

In recent years, fixed-income money managers have begun using systematic investing as an active management strategy to help meet risk, reward and diversification objectives.

WHAT IS SYSTEMATIC FIXED-INCOME INVESTING?

Overview

Given the current environment of stubborn inflation and a frustrated labor market, the overall environment does not bode well for higher interest rates for fixed-income investors. In September, the Federal Reserve indicated that it wasn't likely to raise the current 0.25% federal funds rate until 2022, and even then by only 25 basis points.¹

Today's fixed-income market is producing historically low yields and low-price appreciation. Systematic investing, which is also referred to as quantitative investing, is a relatively new development in the fixed-income market. The strategy, which has long been used in equity analysis, provides a framework for combining data with active management strategies to help generate a return range that meets specific parameters.

Systematic investing combines three key elements:

1. Researching and generating investment ideas based on the current market environment
2. Active portfolio management
3. Transparent and real-time technology reporting that eliminates emotion and behavioral biases from the process

It's important to recognize that systematic fixed-income investing was not feasible before the turn of the millennium. The primary reason for this was because the bond market did not have a system in place to report real-time data for over-the-counter secondary market transactions in USD-denominated corporate bonds, agency bonds and securitized products.

It wasn't until 2002 that the Trade Reporting and Compliance Engine (TRACE) was introduced for the US bond market. TRACE became the fixed-income market equivalent of the ticker tape, reporting trades across the investment grade spectrum in real time. This allowed investors to monitor credit risk and trade more efficiently. The technology became even more significant after 2010 when direct trading between bond buyers and sellers (known as peer-to-peer trading) eliminated bond dealer markups. TRACE offered transparency that enabled lower bid-ask spreads for investment cost savings.²

Today, trading technology has advanced to the point where there is exponentially more data available. Furthermore, artificial intelligence and natural language processing can efficiently analyze these datasets and transform them into fundamental and economic indicators for portfolio managers, as well as gauge investor sentiment in real time.³



Over just the last decade, the volume of fixed-income data available, combined with management expertise, has produced a quantitative leap in understanding risk management and the ability to target risk-adjusted returns in the bond market.

Fixed-Income Glossary

Forward interest rate: The yield and expected capital appreciation of a bond based on current market prices.

Duration: A measurement of a bond's price sensitivity to interest rate changes. Generally, longer maturity bonds are more interest-rate sensitive than shorter maturity bonds.

Yield curve: A graph that plots yields at a specific point in time of bonds with similar credit quality but different maturity dates.

Currency hedging: Investing in financial instruments intended to offset the impact of exchange-rate fluctuations on bonds traded in a foreign currency.

Investment grade: Bonds with a relatively low risk of default, as indicated by their credit rating. Bonds rated AAA, AA, A and BBB are considered investment grade.

Credit spread: The yield difference between bonds of similar maturity but different credit quality. A narrow spread indicates a smaller difference between yields of higher and lower credit quality bonds; a wide spread indicates a larger yield difference.

Bid-ask spread: The difference between the highest price a buyer is willing to pay for a bond (bid) and the lowest price for which a seller is willing to sell it (ask).

High-yield debt: Bonds with credit ratings below those of investment grade (BB and lower).

(Source: Dimensional. 2021. "Systematic Fixed Income Investing at Dimensional." <https://us.dimensional.com/systematic-fixed-income>. Accessed Oct. 26, 2021.)

Advantages of Systematic Fixed-Income Investing

A systematic fixed-income strategy applies investment insights consistently over time, different market environments, and across the universe of securities. By using technology to track changes to thousands of metrics, prices and market conditions each day, it basically removes all elements of emotion and cognitive bias. During a declining market, a bond manager can quickly identify bonds that are more likely to default and reposition the portfolio with a more defensive strategy to reduce downside risk.

Note, however, that an investment manager may improve the systematic framework over time through the introduction of new data and better-honed insights.⁴

"In today's markets, both the level of yields and abundance of data available for investors to process create challenges where systematic fixed-income strategies can help."⁵



Challenges

Because systematic fixed-income investing requires both monitoring and quantitative analysis of data, bond managers must have a deep understanding and be able to process the variables in real time. Without a well-defined framework and disciplined model, analysts can be overwhelmed by the deluge of available data.

Moreover, theoretical strategies may prove to be less efficient in real-time portfolio management. In other words, the transaction costs associated with fixed-income instruments could outweigh the return potential gained by executing those trades.⁶

Be aware that a systematic fixed-income investment strategy does not guarantee higher total return. The value of investments may rise or fall, and risk management does not eliminate the risk of investment loss.

