Mesirow

Why a Currency Alpha strategy may be the key to unlocking a more efficient frontier

Introduction

As investment managers, we recognize the fundamental role fixed income investments play in constructing a well-diversified portfolio. However, in the real world, the decision of how best to invest in fixed income is not always easy. In today's market, bonds are expensive. Yields across the globe are flirting with all-time lows and spreads are the tightest they have been in decades. With this backdrop, allocations to traditional bond strategies have slowed, and investors are searching for new and attractive ways to earn higher yields. The result? An increased interest in Core Plus and related styles of investing.

On its surface, Core Plus is not a new concept. However, as the spotlight shines even brighter on the strategy and investors become more discerning, our first goal in this discussion is to vet the merit of "Core Plus". In this endeavor, we evaluated the Core Plus concept through the lens of Markowitz' Modern Portfolio Theory.[1] The resulting data, consistent with Markowitz' argument, makes a strong case for incorporating more credit into fixed income products.

After establishing the validity behind the Core Plus proposition, we next sought to determine if any incremental opportunity for improvement existed. We studied other asset classes and found currency stood out as a compelling complement to a "Core" portfolio. As one might expect, adding currency took our "Core Plus" model to a new level, increasing returns while simultaneously decreasing risk (volatility).[2] We will explain in greater detail why this was the case, and what benefits a currency strategy offers to traditional Core Plus investing.

Finally, we tie together this research and introduce Enhanced Core Plus ("ECP"), Mesirow's latest solution to help investors seeking new avenues for higher yield, lower correlations and a similar risk profile to their historical traditional fixed income portfolios.

Does a greater use of credit make Core better?

Though "Core Plus" is a broad term, the difference between "Core" and "Core Plus" is typically the addition of credit. The question must then be asked – "is the investor better off with this new allocation?" On the face of it, the strategy sounds riskier.

A few critical elements to note on the Extended Markets strategy:

- **Alpha Strategy, Not Hedge** – The Extended Markets strategy is an alpha strategy, and stand-alone management of currency exposure. (This is important to note because it establishes the management extends beyond hedging.)
- **Components** – There are many different methods of constructing currency strategies, so it is also necessary to specify the details of the strategy. Mesirow's Extended Markets Strategy uses a broad basket of global currencies and allocates capital between fundamental and technical strategies to drive returns.
- **Controlled volatility** – Mechanisms are instilled in the strategy to reduce downside tail risk.

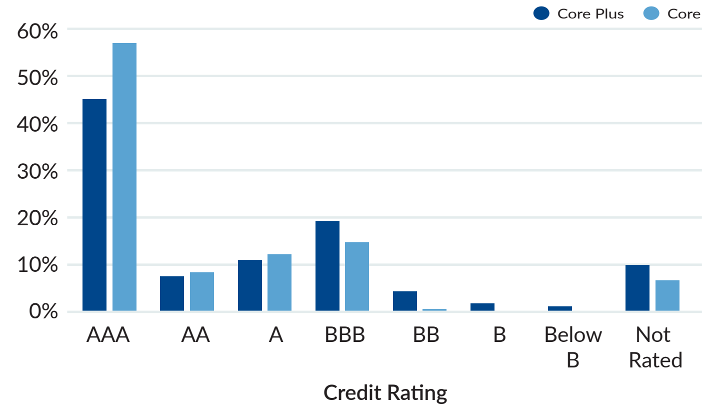
1. Harry Markowitz, "Portfolio Selection" Journal of Finance (1952). | 2. Please note that model, hypothetical and/or simulated performance information do not reflect actual results and portfolio outcomes may differ based on the impact of material economic or market factors and the benefit of hindsight. Please see page four for complete model disclosure information.

