



PUBLIC FIXED INCOME

Short Duration Fixed Income: New Environment, New Opportunities

Discussion

March 1, 2023

Guy Haselmann, Head of Thought Leadership at MetLife Investment Management, recently sat down with Scott Pavlak, Head of Short Duration Fixed Income, to discuss interest rates and the investment landscape in short duration bonds.

Guy: *What a difference a year makes. The risk-free rate was effectively near 0% less than one year ago and real yields were negative. The Federal Reserve has now raised official rates by 450 basis points so far, changing the investment landscape dramatically. Before we dive into what this means for the investment opportunity set, let's begin with how you define a "Short Duration" portfolio.*

Scott: Our definition of short duration covers fixed income portfolios that have an average duration range of half a year running out to 2 ½ years. Depending upon which of our short duration strategies we are discussing, the maximum duration of any individual security will be either 3, 5 or 7 years. Importantly, the sectors and securities in which we invest are in some of the most liquid areas of the fixed income market, which is important because there can be unanticipated liquidity needs that have to be met in some instances.

Guy: What is the average credit quality of the typical short duration strategy?

Scott: Across our short duration strategies, we seek to maintain a weighted-average credit quality of AA- or higher for our managed portfolios. We achieve this by investing in investment-grade securities whose credit ratings range from AAA down to BBB.

Guy: With the investible universe in the front end of the maturity spectrum so large, I suspect portfolio results can differ greatly amongst short duration managers despite the tenors of their various short duration products being not too far apart. Is that true?

Scott: No doubt, and we see this in terms of performance which can vary significantly for peers across the short duration landscape. However, when you look at what peers categorize as short duration strategies in the eVestment universe (comprised of 150+ firms, and 260+ products), surprisingly the durations of these products vary significantly, from 0.01 to 3.96 years (as of December 31, 2022).¹ So, in a year like 2022 when portfolio durations were a significant differentiating factor in terms of performance in fixed income, the wide range of short duration products' durations correlated with the wide dispersion of their returns.

Another key factor to focus on here is the sectors in which various short duration managers invest or concentrate. Some managers maintain heavy allocations (50-100%) to the Investment-Grade Credit or Structured sectors (i.e., ABS, CMBS and RMBS) or invest in more esoteric, less liquid areas like Emerging Markets, High Yield or even in non-dollar securities. So, as you might expect, varying returns in these sectors can have a large impact on performance. This shows why investors and asset allocators in the short duration space should "lift the hood" to better understand where and how investment managers are generating their portfolio returns and importantly, the risks to their strategy.

Guy: Why might institutional entities look to invest in short duration strategies?

Scott: There are many reasons why institutional as well as individual investors may look to invest in short duration strategies. For institutional entities like our short duration clients, which include corporations, state agencies, cities, counties, transportation authorities, foundations, endowments, pension funds, universities, hospital systems, sovereign wealth funds, insurers, and

sub-advisory relationships, they invest in short duration strategies to achieve a wide variety of objectives. To name a few, these may include putting money to work to invest surplus operating funds, match or defease scheduled liabilities as with a debt service reserve, fund nuclear plant decommissioning expenses, invest construction fund monies, as a component of a stable value investment program, or as a tactical asset allocation decision as part of a larger investment effort.

As you mentioned, the Federal Reserve has raised its policy rate or federal-funds rate to a range of 4.5 to 4.75% to date. Today, if you look at incremental spreads on the securities across the sectors in which we invest like Investment-Grade Credit, Structured, Agencies and Taxable Municipals, many of the bonds in our short duration universe now yield 5% or higher. At current market levels, we see an attractive entry point to invest in multisector, high-quality, diversified portfolios like those we construct for short duration clients with all-in, front-end yields near their highest point in over 15 years. Overall, the reset higher in yields in the short duration space compared to where we entered 2022, in addition to the inverted yield curve, highlight our strategy's appeal not just as a cash management substitute but as a standalone asset allocation alternative for investors.



