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What does 'alternative beta' mean in fixed income?

UBS Asset Management

Matthias Dettwiler, Head of Index Fixed Income

'Smart beta' in fixed income

Although the concept of smart beta has been around for years, we haven't seen a clear definition in the fixed income market. At UBS Asset Management (UBS-AM), we classify all non-market capitalization based indices as smart beta, with the exception of factor investing. However, in our opinion, the term 'smart' is misleading as a non-standard index is not automatically smarter. We prefer the term 'alternative beta' as these strategies aim to deliver more targeted beta exposure within a given risk-return framework.

A practical example is the Bloomberg Barclays Fiscal Strength Weighted Global Government index, which offers higher diversification than the standard market value weighted index with very similar risk-return characteristics. We have been managing a fund based on this index for 5 over years. Another example in this area is our liquid corporate ETF range based on this index for over five years. We aim to deliver corporate bond beta exposure by focusing purely on liquid bond issues, providing comparable risk/return characteristics to the standard index with lower transaction costs, minimizing the drag on performance. We additionally complement the liquidity approach with a sustainable and responsible investing (SRI) screen. In practice, this means we offer the same liquidity profile but also apply an SRI filter from MSCI to exclude companies which do not fully adhere to the high standard of sustainable investing.

'Factor investing' in fixed income

While factor investing has been very successful in the equity space, it is still at the early stages in fixed income. It is a trend we have been paying close attention to although we do not believe it is reasonable to assume that equity factors will simply translate to fixed income. Bonds are typically issued close to par, should pay back 100% at maturity and pay a coupon throughout their life. Equities tend to be much more volatile with sharp price movements while bonds rarely double in value (although there can be exceptions like long-dated, high coupon CHF or GBP bonds). That said, we can try to use similar ideas when talking about factors in fixed income such as value, quality, momentum, carry or size. Each has key attributes and are executed in a variety of ways.

– *Value:* A relative value approach used by many active managers. They select the highest yield/spread relative to the lowest for a given quality. It can be derived by selecting higher yielding bonds of similar credit quality within sectors. Fundamental value is mostly based on quantitative screens, such as credit rating for corporate securities.

– *Quality:* A combination of fundamentals and duration in fixed income. Overweight fundamentally strong issuers based on credit ratings and/or fundamental research while reducing duration is seen as positive.

– *Momentum:* Recent outperformers continue to outperform so overweight recent outperformers and underweight underperformers.

– *Carry:* Overweight higher yielding (highest spread) securities relative to those which are lower yielding while risk adjusting the beta exposure to the market. For example: buying the same issuer's bond in a different currency, and then hedging the FX exposure to achieve a higher return in the reference currency.

– *Size:* Smaller issuers typically have fewer bonds outstanding and smaller issue sizes that tend to be less liquid, hence there might be a liquidity premium to be harvested over larger issuers.

Given the lack of a common definition and widely available back-testing results, we are still fairly cautious when promoting these strategies. There are two important points to keep in mind; first, even if there have been robust back-testing results, as and when these factors become widely investible by active and passive managers, such results may not hold true for the future. Second, the implementation of factor investing ideas in fixed income tends to be much more difficult due to liquidity constraints and transaction costs. In practice, if the strategy seeks to harvest 20bps liquidity premium but has substantially higher turnover and wide bid-ask spreads, it would not generate the desired outcome.

A final point is that indices embedding ESG factors are experiencing a great deal of interest and I am proud of what UBS-AM can offer in this area. We have switched all of our Swiss institutional fund platforms to become compliant with standards set by the Swiss Association for Responsible Investments (SVVK - ASIR) and we were among the first providers to offer sustainable corporate bond ETFs in Europe. As investors shift their focus towards the positive impact their investments can have, we are working toward expanding our sustainable offering to meet that demand.

Q&A with Matthias Dettwiler

Q: You head up the index fixed income investment team. How is the team organized and what are the roles and responsibilities within the team?

