



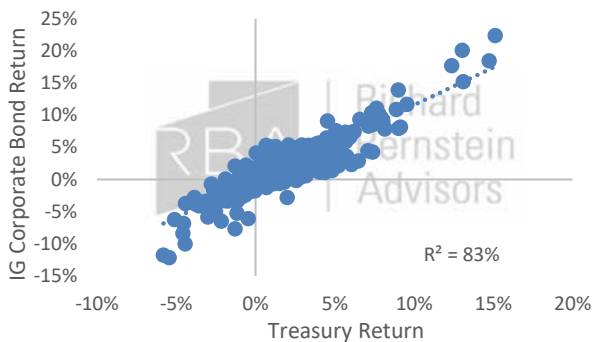
June 10th, 2021

All About the Macro

With the recent end to the 40-year bull market in Treasuries – at least for now – this may be a good time to revisit long standing assumptions about managing Fixed Income. The most important of which is the idea that security selection is the primary driver of performance. However, with the average Intermediate Core Bond fund holding 3000 securities, we are left wondering, how much of Fixed Income performance is really due to credit selection and how much is due to macro factors, like rates?

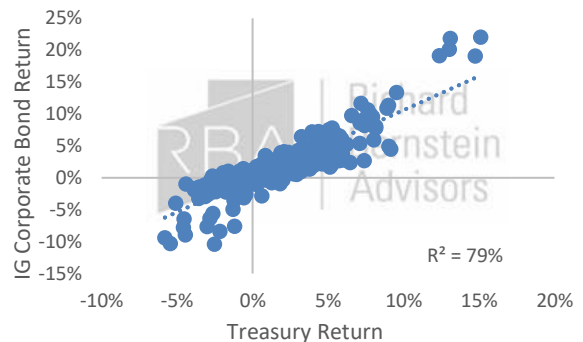
Our conclusion is clear: The primary driver of Fixed Income performance is the Treasury market with the profit cycle a secondary factor. In fact, over the last 44 years, 83% of the variability in investment grade corporate bond total returns (Chart 1) and 79% of mortgage bond total returns (Chart 2) can be explained by moves in rates.¹ The minimal effects of security selection can be highlighted by manager performance over the last decade: The average Intermediate Core bond fund manager has managed to beat the benchmark by just 6bp over the last 10 years (better than the average active equity fund manager, who did not...) as rates and profit cycles have driven returns, not bond selection.²

Chart 1: IG Corporate Credit total returns¹ are driven by Treasury markets:



Source: Richard Bernstein Advisors LLC, Bloomberg

Chart 2: Mortgage bond total returns¹ are driven by Treasury markets:



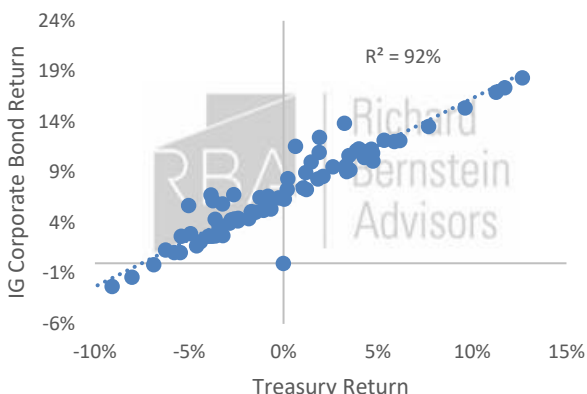
Source: Richard Bernstein Advisors LLC, Bloomberg

Even more stark, when valuations are as rich as today (20th percentile), 92% of price return variation is due to rates (Chart 3). Conversely, when valuations are cheap (80th percentile) very little return variation can be explained by rates, and instead, 40% is due to the profit cycle³ (Chart 4). The rationale for this behavior is simple. The yield difference between a corporate/mortgage bond and a Treasury security (the spread) is the compensation demanded by the investor to take on credit risk. When investors are willing to receive a low spread, like today, it is a sign of their confidence in the earnings and economic outlook, i.e. they make little distinction between a corporate bond and a risk-free note.

This is a starkly different backdrop than one during economic uncertainty or earnings stress, when bond managers are “paid” to take recovery risk – and when corporate bonds yield significantly more

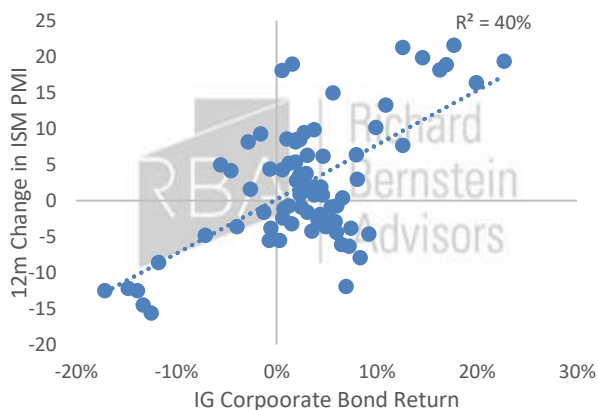
than risk-free bonds. This additional yield falls during profit accelerations and recoveries, aiding in total returns. Timing these peaks and troughs can be immensely additive to performance, further highlighting the importance of macro variables. The ability of a Fixed Income manager to position for these swings – such as last year when investment grade corporate spreads moved 300bps tighter from the March highs – would have generated excess returns to government bonds of 22%.

