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PUBLIC FIXED INCOME

It's Time to Re-calibrate Your Portfolio

Key Themes:

- Diversification, correlations and portfolio construction
- Transition away from excessive monetary accommodation
- Adapting to the transition via changes to asset allocation
- Strategy profile: Long Short Credit as a fixed income alternative

Diversification and Correlations

Diversification is widely considered the most fundamental concept to investing; some refer to it as the only "free lunch" or as the "Holy Grail" of portfolio construction. Diversification analysis was the key component of Harry Markowitz's work on Modern Portfolio Theory which won him the Nobel Prize in 1952; where he proved that a diversified portfolio of around 20 non-correlated investments can lower overall risk without reducing expected returns.

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It is important to note however that correlations between and across financial assets can move materially over time. Moreover, there is clearly a difference between a portfolio of 20 different technology stocks versus a portfolio of 20 securities from a mix of stocks, bonds, real estate, commodities, and real assets spread across various sectors and geographic regions. The latter is obviously more diversified and is better aligned with the theories optimizing a portfolio's risk and return objectives over time.

What typically lowers correlations amongst asset classes, geographies, and economic sectors is the fact that they typically have different variables driving performance. In addition, there are certain paradigms when exogenous factors overpower those drivers and cause correlations to rise or fall considerably, and when they do, portfolios should adapt accordingly.

Transition from Extraordinary Monetary Stimulus

Few would argue that the unprecedented global monetary and fiscal stimulus provided after the financial crisis of 2008 was a boon to almost all asset classes. Financial asset returns during this period have generally been well above historical annual averages. Some like to say that the stimulus borrowed from future returns, thus making "today" better at the expense of "tomorrow".

The stimulus was so long lasting and ongoing (2008-2022) that market psychology seemed to shift toward a general "risk-on", "yield-seeking" and "buy the dip" mind set. A herd mentality was evident, and by most appearances those actions appear to have worked out well. Since most financial assets collectively rose to historical high valuations during the past decade, it is obvious and not surprising that asset class correlations correspondingly soared in tandem.

Now that many global central banks are or appear to be removing accommodation, history may look back on 2022 as a transition year; one that began and required significant and critical shifts in portfolio construction and asset allocation.

Adapting and Re-assessing Asset Allocation

We believe going forward, it is likely that asset correlations will decline and fall back to more historical levels. Diversification should begin to matter more. Also, we believe active management could finally start outperforming passive or index strategies. As portfolios adjust to the new paradigm, we see financial markets becoming more 'two-way' with an increase in volatility and as well as the potential for dramatic short-term changes in market liquidity. Security fundamentals and valuations could begin to be more impactful components of portfolio performance.

There are many strategies that can be added or deployed in a portfolio to try and adjust and capitalize on this transitional period. The remainder of this note will discuss one such strategy. Since inflation is currently quite high, there are many discussions about how to maintain fixed income exposures without them becoming a drag on the portfolio should they get hit more sharply than equities by rising official interest rates. For this reason, the rest of this note will discuss the potential benefits and mechanics of a Long Short Credit strategy.

Characteristics and Potential Benefits of a Long Short Credit Strategy

Having long and short exposures offer the potential to generate absolute returns in any market environment. Taking both long and short positions increases the investment universe, typically offering a more diversified portfolio that is less correlated with equity and fixed income markets. Since there is potential for returns from both rising and falling security prices, the strategy, unlike long-only strategies, is less reliant on upward markets to generate returns. With credit spreads exceptionally tight there are plenty of shorting opportunities.

Because many of these types of strategies are diversified across asset classes and sectors, it is sometimes difficult to measure performance against a specific benchmark. Therefore, we feel the best benchmark might be the return you can get from cash. Maybe the best way to understand this and some of the other distinguishing aspects of these types of strategies is with a real example.

MetLife Investment Management (MIM) has a Long/Short Credit strategy dating back to February 1, 2011. The strategy portfolio managers embrace several key principles in their approach to managing the strategy. By not being tied or limited to a benchmark, they seek to search a wide swath across investment grade, high yield and emerging market debt to find idiosyncratic total return ideas. Helping in this regard, is a large team of 149 investment professionals, including PMs with an average of 24 years of experience and team members spread across the globe.

Next, the PMs aim to minimize interest rate sensitivity. By focusing on idiosyncratic trade ideas and utilizing a variety of sub-strategies (core longs, shorts, pairs trades, catalyst driven, opportunistic), the PMs seek to achieve their third objective of maintaining a low correlation to the broader fixed-income indices. The goal is to create a strategy that can act as an attractive portfolio diversifier, volatility dampener and one that mitigates downside risks for a multi-asset portfolio. MIM believes structuring objectives in this way provides a compelling alternative to traditional bond strategies as well as an attractive complement to traditional strategies particularly in a market environment of dissipating governmental and central bank stimulus.

We feel a good argument can be made for today being the ideal time for global diversified portfolios to re-examine their asset allocation mix with a particular focus on how correlations, liquidity and volatility may shift under 2022's shifting central bank narrative. We believe long short credit strategies with the potential to generate absolute return, help provide downside protection and low correlation objectives is one of several such adjustment strategies that investors may want to consider.

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Guy Haselmann is Head of Thought Leadership at MIM where he is responsible for developing and managing investment insights. He has over 25 years of international asset management experience including as CIO, market strategist, and portfolio manager. Formerly Guy was Managing Principal of FETI Group which invented and developed scoring methodologies to evaluate intangibles such as ESG, Cybersecurity and human rights variables. Guy is a frequent guest on Radio and TV where he shares his views on capital markets. From 2010 to 2018, he served on the NJ State Investment Council which oversees the state's $90 billion public pension.

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Joshua Lofgren is a portfolio manager and member of the investment grade credit team for MetLife Investment Management (MIM) Public Fixed Income. In this role, he is involved in the management of all of the firm's investment grade credit strategies and leads the long/short credit strategy.

Joshua joined MIM in September 2017, in connection with the acquisition of Logan Circle Partners (LCP) by MetLife. Prior to joining LCP in 2012, he worked in the securities division at Goldman Sachs in New York for nine years, working with institutional clients across a range of credit products, including investment grade and high yield credit, in both cash and derivative form. He has 17 years of industry experience.

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