INVESTMENT
INSIGHTS

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(a division of Scout Investments)

Finding Opportunity in Market Volatility

Mark Egan, Managing Director and lead portfolio manager for Reams fixed-income strategies, explains why volatility is a key driver of performance in the fixed-income market. He also discusses the firm's definition of risk, as well as ways to achieve clients' objectives — all while keeping a long-term perspective.

P&I: Reams manages a diverse lineup of products, from low duration to unconstrained to LDI capabilities. Can you please elaborate on the genesis of these products since Reams got its start back in 1981?

Mark Egan: Reams was founded in 1981 by several people who worked for the in-house pension group at Cummins Inc. Cummins was our first client and we were given open guidelines with objectives to achieve a real rate of return and maximize total return. From the very beginning, we sought value in all sectors of the fixed-income market, including high yield, foreign currencies, foreign markets and emerging markets. I think Reams may have been one of the first firms with an investing style that later became known as Core Plus. Our ability to manage this way from the beginning, with few constraints, is also one of the reasons why we were early in the unconstrained space. Over time, however, client guidelines have become more specific with objectives focused on beating a benchmark. We have evolved with this style of investing but if you look at us from year to year and quarter to quarter, we will have more variance relative to the benchmark.

The genesis of our product lineup was born out of client needs. An existing client would ask us to pursue a different strategy to fulfill a different need. First, it was a more intermediate kind of duration, then low duration, long duration, core rather than core plus, real return, or unconstrained. Clients became comfortable with our approach, our follow-through and how we define risk, and they would trust us with new assignments.

P&I: Your investment philosophy and process are grounded in the belief that volatility is essential to finding opportunity. Please explain.

Mark Egan: At Reams, we've always believed that volatility makes the world more interesting—and gives you better opportunities — because it causes mispricings between assets. We believe, and our investment philosophy is based on this premise, that volatility is the key driver of price changes in the market. So, interest rate volatility, credit volatility, equity-market volatility, currency volatility — as they move through time, cause relative value differentials to take place. We employ macro and bottom-up strategies to uncover and then respond opportunistically to these movements.

P&I: Many fixed-income managers are focused on income and yield potential. What are your views?

Mark Egan: It depends on the type of portfolio you are managing. For example, if you are managing in a low-duration space, which we do, income will be the dominant factor because there is very little to do in terms of big price changes or capturing capital gains. The biggest thing in low duration is the avoidance of mistakes. Looking back at 2007 and 2008, I think one of the things that people didn't talk about enough was how many low-duration managers mis-defined risk and were using subprime securities and things like that. They took on tremendous downside potential for a little bit of extra income because yield is so important in low-duration portfolios.

Moving farther out on the maturity and risk spectrum, we believe that yield in general isn't going to be the primary factor driving how you fare from a total return perspective. It goes back to how volatility works. It's our belief that over time, you will get more opportunities to add value through changes in price, which comes through changes in volatility, rather than just focus on absolute yield.

In a market like this where it's relatively calm, you'll find across all our products that we are fairly neutral with respect to risk. We are very liquid, very clean, and we have a yield deficit relative to benchmarks. Other managers may be overweight credit, overweight risk because yields are low and volatility is low, so it seems kind of safe. We think just the opposite.

P&I: Another key principle to your unique investment process is the way you define risk. It's not about tracking error, is it? Please discuss your approach to risk management.

Mark Egan: It comes back to our starting point. In 1981, the original Lehman Index existed but it certainly wasn't used as a risk benchmark. As time progressed, the market became set on defining risk as volatility relative to the benchmark. People are very comfortable with this definition and that's how the vast majority of asset managers have come to manage portfolios and manage risk. We think it's not necessarily in the client's best interest.

Over the past several decades, there's been this ability to latch onto an index, which is conducive for growth in assets, but it has caused a kind of hollowing out of managers. If you get a period where bonds have 0% to 2% return, which we think is likely, latching yourself onto an index and calling it a victory is not going to work. You need to at least imagine a world that's not like the last 30 years and ask, how is the investment going to be used, what's the best way to use it and what's the best way to define risk?

We define risk first by asking clients, is the way you're managing assets giving you a reasonable chance to achieve your investment goals? And the second way we define risk is the permanent loss of principal. When we look at securities, the first thing we do is to ask, if there were to be a default, or something that you can't foresee occurs, what is your recovery going to be and what kind of impairment are you going to have?

Risk is not this variance relative to an index in a short period of time. Using the current environment, if the index, which yields about 2%, returns 2% in the next three to five years and that does not come close to achieving your investment needs, then that's a risky investment strategy to us. The fact that an investor matched the index with volatility relative to the index of virtually zero but didn't reach their investment goals, that's risk to us.

P&I: What are ideal market conditions for Reams to be able to generate alpha and meet client investment objectives?

Mark Egan: We need volatility, primarily interest rate and credit volatility, over a full market cycle. Those are ideal conditions for us and we've seen enough of them — 2007 to 2012 — it's kind of like the gift that kept on giving.

The flip side of that would be, what's the least ideal market for us? The answer is a year like last year, when not much happened. That's kind of the anti-perfect market, where volatility flatlines.

If you're looking at a longer-term horizon of three to five years or two to four years, I think that environment will have reasonable pockets of volatility, which is the ideal environment for us.

P&I: How does your process and investment philosophy position you for the future?

Mark Egan: We can't know the future, and from our perspective, we shouldn't pretend to. At Reams, we respond to volatility in the market — if and when it occurs. If volatility continues to be low, we think that a relatively neutral risk position and a high degree of liquidity in the portfolio is what you should be doing.