Guy: *I would think that the inverted yield curve works in your favor?*

Scott: The degree to which the yield curve has inverted, more specifically in the very front end of the maturity spectrum, has created an opportunity whereby an investor can earn a higher yield while simultaneously assuming lower interest rate risk, making short duration strategies attractive. As part of our investment process, we utilize different yield curve strategies to best manage portfolios to take advantage of the current shape of the yield curve as well as what we project the yield curve to be over the next few quarters. Consistent with what we do in any environment, we frequently perform analyses to evaluate how our securities and portfolios will perform over various interest rate scenarios as we look to position portfolios for an anticipated reshaping of the yield curve. While we know that the yield curve will eventually normalize, we believe interest rates in the front end of the maturity spectrum will remain elevated relative to where they have been over the last few years.

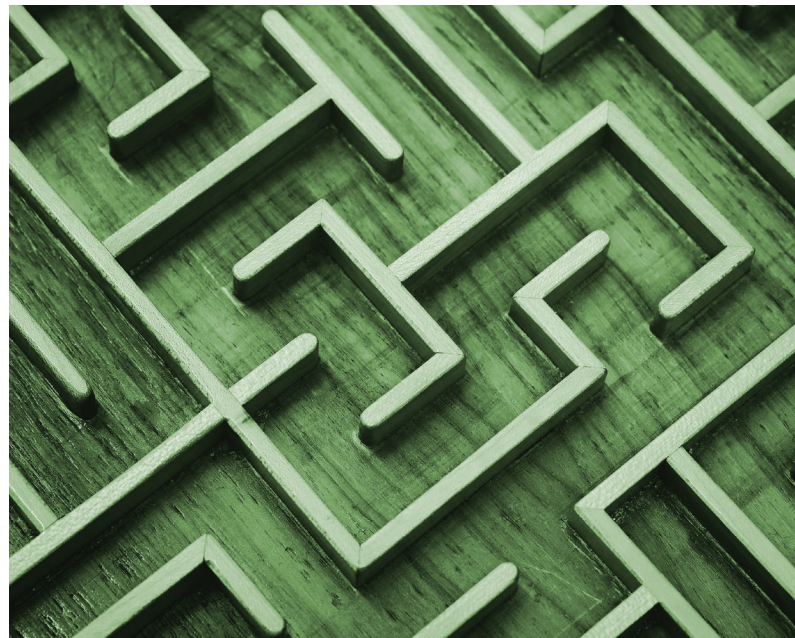
Guy: *Is the potential of a recession a major worry for you?*

Scott: We believe the present environment characterized by major fiscal and monetary policy shifts, coupled with elevated geopolitical tensions, has driven heightened interest rate and spread volatility, which present opportunities for seasoned managers. Our investment team has worked together through multiple market cycles and navigating through a recession is not unfamiliar to us. Whether or not economic activity slows sufficiently enough to trigger a mild or deep recession, we believe that short duration fixed income offers a wide choice of securities in different sectors with varying attributes and sensitivities to economic activity that we can utilize to manage through a downturn. Specifically, given our outlook that the economy will weaken with the business cycle nearing an end with a contractionary environment unfolding, we have shifted to a more defensive, higher-quality positioning concentrating on less economically sensitive sectors, and subsectors and securities with greater liquidity. At current market levels, even with the increasingly softer economic data we foresee, we believe this represents an attractive all-in yield entry point compared to where short duration strategy yields have been for most of the post-Great Financial Crisis period.

Guy: *Market and economic uncertainties are particularly elevated now due to central bank,*

fiscal, and regulatory actions combined with global economic growth worries and heightened geopolitical tensions, among other factors. I would think that due to the short tenor, relatively low volatility, and more favorable liquidity profile of the securities with which you populate your short duration portfolios—that these characteristics also help make this strategy look particularly attractive?

Scott: I would agree with you that the current market landscape holds a greater degree of uncertainty than we are normally accustomed to. Much of this is due to the most aggressive monetary policy tightening cycle by central banks that we have seen since the 1980s as well as economies recovering at different paces from the distortions created by the pandemic. Additionally, a war in Eastern Europe, heightened US-China tensions, slowing global growth and still elevated inflation means the market has had a lot to digest and think about.