Chart 3: When spreads are tight (20th percentile), rates are the key factor in IG Corporate Bond Returns:
(6/30/1989 – 5/31/2021)



Source: Richard Bernstein Advisors LLC, Bloomberg

Chart 4: When spreads are wide (80th percentile), the profit cycle is key factor in IG Corporate Bond Returns:
(6/30/1989 – 5/31/2021)



Source: Richard Bernstein Advisors LLC, Bloomberg

Macro factors will matter even more today, as many of the tailwinds managers have enjoyed for years (lower rates/high coupons) have turned to a headwind. In fact, even a small change in yields can overwhelm the impacts of security selection. For example, at a current yield of 2.12%, just a 25bp rise in rates can wipe out a year’s worth of investment grade corporate bond income. Historically, we have never seen such a small move in yields cause so much damage to returns (Chart 5). This math explains why 99% of Intermediate Core Bond managers had negative total returns in Q1.²

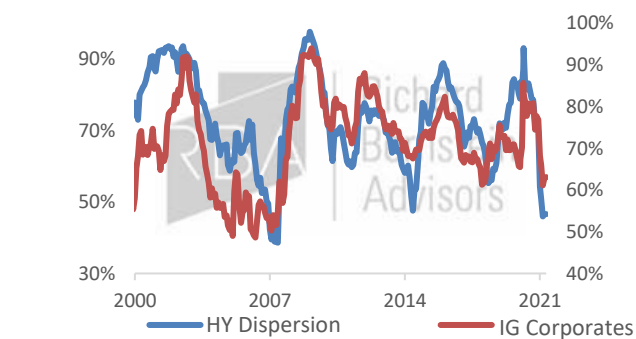
Also consider that dispersion — the percentage of securities that trade far away from the benchmark — is near all-time lows in corporate credit.⁴ With most bonds effectively trading the same, the opportunity set for security selection could be even lower than in the past (Chart 6). Understanding these dynamics highlights the need to take a proactive approach to managing the macro exposures within fixed income, rather than solely focusing one’s resources on individual bond selection.

Chart 5: Amount rates would have to move to wipe out IG Corp Bond returns over a year is at lowest ever:
(1/31/1996 – 5/31/2021)



Source: Richard Bernstein Advisors LLC, Bloomberg

Chart 6: Low yields and tight spreads mean rates drive returns, not credit:
(1/31/1998 – 5/31/2021)



Source: BofA Global Research

- 1 Using rolling quarterly return data from 1/30/1976 through 5/31/2021, excluding 1/1/2009 – 12/31/2010 due to exceptional volatility around the Great Financial Crisis
- 2 Based on absolute returns reported in Morningstar versus Bloomberg Barclays US Aggregate Index
- 3 Using ISM Manufacturing PMI as a proxy for the profit cycle
- 4 In HY, proportion of face value in the DM USD High Yield index outside of +/- 100bp of overall index level. In IG, proportion of face value in the DM USD High Yield index outside of +/- 25bp of index

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Index Descriptions:

The following descriptions, while believed to be accurate, are in some cases abbreviated versions of more detailed or comprehensive definitions available from the sponsors or originators of the respective indices. Anyone interested in such further details is free to consult each such sponsor's or originator's website.

The past performance of an index is not a guarantee of future results.

Each index reflects an unmanaged universe of securities without any deduction for advisory fees or other expenses that would reduce actual returns, as well as the reinvestment of all income and dividends. An actual investment in the securities included in the index would require an investor to incur transaction costs, which would lower the performance results. **Indices are not actively managed and investors cannot invest directly in the indices.**

Bloomberg Barclays US Aggregate Index: The Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency).

High Yield (HY): ICE BofA US High Yield Index: ICE BofA US High Yield Index tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market

IG Credit: Bloomberg Barclays US Corporate Bond Index: The Bloomberg Barclays US Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by US and non-US industrial, utility and financial issuers.

Mortgages: Bloomberg Barclays US Mortgage Backed Securities (MBS) Index: The Bloomberg Barclays US Mortgage Backed Securities (MBS) Index tracks fixed-rate agency mortgage backed pass-through securities guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). The index is constructed by grouping individual TBA-deliverable MBS pools into aggregates or generics based on program, coupon and vintage.

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