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Multi-Sector Fixed Income

A Changing Landscape for Multi-Sector Fixed Income Investing

It's no secret that multi-sector fixed income strategies have seen significant inflows and growth in assets under management since the financial crisis. Given low yields, reasonable global growth and attractive valuations for credit instruments, investors in recent years have added exposure to a broad array of income-focused fixed income strategies. However, we believe the approaches to multi-sector fixed income investing that worked over the past five years are unlikely to work over the next five years—or at least they won't work nearly as well.

We see multi-sector portfolios confronting a number of challenges in the medium term, including how to maintain income without significant increases in U.S. credit allocations or a deterioration in the quality of those allocations; how to generate positive total returns in an environment of low rates, tight spreads and relatively high correlations; and how to ensure that fixed income exposures contribute to portfolio diversification rather than detract from it. In this paper we discuss the changing market dynamics giving rise to these challenges and how multi-sector fixed income strategies may evolve to overcome them.

Executive Summary

- Changing market dynamics suggest the approaches to multi-sector fixed income investing that have worked in recent years are unlikely to offer similar benefits going forward, inspiring a need for a corresponding evolution in these strategies.
- Given changes in bond market composition and market valuations, multi-sector investors will be challenged to maintain income levels, generate positive total returns and manage fixed income exposures that are contributing to overall portfolio diversification.
- Multi-sector investors may need to incorporate a broader range of income levers into their portfolios, including U.S. munis, global investment grade and high yield credit, local-currency EMD, China debt, private debt and alternative income strategies.
- Principal protection has reemerged as a key concern of multi-sector investors, driving interest in such solutions as tactical duration overlay strategies and unconstrained and credit long/short strategies.
- More complex, global markets and an increasing frequency of market perturbations are likely to create a premium on both thoughtful long-term strategic allocation and shorter-term tactical positioning.

What Is Multi-Sector Fixed Income?

Multi-sector fixed income is best described as the construction of fixed income portfolios designed to meet client income or total return objectives in an efficient manner, where efficiency is generally defined as minimizing volatility, minimizing correlation to other asset classes, or meeting other client-specific objectives. From a practical standpoint, strategies that identify as “multi-sector fixed income” share several common attributes, including:

- Above-benchmark (often the Bloomberg Barclays U.S. Aggregate) income objectives
- Considerable manager flexibility regarding sector allocations and duration management
- A focus on non-agency mortgage-backed securities, U.S. high yield and hard-currency emerging markets debt as the key sources of above-average income generation

In many ways, multi-sector fixed income is simply the latest stage in a continued evolution toward broader—and more complicated—fixed income strategies. For example, government and mortgage allocations began moving into core portfolios 30 years ago and into core-plus strategies in the early 2000s, and that broad trend—supported by the continued integration and globalization of fixed income markets—continues today with investor allocations to multi-sector fixed income.

However, it’s critical to note that just about every fixed income investor, whether institution or individual, is already engaging in multi-sector investing, either explicitly or implicitly. For example, an institution that creates separate allocations to core, emerging markets debt and high yield strategies is creating a multi-sector fixed income portfolio—albeit one in which the investor is controlling the asset allocation decisions.

In a world where fixed income markets are increasingly linked and investors are permitted to invest in a wide range of global fixed income markets, we see a bifurcation in investor behavior that will become more pronounced over time. Given the complexity, speed and breadth of fixed income markets, one group of investors increasingly will allocate to multi-sector fixed income products, essentially giving even more decision-making flexibility to their investment managers. Another group will move in the opposite direction, however, unbundling existing products and internally managing a sophisticated asset allocation process that encompasses the full range of fixed income opportunities.

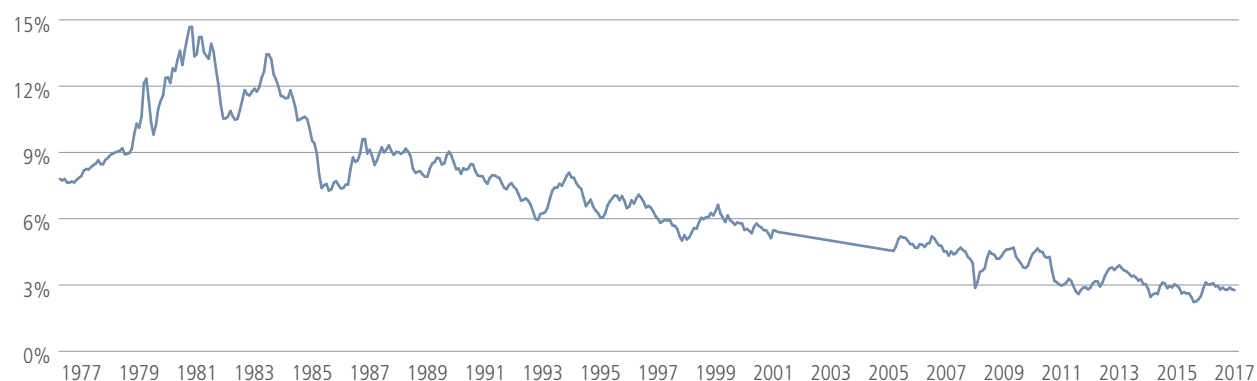
As we discuss later, there are advantages, disadvantages and tradeoffs to both approaches. But our conviction is that both types of investors will face challenges successfully managing their fixed income exposures over the next five years.