For short duration portfolios it has also translated into an inverted yield curve, which means they currently out-yield longer duration fixed income portfolios. Given our core tenet that income or yield drives performance over market cycles (and not price moves per se), the yield per unit of duration for our strategies is attractive. In our view, this will remain the case, even when we eventually return to a positive sloping yield curve as interest rates in the front end will remain elevated compared to recent history. Our team employs a top-down approach to set macro themes to help formulate

sector allocations and establish our risk budget. As a result, we are able to express nuanced market views in the short duration space as we diversify our client portfolios to mitigate the risks of any one sector or security having an outsized impact on portfolio performance in a negative way. The highly liquid nature of the different sectors and subsectors in which we invest in short duration means we are able to tailor or customize portfolios to meet individual client liquidity needs and/or risk tolerances. Our group could not accomplish this without the help of our large, deep research and trading teams that span the globe and work to unearth opportunities through a bottom-up process to source and populate portfolios with our teams' best ideas, consistent with our top-down themes.

Guy: You said that an experienced active manager should be able to generate alpha above a benchmark. You have decades of investment experience in the short duration space, so please share some thoughts about how you have found success and navigated through so many investment cycles and regimes.

Scott: I can only share with you how we approach things and what has worked well for our team over multiple market cycles. Looking carefully at our historical performance attribution, it shows that sector allocation, security selection and yield curve positioning, rather than duration management, have been the primary drivers of our excess returns vs. benchmark indices. Some managers may be good at it, but we do not believe that making large short-term tactical bets on the direction of interest rates, i.e., duration, is an effective way to consistently add value to fixed income portfolios over time. We run performance attribution across our strategies daily to provide real-time feedback and continuously test the validity of our assumptions.

Over time, our team has focused on constructing and managing diversified portfolios for clients using Treasuries as well as securities from the various "spread sectors" (Corporate, Agency, Taxable Municipal, Asset-Backed, Commercial Mortgage-Backed and Residential Mortgage-Backed). We focus on establishing a yield advantage relative to a benchmark index as our research has shown that over time the income component of total return is much more important in driving performance rather than the price component. Overall, our top-down approach in identifying key drivers of markets and fixed income returns, while

adjusting our risk "on-or-off" appetite, has been critical in helping our team produce a long-term track record of outperforming our benchmarks.

Guy: How do you narrow down the large universe of investment alternatives in your short duration space? Do you factor in bottom-up analysis side-by-side with the macro or economic back drop? What is your process?

Scott: As mentioned, our investment process begins with top-down analysis of the economic landscape, concentrating on changes in economic growth, inflation expectations and monetary and fiscal policies. We develop themes to help us determine optimal sector allocations and risk budgets.

Once we develop our top-down themes, we work carefully with our research colleagues to source our collective "best ideas" for security selection which for corporate issuers includes a focus on operating fundamentals, financial statement analysis and evaluation of management and their financial policy and priorities, among other key credit risk determinants. We also have dedicated professionals who conduct structured products analysis and assist in identifying relative value and mispriced opportunities in the ABS, CMBS and RMBS sectors. For securitized holdings, during the security selection process, our team analyzes the expected performance of the underlying collateral across a broad range of scenarios. These include macro-analysis driven by our top-down investment approach, as well as more market- and sector-specific dimensions. Similarly, we have a dedicated municipal research team that covers both General Obligation and Revenue-backed municipal bonds. Like other sectors, we consider various macroeconomic drivers including unemployment, housing, regulatory and consumer trends, as well as monetary and fiscal policy at the national, state, and local levels.

Guy: Does this mean that you can change your mind or admit you are wrong or willing to sell before maturity?

Scott: All good portfolio managers should have a "sell discipline". As an active manager, we would not describe ourselves as buy-and-hold investors. For us, selling a security may be driven by macro theme shifts, a change in our assumptions, or security-specific considerations like a deterioration in fundamentals, a bond reaching its target spread objective or when another security represents a better relative value opportunity.

Guy: *Any final thoughts?*

Scott: As the Federal Reserve nears the end of its tightening cycle, we believe the short duration space offers investors an opportunity not seen for more than a decade. Although interest rates may decline as economic growth slows and inflation moderates, yields in the front end of the maturity spectrum are likely to stay elevated for the foreseeable future. We

also think it is important for investors to focus not only on absolute returns but also on risk-adjusted returns when evaluating or comparing manager performance. Specifically, investors should be attuned to the various types of risk a manager is taking to generate excess returns, something not all short duration investors may have focused on in the past.

Endnote

¹ [eVestment: The Source for Institutional Intelligence](#)



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