TABLE 1

	Aggregate	IG Credit	Treasuries	MBS	HY Credit BB/B	Hybrid/ Pref	HY Loans	Converts	S&P 500
Aggregate	1.00	0.78	0.87	0.90	0.09	0.36	-0.17	-0.20	-0.19
IG Credit	0.78	1.00	0.42	0.53	0.54	0.77	0.31	0.28	0.28
Treasuries	0.87	0.42	1.00	0.84	-0.36	0.05	-0.58	-0.57	-0.52
MBS	0.90	0.53	0.84	1.00	-0.08	0.08	-0.29	-0.33	-0.36
HY Credit BB/B	0.09	0.54	-0.36	-0.08	1.00	0.47	0.91	0.85	0.72
Hybrid/Pref	0.36	0.77	0.05	0.08	0.47	1.00	0.30	0.38	0.46
HY Loans	-0.17	0.31	-0.58	-0.29	0.91	0.30	1.00	0.80	0.65
Converts	-0.20	0.28	-0.57	-0.33	0.85	0.38	0.80	1.00	0.87
S&P 500	-0.19	0.28	-0.52	-0.36	0.72	0.46	0.65	0.87	1.00

Source: Bloomberg. Data from 3/2004–6/2019

CHART 1: **AVERAGE % OF PORTFOLIO, CALCULATED CREDIT QUALITY**

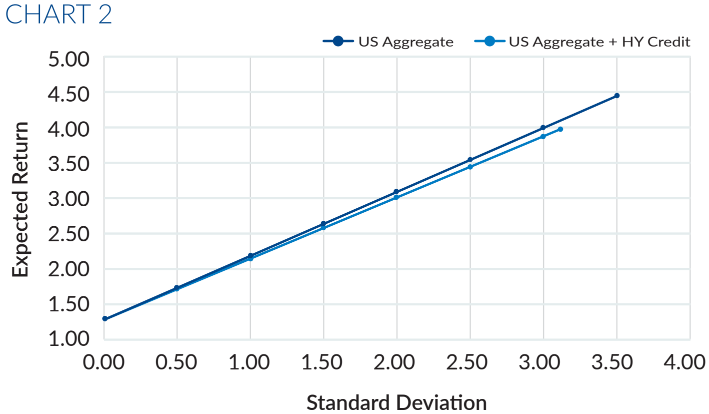


Source: Morningstar Direct. Morningstar defines their Core style as portfolios that have less than 5% allocated to below-investment grade investments. Their Core Plus styles allow more flexibility to hold noncore sectors such as corporate high yield, bank loan, emerging-markets debt, and non-U.S. currency exposures, and typical have higher exposures to lower tier credits. https://www.morningstar.com/articles/929313/12-charts-on-morningstars-new-us-core-bond-categories

To evaluate this, we used Harry Markowitz' Modern Portfolio Theory (MPT). Developed in the 1950s, Markowitz created a framework for portfolio construction based on maximizing returns while minimizing volatility (risk). In particular, Markowitz' work focused on an investor's ability to diversify away risk through the management and reduction of correlation between the returns of asset classes.

After reviewing historic correlations, the decision to add fixed income credit to an Investment Grade portfolio appears compelling. Most credit assets that offer incremental yield (high yield credit, high yield bank loans, hybrid/preferreds) have correlations that are low in relation to the Bloomberg Barclays US Aggregate Bond Index, the standard benchmark in fixed income portfolios. Based on Markowitz, the addition of these asset classes should allow better portfolio performance and more stable returns. This can also be visually demonstrated in the shift of the efficient frontier (another application of Markowitz) seen below.

CHART 2



The mean variance optimization was run with the following constraint: the US Aggregate + HY Credit portfolio could hold no more than a 20% allocation in high yield. This 20% limit was incorporated so the analysis would mimic a typical "core plus" portfolio. | Source: Bloomberg. Bloomberg Barclays US Aggregate Bond Index, Bloomberg Barclays US Corporate High Yield Ba Bond Index and FTSE 3-Month T-Bill 4/2004–6/2019

In the graph, we compare the efficient frontier of two portfolios – the first represents the Bloomberg Barclays US Aggregate Bond Index (the "Aggregate"), the second represents a portfolio that allows up to a 20% allocation of the Bloomberg Barclays Ba High Yield Corporate Credit Index. As seen above, the addition of credit shifts the curve out meaningfully. This new portfolio mix, which is meant to replicate a typical "Core Plus" portfolio, receives more expected return while the risk (or standard deviation) remains the same or lower across the spectrum of possible returns.

