

How to FiX your fixed income portfolio

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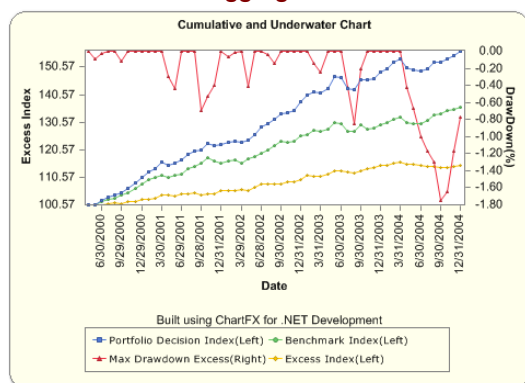
Flipping through one of the many conference programs which I receive almost daily, I was struck by the title of a presentation due to be given at an upcoming seminar. It read “Fixed Income Alpha: not an Oxymoron”. Provocative, certainly; but the mere fact that active fixed income alpha as a concept needs to be defended in such a way gives rise to the question of how effective active FI managers have been, or are capable of being, in this realm. Thankfully for me and my colleagues at FX Concepts, this seems to be less of an issue in the field of currency, where the notion of skill-based alpha through active management is not perceived as being so far-fetched.

The point was recently driven home by a client for whom we have been running an active alpha currency overlay for several years. He provided us with data from his fixed income portfolios which reveals the “oxymoron” dilemma – as evident below, few of his active FI managers (and we are talking about the biggest names in the business) have generated much in the way of compelling FI alpha over the past years – especially when risk and drawdown are taken into account.

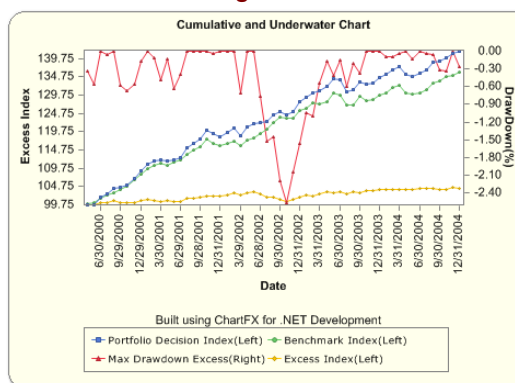
FX Concepts DCO vs. Global Fixed *

	FXC	Mgr A	Mgr B	Mgr C
Excess Return (annualized)	3%	1%	0.50%	1.50%
TE	1.77%	1.50%	1.70%	2.00%
IR	1.69	0.67	0.29	0.75
Max DD	1.80%	2.50%	3.80%	4.50%

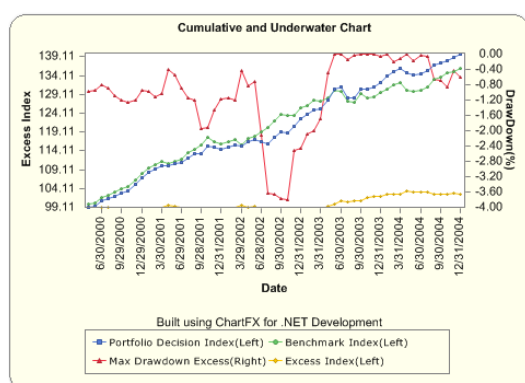
Lehman Global Aggregate Index + FXC DCO



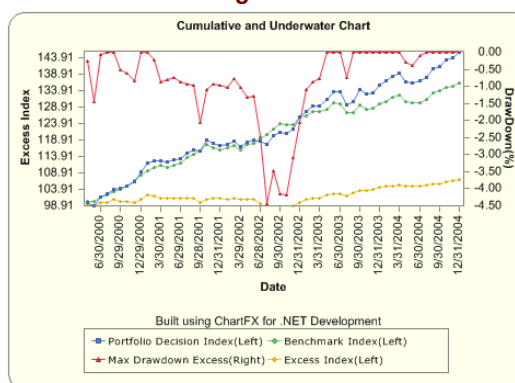
Fixed Income Manager “A” vs. Lehman GA



Fixed Income Manager “B” vs. Lehman GA



Fixed Income Manager “C” vs. Lehman GA



* based on the analysis done for a client using the AlphaEngine software (www.mcubeit.com)

