other words, although managers can access asset classes such as sub-investment-grade credit or emerging markets, it is important to understand that they tend to do so only when they see significant value within these areas and can reduce or eliminate the exposure when they see less value (often called “beta rotation”).

Directional strategies therefore capture alpha through beta rotation and security selection and use top-down views to take outright positions on the direction of both credit spreads and yield curves as well as cross-sector (for example, financials versus non-financials). They also typically adopt a “best ideas” approach to security selection within each sub-asset-class with a focus on maximizing return per unit of risk. At the same time, these strategies are typically sophisticated users of volatility and are keen to identify cheap ways of implementing downside protection to not only manage risks, but also to benefit from possible rises in volatility.

A component of some directional strategies is what we regard as “low-volatility income strategies,” which typically invest in shorter-dated, high-quality credit. They tend to be directional because of their reliance on credit-beta to drive returns. However, although offering some degree of inherent diversification, the asymmetric return profile of credit means that such strategies tend to underperform their objectives in a spread-widening environment. Importantly, this is only a component of such strategies.
Idiosyncratic relative value strategies are less exposed to the overall directionality of markets having a greater focus on “relative value” trades that managers do not expect to be driven by market beta. Examples include implementing a view within a single-country yield curve or perhaps cross-country yield curve views. In the case of a single-country yield curve trade, a manager might build a long exposure to the 10-year part of the yield curve and a short exposure to five-year part of the yield curve, expecting to make a profit from bonds with a 10-year maturity performing better than bonds with a five-year maturity. Equally, in the case of a cross-country yield curve view, a manager might build a long exposure to US interest rates and a short exposure to UK rates, expecting to profit from US bonds performing better than UK bonds. The success of relative value trades is much more dependent on how the pricing of these individual assets move in relation to each other and is therefore typically less dependent on the overall direction of the market. These strategies should perform best in environments with a high level of market dispersion.

Credit typically forms a much smaller part of the opportunity set. Although strategies in this space may have access to the full investment opportunity set (including sub-investment grade and emerging markets), the focus tends to be on investment grade given the nature of relative value trades that predominantly involve the government curves and currencies of developed markets.
We believe that a multiple-manager approach is likely to result in a more attractive risk/return profile.

Strategies within this universe have different areas of specialization and generate returns in different ways, meaning that there may be benefits to accessing more than one style of absolute return fixed income strategy. In particular, when more aggressive strategies are adopted, using multiple managers has the benefit of reducing the impact of poor performance from any one strategy.

We therefore believe that a multiple-manager approach enables investors to access complementary skill sets, which is likely to result in a more attractive risk/return profile than that achieved by utilizing a single-manager approach. In practice, the size of any allocation to absolute return fixed income, the structure of the wider growth portfolio (in particular the existence of other flexible fixed income strategies or macro hedge funds), and governance constraints will also be important considerations.

In the current market environment, characterized by a scarcity of cheap beta, we believe investors should tilt absolute return fixed income allocations toward the idiosyncratic relative value style because returns from these strategies should be less dependent on the overall direction of markets. However, the reverse could be true in circumstances when markets appear to offer significantly better value.
CONCLUSION

In summary, absolute return fixed income strategies can provide investors with access to a broad global opportunity set of alpha sources that is expected to exhibit a low correlation with the overall direction of interest rates and credit spreads, and is expected to act as a portfolio diversifier. Ultimately, the focus is on a move away from broad market returns toward manager skill reflecting today’s low-return environment.
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