TABLE 2

	Aggregate	IG Credit	Treasuries	MBS	HY Credit BB/B	Hybrid/ Pref	HY Loans	Converts	S&P 500	Currency Alpha
Aggregate	1.00	0.78	0.87	0.90	0.09	0.36	-0.17	-0.20	-0.19	0.14
IG Credit	0.78	1.00	0.42	0.53	0.54	0.77	0.31	0.28	0.28	0.05
Treasuries	0.87	0.42	1.00	0.84	-0.36	0.05	-0.58	-0.57	-0.52	0.17
MBS	0.90	0.53	0.84	1.00	-0.08	0.08	-0.29	-0.33	-0.36	0.14
HY Credit BB/B	0.09	0.54	-0.36	-0.08	1.00	0.47	0.91	0.85	0.72	-0.12
Hybrid/Pref	0.36	0.77	0.05	0.08	0.47	1.00	0.30	0.38	0.46	-0.03
HY Loans	-0.17	0.31	-0.58	-0.29	0.91	0.30	1.00	0.80	0.65	-0.13
Converts	-0.20	0.28	-0.57	-0.33	0.85	0.38	0.80	1.00	0.87	-0.16
S&P 500	-0.19	0.28	-0.52	-0.36	0.72	0.46	0.65	0.87	1.00	-0.07
Currency Alpha	0.14	0.05	0.17	0.14	-0.12	-0.03	-0.13	-0.16	-0.07	1.00

Source: Bloomberg, eVestment. Data from 3/2004–6/2019

The performance difference maker – Currency Alpha

If adding a lesser-correlated asset such as credit can create such a dramatic shift in the efficient frontier, it stands to reason that investment managers could search for additional asset classes that can add non-correlated returns to their portfolio. It is for that reason that we believe currency strategies could be the next game changer in fixed income portfolio management.

Currency is a long-established asset class in the financial world but is often overlooked by investors due to unfamiliarity, complexity and perceived volatility. It is also often viewed only in the lens of hedging. However, the uniqueness of currency as an asset screams opportunity due to its low correlations to traditional asset classes. If asset managers can harness currency's potential, an improved portfolio should typically be the result.

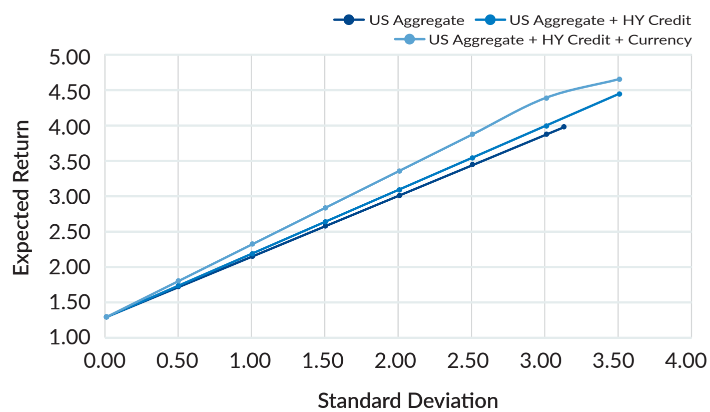
To test this theory, we studied Mesirow's Currency Alpha Extended Markets Strategy.

First, we examined whether the strategy harbored any hidden correlations with other asset classes. Then we incorporated the currency strategy's historical returns into the Core Plus portfolio modeled above to establish currency's impact.

To test correlation, we analyzed historic monthly returns through the inception date of the Extended Markets strategy. As suspected, the strategy showed almost no correlation to other market segments.

Then we incorporated the currency strategy's historical returns into the Core Plus portfolio modeled above to view currency's impact.