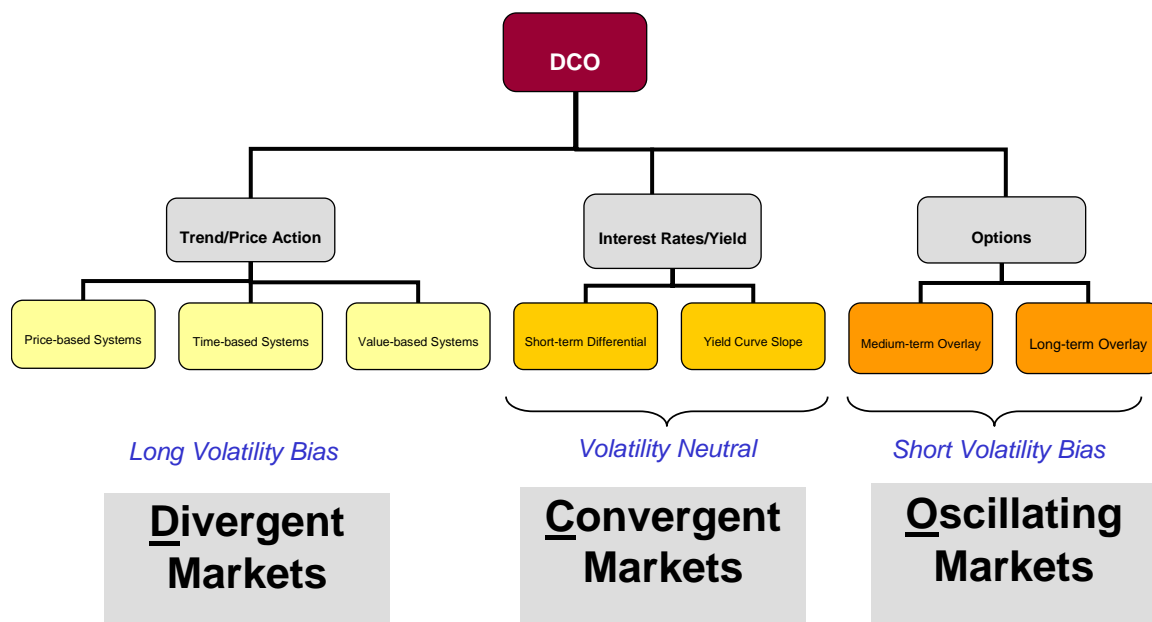
The numbers above clearly show the relative success we have achieved at generating alpha vs. traditional active FI managers. They also illustrate the diversification benefits, given the lack of correlation – while the drawdown profile is very similar among the three fixed-income managers, it is completely different between the FI group and the currency overlay.

It was therefore not very surprising when another client of ours approached us recently with a compelling idea; to create a passive fixed-income fund combined with an active FX overlay. His reasoning was quite understandable; it has often been stated that currency returns amount to anywhere from 30% to 70% (depending on who you ask) of international fixed income returns, and are certainly responsible for the lions' share of volatility of returns. Compared with this significant "beta", the alpha derived from pure fixed income decisions such as credit, duration management, etc. seems almost insignificant – and has historically delivered more volatility than return.

The client in question therefore decided that by passively replicating an international fixed income index and then adding an alpha currency overlay targeting 250 bp p.a., he would have the chance of outperforming the benchmark index by a significant margin compared to most active international fixed managers. The strategy through which he decided to implement this, our Diversified Currency Overlay (DCO) program, has become the principal alpha generator for his new international fixed-income portfolio. In the 6 months since inception, this program has already added over 60 bp (net of fees) in uncorrelated return to the fund's index – despite difficult currency markets through much of the first half of 2005 - which by any account can be considered a healthy outperformance of the fund's passive FI benchmark.

So – why does it make so much sense to use currency as an alpha engine for a fixed income portfolio? Simply, because there are a greater number of return drivers in the currency market than in fixed income - and because currency returns have a low correlation with fixed income returns. A large percentage of players in the FX market are not "profit-maximizers" and this results in a number of inefficiencies – or "betas" - which can be empirically proven to generate returns over the long-term. At the heart of our Diversified Currency Overlay Program we seek to spread risk over four thematic modules, each designed to effectively capture one of these betas, consisting of: directional trading, value (mean-reverting) trading, yield-based (carry) trading, and volatility (options-based) trading.

Even if the above process were to be implemented on a rudimentary or "naïve" basis the excess return would be quite compelling, especially on a risk-adjusted basis - as information ratios over .5 should be easily achievable. The process does not stop there, however. Where specialist currency managers should be able to add the most significant value for their fees is in adding alpha to the FX beta described above and by reducing volatility, through "smart" (skill-based) systems and comprehensive risk-management techniques. Our DCO program starts by allocating risk within each of the 4 above-mentioned themes over multiple, uncorrelated systematic models – each of which attacks a different element of the "theme" in question. Directional risk should be spread over multiple horizons (from short-term "breakout" positions to long-term trend-following), while carry trading should focus not only on absolute levels of interest rate differential but also on the relative attractiveness of various yield-curves. Finally, volatility should be traded as its own class of risk, focusing not only on the much-followed "implied-realized" relationship, but also others dimensions as well.



Through this diversification over multiple skill-based systems, a basic portfolio allocation is derived as seen above. The trick then becomes, as for all asset managers, how to dynamically optimize the allocation between various currency themes so as to have the largest allocation to whichever theme is currently the most “in play”. For this, a number of macro-based quantitative systems are employed – along with a good qualitative understanding of the micro- and macro-dynamics of the FX market. Finally, risk management is essential – both bottom-up, within the portfolio construction process and also top-down, with respect to a sound “reality check” of model-generated positions and comprehensive monitoring for event risk and other “tail” events.

The result of all this is a strategy which has yielded an annualized return of 236 bp over the past 17 years, with an information ratio over 1.5 during the past 3 years (since the increased diversification of our process). Take this kind of performance, along with the transparency and liquidity (no funding needed) of foreign exchange, and you have a winning alpha engine for your fixed income portfolio!