INVESTMENT INSIGHTS

MICHAEL D. HYMAN, CIO
Global Investment Grade
& Emerging Markets
Invesco Fixed Income

Can Core Plus Extend Your Fixed Income Strategy?

A stock market that has been trading at record highs has forced investors to consider other asset classes to complement a diversified portfolio. A core fixed-income strategy is one place to look, but rising interest rates complicate that approach. Enter core plus, which extends fixed income to related categories that can provide income and increased diversification, among other benefits. Michael Hyman, chief investment officer of global investment grade and emerging markets for Invesco Fixed Income, discusses the benefits of a core-plus strategy in today's market.

|Q.| *In March, the Federal Reserve raised interest rates and signaled two more increases this year. How does that factor into your analysis of fixed income?*

|A.| Our view of the rate environment is that we've had significant movement off the lows and we feel rates are getting much closer to what our model shows are proper valuations. Also, if you look at the impact of the Fed raising rates, the overall level of the 10-year Treasury is almost the same as it was when the Fed began raising rates about a year-and-a-half ago. Just because the Fed is raising short-term rates doesn't necessarily mean that long-term rates are going to rise.

|Q.| *Is now a particularly good time for asset owners to consider a core-plus strategy? Why?*

|A.| There is still value in fixed income and ample opportunity to produce alpha. Equities have had a very strong run, and there are a decent number of investors who may be looking for an opportunity to reallocate some of those equity gains. A core-plus strategy would be an ideal position for those assets.

|Q.| *What should asset owners expect from a core-plus strategy?*

|A.| A core-plus strategy typically generates a steady income and provides capital appreciation over time. These are very high-quality portfolios, so generally 75% of the assets are in investment-grade bonds. They also have the potential to provide strong principal protection.

|Q.| *What are the components of Invesco's core-plus strategy? How does it differ from other such strategies?*

|A.| Our strategy is a diversified portfolio of fixed income that's benchmarked against the Bloomberg Barclays US Aggregate Index. That index primarily includes Treasuries, mortgages, corporate credit and some structured securities. That component is the core. The "plus" asset classes we consider are things like high-yield securities, emerging market securities, utilizing rates and currencies to enhance alpha, as well as using indexed structured securities, like CMBS and non-agency mortgage securities.

|Q.| *What asset classes or categories are you favoring?*

|A.| Areas that had been hit hard based on potential policy outcomes, like Mexican fixed income, are among the opportunities we've taken advantage of, post election.

Currently we are overweight in high-yield bonds, which tend to perform really well against other fixed-income assets in a rising rate environment. When rates are rising, high-yield bonds tend to absorb that increase in the risk-free rate within their spread. That, by definition, means they're outperforming Treasuries.

We like bank-preferred securities, and we think that from a credit and regulation standpoint, they have significant tailwinds.

|Q.| *How are futures and options used?*

|A.| We use futures and options to hedge our interest rate exposure. It allows us to buy the bonds we feel have the most value, and then we'll use futures to get the duration of the bonds to the level that we want. For example, we could buy a 30-year corporate credit bond because we feel that is where the value is in terms of the credit spreads. Then we would use futures to hedge the duration of that bond back down to the index duration. The use of these futures allows us to hone in on our views of the risk of a particular issue or the behavior of a credit instrument, versus having to take unintended interest rate exposure because of where we see value in the spreads.

|Q.| *How will President Trump's economic policies affect your decision-making process going forward?*

|A.| The most impactful area could be corporate tax rate policies. These policies could obviously be critical in improving overall corporate fundamentals and the overall leverage in the corporate credit market, which would be fairly bullish.

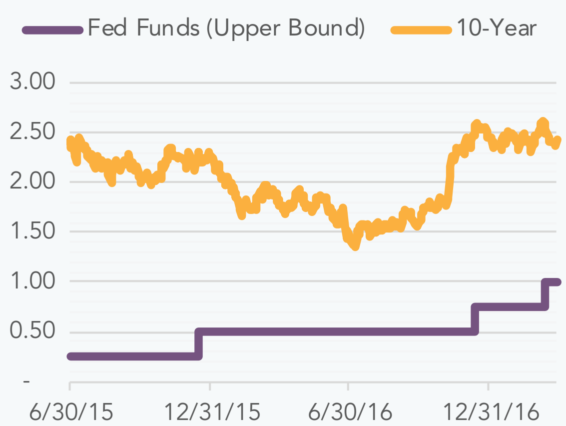
|Q.| *Do Brexit or a focus on bilateral trade affect you?*

|A.| We prepare a list of who the winners and losers might be from these outcomes and position the portfolio appropriately. Great Britain, by itself, is not large enough to impact the U.S. economic outlook, so we look at companies that have large exposure to Great Britain — how does that impact their earnings and how does that potentially impact their spreads?

|Q.| *What are you watching closely?*

|A.| Our major concern is global financial conditions. Even though rates have risen, so have growth expectations, while financial conditions have remained easy. If we were to see any type of turn with that — for example, a lowering of growth expectations or a significant tightening of conditions in China — that would certainly be a major red flag for us.

10-YEAR TREASURY vs. FED FUNDS



Source: Bloomberg

|Q.| *Do you use dynamic asset allocation?*

|A.| Yes. Part of our investment process is that we are constantly measuring relative value across the major investible fixed-income classes. For example, credit is an area where we do asset allocation on a dynamic basis. But given the size of the strategy and liquidity, those can be a little bit harder to steer.

|Q.| *What are some of the risks of a core-plus strategy that asset owners need to understand?*

|A.| Regardless of what the manager does, the portfolio will have some sensitivity to how interest rates are moving in any given period. The other risk is credit risk and the potential for high-yield securities to have some volatility.

|Q.| *How are core-plus strategies evolving?*

|A.| They've become increasingly global in terms of the opportunities that they pursue. You see more overseas companies issuing bonds in the U.S. market.

You've also had changes in the underlying composition of the index over time, and fixed-income categories have come in and out of favor. For example, structured securities, due to regulation and lack of issuance, have really shrunk as a proportion of risk asset classes in the overall U.S. fixed-income market. ■

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