CHART 3



The mean variance optimization was run with the same constraints outlined in Chart 2, plus an additional constraint that the US Agg + HY Credit + Currency portfolio could hold no more than a 20% allocation combined towards high yield and currency strategies.

Source: MFIM*, Bloomberg. Bloomberg Barclays US Aggregate, Bloomberg Barclays US Corporate High Yield Ba, FTSE 3-Month T-Bill 4/2004–6/2019

As expected, adding a non-correlated asset once again shifted the efficient frontier. Incorporating a currency alpha allocation to our "Core Plus" portfolio improved returns greatly while maintaining the same standard deviations. It is for this reason that we believe that an appropriate currency strategy can create a radically new fixed income strategy, which is the basis of Mesirow's new appropriately named, "Enhanced Core Plus".

Our conclusion

We believe the strength of the historic numbers speak for themselves. There appears to be a strong case for a strategy that integrates core fixed income with credit and currency alpha.

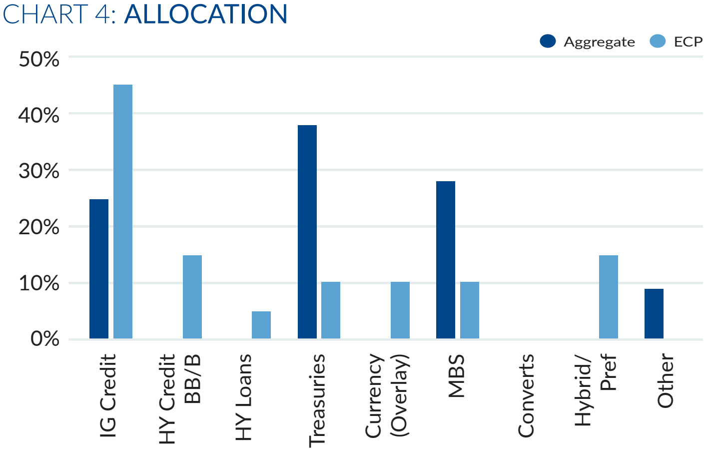
While Mesirow's Enhanced Core Plus ("ECP") strategy just launched in October 2019, the building blocks of the strategy and modeled results make a strong case for its differentiation in the fixed income asset class.

TABLE 3

	Agg	ECP	Range
IG Credit	25%	45%	25–75%
Treasuries	38%	10%	0–25%
MBS	28%	10%	0–25%
HY Credit BB/B	0%	15%	0–25%
Hybrid/Pref	0%	15%	0–25%
HY Loans	0%	5%	0–15%
Converts	0%	0%	0–10%
Currency (Overlay)	0%	10%	0–10%
Other	9%	0%	

Source: Bloomberg Barclays, MFFI

CHART 4: **ALLOCATION**



Source: Bloomberg Barclays, MFFI

Model results also echo a similar sentiment. We back-tested ECP's standard allocation through 2000, which produced attractive returns throughout the period, including before and after the 2008/2009 financial crisis. The model outperformed the Bloomberg Barclays US Aggregate by 129bps and generated a Sharpe ratio of 1.19 versus 0.96 for the index.** These are findings that we believe are compelling and are consistent with having the components to create an even more optimal efficient frontier for many fixed income portfolios.

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* The Extended Markets Currency Alpha Strategy (Extended Alpha Strategy) commenced trading in April 2004 as a carve-out from an institutional account. From April 2004 through December 2010 performance is based on an equal weighted composite of all accounts invested in the Extended Alpha Strategy; from January 2011 performance is based on the asset weighted performance of all accounts invested in that strategy. Performance fees are accrued daily, paid quarterly and a high water mark is employed. Performance is in USD and all returns and statistics are based on monthly returns. The composite includes all fee paying accounts, including both commingled and managed accounts. Currency trading may involve instruments that have volatile prices, are illiquid or create economic leverage. Emerging markets securities involve risks such as currency fluctuation and political and economic instability that could result in additional volatility. Unhedged short sales expose the strategy to additional liability.

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