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A FAVORABLE ENVIRONMENT FOR SHORT-DURATION FIXED INCOME

While rising interest rates over the past year have been painful for most fixed-income sectors, all-in higher yields and the inversion of the yield curve have now made short-duration strategies an attractive area for institutional investors to explore, according to MetLife Investment Management.

Scott Pavlak, head of short-duration fixed income at MetLife Investment Management, defines short-duration portfolios as those whose average durations range from a half- to two-and-a-half years. In his view, now is an opportune time to invest in this space. His optimism is based on the belief that the Federal Reserve has neared the end of its current tightening cycle; front-end yields are at levels not seen since the Global Financial Crisis and unlikely to decline to the low levels that have prevailed for much of the post-GFC period; and the firm's research that shows a short-duration portfolio's income generation, more so than price return, will drive performance over a market cycle.

"We looked at the total returns of a simple one- to three-year Treasury index to analyze the composition of returns going back several decades," Pavlak said. "Price-only returns were negative over many five-year rolling cycles, but income-only returns were positive – so much so as to push overall returns consistently positive. It is why when constructing a portfolio, a core tenet of our investment philosophy is to continuously strive to have a 'yield advantage' compared to the various benchmark indices we manage against."

THE TIME IS RIGHT

MetLife Investment Management's institutional clients use short-duration strategies for a variety of objectives. According to Pavlak, these may include investing surplus operating funds, matching assets to liabilities, incorporating a portfolio as part of a stable-value investment program or making a defensive, tactical allocation within a broader investment strategy.

Regardless of the client's goals, we believe the short-duration environment is more appealing today than it has been in a long time. "As an active manager, structuring a high-quality, multi-sector, liquid portfolio with an average AA rating and an average yield of 5% to 6% is an opportunity that many institutions find compelling. As a result, the firm has seen inflows from existing clients and new mandates from others," Pavlak said.

ACROSS THE UNIVERSE

The universe of short-duration strategies is large – and it encompasses a wide variety of sector preferences, average portfolio durations and credit quality, according to Pavlak.

For example, some managers invest exclusively in U.S. government securities, while others allocate heavily to investment-grade credit or structured bonds, such as asset- and mortgage-backed securities. Still others may include allocations to less-liquid areas like emerging markets, high-yield and nondollar securities. Additionally, some managers completely hedge duration risk while others in the short-duration space have average portfolio durations that stretch to as much as four years.

The sheer breadth of the short-duration universe underscores the importance of knowing how managers generate

performance and understanding how they manage risk. "Depending on the market environment, there can be significant dispersion in manager performance. We believe it is important for entities allocating capital to an investment manager to lift the hood on a firm's resources and strategies to better understand not just what managers are doing to achieve their returns but also the risks they are taking in the process," Pavlak said.

MetLife Investment Management's short-duration team employs a joint top-down and bottom-up approach. "Top-down identifies investment themes that, in turn, help drive sector allocations and risk budgeting decisions. Then, working with the firm's global credit, structured and municipal research groups, the team utilizes a bottom-up security selection process to source best ideas to populate portfolios within each specific sub-sector," he said. Portfolios typically maintain an average credit quality of at least AA minus and are multi-sector in nature, with varying allocations based on the team's outlook as well as sector and security valuations.

In our view, investors should continue to earn attractive returns from their short-duration portfolios, despite potentially elevated interest rate and spread volatility.

DEFENSIVE STANCE, TACTICAL OPPORTUNITY

Pavlak sees an attractive return environment for short-duration strategies continuing for the foreseeable future. His team expects the Fed to hold the fed funds rate steady this year, which is contrary to the predictions of others.

"Our view is that we saw the peak in front-end interest rates – two-year to five-year yields – in early March of this year, and that the Fed will be biased to stay on the sidelines as the labor market remains resilient and inflation, although also having peaked, will be slow to decline to the Fed's target levels," Pavlak said. "From our perspective, even with a lower fed funds rate in 2024 and 2025, interest rates at the front end will remain higher than where they have been over the last decade. Putting all of it together means that, in our view, investors should continue to earn attractive returns from their short-duration portfolios, despite potentially elevated interest rate and spread volatility."

In anticipation of an economic slowdown that it expects to play out later this year, the MetLife Investment Management short-duration team has sought to position its portfolios more defensively. The prospect of a further contraction in the economy with continuing financial stress and potentially

wider credit spreads has the team emphasizing higher quality trades in their portfolios while reducing exposure to various cyclically exposed sub-sectors and securities.

As it relates to the current yield curve, Pavlak explained, "While we know at some point [it] will likely normalize, today with the inverted yield curve, we believe a manager has to balance the temptation to grab only the shortest-duration, highest-yielding securities against the prospect that if interest rates rally, in general, a longer-duration security with a lower yield may perform better. We like the idea of structuring portfolios that maintain a duration where investors can lock in near-the-top yields for an extended period of time."

IMPORTANCE OF MANAGER SELECTION

What should institutions look for when hiring a short-duration manager? Pavlak listed a number of attributes that are worth exploring.

There is no substitute for stability and experience, he said, adding, "We believe a seasoned team that has worked together for years and is familiar with managing portfolios through changing monetary and business cycles can give investors a degree of confidence as, in our view, they are able to validate how the team and its investment process have performed over longer and differing market cycles."

In addition, "we believe a team of dedicated short-duration sector specialists brings a laser-like focus to the front end of the fixed-income market and should be better attuned to its opportunities and risks – unlike generalist fixed-income teams that may manage across the entire maturity spectrum," Pavlak said. Experience in constructing portfolios that diversify risks, specifically across the multitude of short-duration sub-sectors, is also important, he noted. "Ultimately, of course, performance is where the rubber meets the road. If managers are properly resourced, can identify opportunities for alpha generation as well as address the inherent risks present at different points in the cycle, results should follow accordingly," he said.

Overall, Pavlak emphasized the importance of building and maintaining strong relationships with institutional clients, as well as having a global presence and access to a broad and deep resource base. "Our institutional clients place a high value on all of these characteristics," he concluded. "They understand the benefits of partnering with a manager who prioritizes communication, accessibility and whose time-tested investment process produces consistent results." ■

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