A: The team managing index fixed income assets is split into two pools of investment professionals: portfolio managers who are fully dedicated to index strategies such as Global Aggregate, corporates or emerging market debt; and single market portfolio managers who are specialists in regional markets such Swiss Franc or Australian Dollar. This set-up allows us to leverage their specialized market knowledge. In addition, every portfolio manager is supported by several teams such as investment specialists, research analysts, corporate actions experts and risk managers. The investment team is highly experienced, with most of the portfolio managers having worked in the industry or even at UBS for over 10 years. Every client account and fund has a dedicated portfolio manager and a deputy portfolio manager with clear responsibilities.

Portfolio managers "own" the performance of their accounts and are therefore highly motivated to deliver the best possible results for clients.

Q: What is on the minds of your current index clients or investors?

A: We serve a truly global and diverse client base, and as such, manage a wide range of index strategies spanning the entire spectrum of fixed income sectors and regions. Fixed income indexing is still less established compared to equity indexing. Therefore, we have seen greater demand in recent years for everything from traditional index strategies to enhanced indexing, alternative beta, ESG factors and other types of customization. Traditionally, clients preferred index strategies for the government sector but recently we have seen far more interest in corporate and emerging market debt indices, which are certainly more challenging to track. To highlight just a few, our flagship Global Aggregate fund, that tracks a universe of more than 21,000 securities, is popular with many of our clients. Our liquid corporate ETFs, focusing on liquid issues in fixed income, have also experienced very strong demand.

Q: How do you go about customizing a fixed income index portfolio to address specific client needs?

A: The key is definitely to understand the client's specific needs and objectives. We are often asked for our suggestions for index selection and investment approach to meet that client's specific needs. From my experience, it's the most fruitful discussion to have as for an index portfolio the most important decision is the index selection. Standard indices may not always be the best solution, especially in recent years, as the index offering has exploded. So not surprisingly, UBS-AM is loading about 20,000 different indices on a daily basis!

Being able to leverage the extensive experience of the broad fixed income team is also enormously helpful as our market can behave completely differently in times of crisis. While many in our industry may have worked in financial services during 2007/2008, they may not necessarily have been in a role where they were responsible for taking daily decisions that substantially impacted client money. Within our team, in recent years we have added young and highly skilled talents, who bring new ideas and approaches with them. This means we can leverage both long-term experience and new ideas when building solutions for clients. In a nutshell, the earlier the client involves us in the decision-making process, the more we can offer in order to find the best solution.

Q: With the rise of passive portfolio management, what is your vision for UBS index investments business?

A: For me, it's not an active versus passive debate but much more about what best serves the clients' needs. The low interest rate and low volatility environment has certainly made active fixed income managers' lives more difficult. In my opinion, as we saw in the equity world, irrespective of where we are in the economic cycle, there is a need for both active and passive solutions. Given that in general, a vast majority of fixed income assets are still managed actively, I am positive that we will see further growth in passive fixed income solutions in the years to come. I am convinced that to successfully manage index fixed income assets, you need talent and experienced portfolio managers along with a robust platform. At UBS Asset Management, we have the great benefit of being a truly global house that can offer different solutions in a compelling way. We currently manage index assets of 330 billion dollars (30 June 2018) across all asset classes. (As at 31 March 2018).

About Matthias Dettwiler

Matthias Dettwiler has overall responsibility for all index tracking fixed income portfolios globally. Prior to being appointed to his current role in November 2012, Matthias headed the FX and Global Bonds team in Zurich, and was responsible for implementing active and passive global bond strategies across Zurich-based portfolios. In addition, he was a senior portfolio manager of USD-denominated money market, short and medium term aggregate and credit mandates for more than 10 years. Matthias holds the "Certified International Investment Analyst" designation and the "Swiss Federal Diploma for Expert in Finance and Investment". He is a member of the European Council of Bloomberg Barclays Indices and the FTSE EMEA Bond Index Series Advisory Committee.

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