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Unconstrained Bond Funds Are No Panacea For Rising Rates

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Catering to fears of a bond market Armageddon has enriched managers of unconstrained bond funds. Whether the funds are helping investors is a different question.

Touted as an elixir for looming rate hikes and razor thin yields, unconstrained bond funds have become the darling of fixed income investors, attracting $36 billion in 2014, according to Lipper. Although many of the funds may outperform the broader bond market in the coming year, investors should be wary: some of the most popular unconstrained strategies could significantly increase a portfolio's exposure to risk, especially during a downturn.

As the Federal Reserve prepares to raise interest rates as soon as mid 2015, investors are increasingly wary of traditional bond funds, which track benchmarks that are highly sensitive to interest rate risk, such as the Barclay's Aggregate Bond Index. By ignoring benchmarks altogether, unconstrained bond funds are free to employ an array of strategies – including calls on global macroeconomic events, credit risk, and interest rates – to maintain total returns typically between 2% and 4% in even the most vexing market conditions, says Jason Kephart, a fund analyst at Morningstar.

"People have been anticipating interest rates to go up, and I think a lot of investors have thrown up their hands and said 'well give me something that can go all over the globe to get returns,'" says Barry Fennell, an analyst at Lipper.

The Federal Reserve may raise interest rates in 2015.

In the past year, the most overwhelmingly popular strategy – adopted by roughly 80% of fund managers – has been to dramatically dial back exposure to interest rate risk. While a 1% rate hike would send the Barclay's Aggregate Bond Index tumbling more than 5.5%, many unconstrained bond funds, such as Eaton Vance's Global Macro Absolute Return Advantage Fund, would hardly be affected at all. Others, such as the Goldman Sachs Strategic Income Fund, actually benefit from higher rates, according to Morningstar.

While potentially a life raft for investors struck by a sudden, unanticipated increase in interest rates, the strategy comes at a cost: as managers cut back rate risk, they typically boost credit risk to maintain solid returns, says Arif Husain, head of international fixed income at T. Rowe Price. The ten largest unconstrained bond funds have an average credit quality of BB, which is just below investment grade, and substantially riskier than the AA- average of the Barclay's Aggregate Bond Index, according to Morningstar.

Juiced up by high yield bonds, an unconstrained bond fund can lose the capacity to counterbalance risk from equities, which is one of the primary purposes of a bond portfolio, says Rand Spero, president of Street Smart Financial. The typical unconstrained bond fund has beta of 0.46, indicating a positive correlation with the stock market. During sharp downturns, the correlation can become even stronger, says David Nadig, chief investment officer at ETF.com.

"Investors shouldn't assume these funds are a substitute for regular bond funds just because they have the world 'bond' in them," Spero says.

For investors, the increased risk may not be worthwhile. If interest rates rise in 2015 by the 0.75% currently priced into the market, the Barclay's Aggregate Bond Index is poised for a total return of about 2.5% in the coming year, roughly equal to the gains sought by many unconstrained funds, says Scott Kimball, a portfolio manager at Taplin, Canida & Habacht.

In fairness, unconstrained bond funds are actively managed, and could potentially bail out of risky positions in advance of a downturn, says Rick Rieder, chief investment officer for fixed income at Blackrock. There are good reasons for fund managers to scope out high yield bonds, especially as increasing illiquidity in the fixed income market creates more opportunities to exploit mispricing, Nadig says.

"Only about 10% of the corporate bond market trades on a given day, and more than 30% doesn't trade in a given year," says Steve Sachs, head of capital markets for Proshares Advisers. "There is a lot of mispricing to take advantage of."

The question is whether investors can trust managers to ditch risky positions at the right time. In the summer of 2011, when the S&P 500 dove about 7%, unconstrained bond funds lost about 2%. While that isn't as sharp as the 3% drop in the S&P U.S. High Yield Corporate Bond Index, it's much worse than the Barclay's Aggregate Bond Index, which gained more than 2% during that period, helping investors offset losses from stocks, according to data from Morningstar.

There are still reasons for investors to consider unconstrained bond funds, so long as the funds don't comprise more than a small fraction of their portfolio, typically a percentage in the low single digits, Kephart says. One of the most compelling cases is for diversification, as steady performance from a well managed fund can help smooth a portfolio's returns, Rand says.

"Core bond funds give you a lot of exposure to interest rate risk, while unconstrained bond funds expose you to other types of risk that make you a little money a lot of times," Rieder says. "So you marry traditional fixed income exposure to an unconstrained fund, and you get higher returns with less volatility."

The main challenge is finding the right manager. Unconstrained bond fund performance is immensely varied. In the year to date, returns ranged from 11% for Cedar Ridge Unconstrained Credit Fund to -8% for Goldman Sachs Fixed Income Macro Strategies Fund, according to Morningstar. The best bets are funds that have a long track record of solid returns, even during rocky periods like the summer of 2011, Kephart says. Stay away from funds that simply load up on credit risk, says Sachs.

“With unconstrained bond funds, what you are really buying is a manager, and you hope they do a good job,” says Brent Burns, president of Asset Dedication.