People often ask us what happens if we have another 2008. I think 2008 was mischaracterized: it was an enormous opportunity for managers who had the ability and insight and wherewithal to capture returns, which were spectacular.

We're due for another one. It won't be exactly the same, the causes won't be exactly the same, but it always looks the same. It looks like people panicking and fleeing and trying to sell things that nobody wants to buy. That's our best opportunity. ❖

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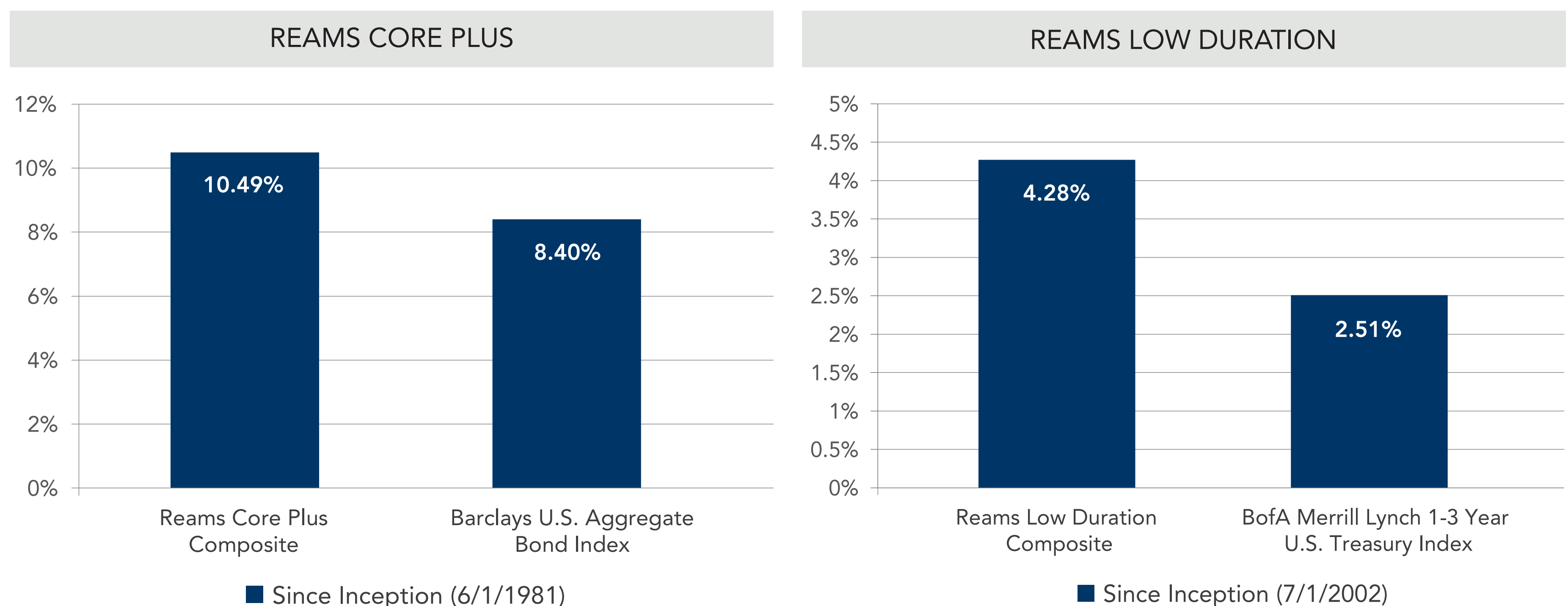

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About Reams Asset Management

Reams has actively managed fixed income portfolios since 1981, applying a consistent investment process that has been tested over many market cycles. The investment team designs portfolios with an emphasis on downside risk protection, capital preservation and maximizing total return. Reams does not attempt to predict interest rates or future market events but, rather, responds to market moves as they happen. Reams' investment process places strong emphasis on a bond's underlying asset value and position within the capital structure, which minimizes downside risk and the temptation to reach for yield.

Our mission is to provide clients with the highest quality investment management expertise and unmatched client service in all product areas over the long term. Managing directors, portfolio managers and analysts work together closely to apply Reams' proven philosophy and process, tailoring the process to meet each strategy's objective and client-specific guidelines.

Scout Investments, which manages equity strategies, acquired Reams Asset Management in 2010. Together, Scout and Reams take a long-term view of investing and share a commitment to serve the distinct needs of our global institutional clients.

Disclosure: Returns are annualized. Past performance is no guarantee of future results. Performance figures are in U.S. dollars and assume reinvested income for the entire period. Performance figures are stated net of fees. All investments involve risk, including the possible loss of principal. The Core Plus Fixed Income Composite invests primarily in investment grade securities with investments in high yield securities and foreign securities, while maintaining an average portfolio duration of generally between 2 ½ to 6 years. The Core Plus Fixed Income Composite may invest in derivatives, including credit default swaps and related instruments, such as credit default swap index products. These derivative securities may be used to enhance returns, increase liquidity and/or gain exposure to certain instruments in the market (such as the corporate bond market) in a more efficient or less expensive way. The Low Duration Fixed Income Composite invests primarily in investment grade securities, while maintaining an average portfolio duration of generally between 1 and 3 years.

The Barclays Capital U.S. Aggregate Bond Index is an unmanaged, market-value-weighted index of taxable investment grade, fixed rate debt issues, including government, corporate, asset-backed and mortgage-backed securities, with maturities of 1 year or more. The BofA Merrill Lynch 1-3 Year U.S. Treasury Index is an unmanaged index that tracks the performance of the direct Sovereign debt of the U.S. Government having a maturity of at least 1 year and less than 3 years.

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