Today's Fixed-Income Environment

Investment markets are driven by many different factors, but what's interesting is what we don't know until it happens. For example, the COVID-19 pandemic dramatically changed consumer behavior and global demand. The impact of lockdowns and social distancing actually changed the beta range (a measure of a security's volatility in relation to the overall market) for equities and bonds. Specifically, betas trended lower among so-called essential infrastructure, such as health care, food and beverage, and utilities. Meanwhile, low-demand sectors such as airlines, energy and hospitality transitioned to higher than historical beta ranges.

This dynamic created an all-new risk factor the modern market had not witnessed: the stay-at-home factor. Moving forward, one of the most significant advantages of the systematic investment model is the ability to quickly identify and assimilate new factors as they emerge from a wide variety of data sets and vast amounts of data.⁷

Final Thoughts

A systematic fixed-income strategy is a framework to identify, test and implement investment ideas using an objective, disciplined and repeatable process. The technology component allows analysts to assess multiple factors, risk forecasts, transaction costs, and other inputs to deliver optimal portfolio diversification.

Consult with your financial professional about the best way to help maximize fixed-income strategies within your own portfolio, particularly given today's changing landscape for interest rates.



- ¹ Vivien Lou Chen. MarketWatch. Oct. 23, 2021. "The Federal Reserve's next interest rate-hike cycle is coming but may not look like what officials have been projecting." <https://www.marketwatch.com/story/the-federal-reserves-next-interest-rate-hike-cycle-is-coming-but-may-not-look-like-what-officials-have-been-projecting-11634941816>. Accessed Oct. 26, 2021.
- ² Dimensional. 2021. "Systematic Fixed Income Investing at Dimensional." <https://us.dimensional.com/systematic-fixed-income>. Accessed Oct. 26, 2021.
- ³ BlackRock. 2021. "Systematic Fixed Income Investing." <https://www.blackrock.com/uk/intermediaries/themes/structured-income/systematic-fixed-income>. Accessed Oct. 26, 2021.
- ⁴ Ibid.
- ⁵ Coryanne Hicks. U.S. News & World Report. Feb. 10, 2021. "Q&A: BlackRock's Jeff Rosenberg on Fund Strategy." <https://money.usnews.com/financial-advisors/articles/q-a-blackrocks-jeff-rosenberg-on-systematic-fixed-income-investing>. Accessed Oct. 26, 2021.
- ⁶ BlackRock. 2021. "Systematic Fixed Income Investing." <https://www.blackrock.com/uk/intermediaries/themes/structured-income/systematic-fixed-income>. Accessed Oct. 26, 2021.
- ⁷ Manjunath Boraiah and Brett Janis. Wells Fargo Asset Management. March 2021. "Systematic fixed income for investors: Why now?" <https://www.wellsfargoassetmanagement.com/assets/public/pdf/insights/investing/systematic-fixed-income-for-investors-why-now-intl.pdf>. Accessed Oct. 26, 2021.

This content is provided for informational purposes. It is not intended to be used as the sole basis for financial decisions, nor should it be construed as advice designed to meet the particular needs of an individual's situation. None of the information contained herein shall constitute an offer to sell or solicit any offer to buy a security. Individuals are encouraged to consult with a qualified professional before making any decisions about their personal situation. The information and opinions contained herein provided by third parties have been obtained from sources believed to be reliable, but accuracy and completeness cannot be guaranteed by AE Wealth Management. Neither AEWM nor the firm providing you with this report are affiliated with or endorsed by the U.S. government or any governmental agency. Investing involves risk, including the potential loss of principal. No investment strategy can guarantee a profit or protect against loss in periods of declining values. AE Wealth Management, LLC ("AEWM") is an SEC Registered Investment Adviser (RIA) located in Topeka, Kansas. Registration does not denote any level of skill or qualification. The advisory firm providing you this report is an independent financial services firm and is not an affiliate company of AE Wealth Management, LLC. AEWM works with a variety of independent advisors. Some of the advisors are Investment Adviser Representatives (IAR) who provide investment advisory services through AEWM. Some of the advisors are Registered Investment Advisers providing investment advisory services that incorporate some of the products available through AEWM. Information regarding the RIA offering the investment advisory services can be found at <https://brokercheck.finra.org/>. 11/21 - 1895282