The Current State of Multi-Sector Fixed Income

Multi-sector fixed income portfolios are designed to accomplish three main objectives for investors: 1) provide income and total return; 2) provide diversification benefits within a broad portfolio that includes equities and alternatives; and 3) protect principal. Over the past 10–15 years multi-sector strategies largely have been successful in accomplishing these interrelated goals. In our opinion, one critical reason for this success dates back almost 40 years, when the structural decline in bond yields began, largely driven by persistent disinflation trends (see Figure 1).

FIGURE 1. YIELDS ON LONG-TERM U.S. BONDS HAVE BEEN IN STEADY DECLINE SINCE THE 1980s

30-Year U.S. Treasury Constant Maturity Rate, Weekly, January 1977 to December 2017

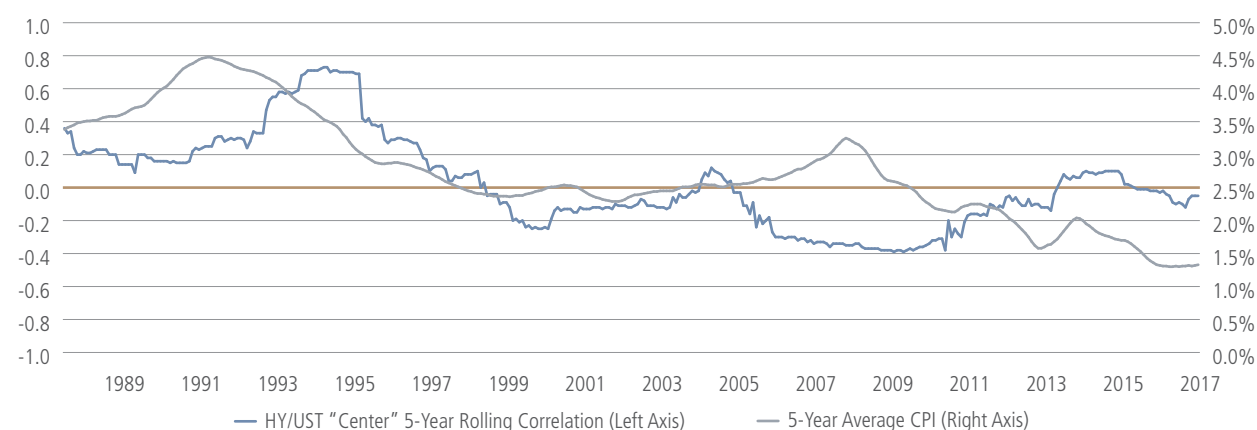


Source: Federal Reserve.

Note: The 30-year Treasury constant maturity series was discontinued on February 18, 2002, and reintroduced on February 9, 2006.

This secular decline in interest rates has had some obvious implications for bond portfolios generally, including providing a support for total returns and a powerful tailwind for declining risk premiums across a wide range of fixed income securities. In addition, the decline in inflation and inflation volatility created a subtle but critical development for multi-sector fixed income portfolios: As inflation moved lower, risk-free assets such as government bonds became negatively correlated with key credit sectors like U.S. high yield (see Figure 2). As a result, government bonds, with their low or negative correlation to other fixed income markets, have significantly dampened fixed income portfolio volatility in recent years.

FIGURE 2. U.S. HIGH YIELD EXHIBITS LOW CORRELATIONS TO TREASURIES WHEN INFLATION IS LOW



Source: Bloomberg.

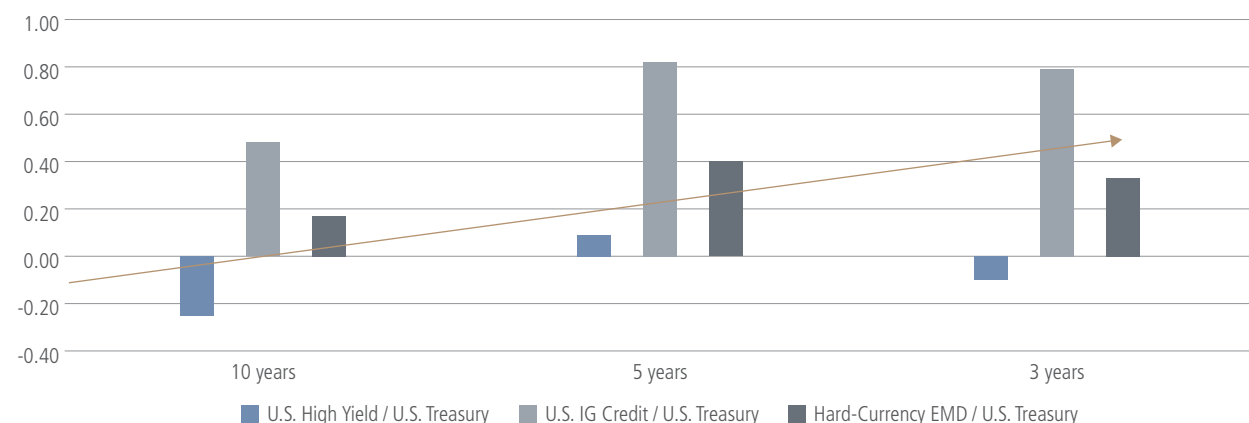
Our portfolio solutions in the multi-sector space since the mid-2000s have attempted to recognize the importance of these trends. To capture the benefits of the structural decline in inflation-oriented risk premiums we have advocated that portfolios focus on multiple income-producing sectors while also maintaining what we perceive as above-market allocations to government bonds to minimize overall portfolio volatility.

As we look forward, however, changes in bond market composition and market valuations are exposing inherent—and rising—tensions among the three fundamental objectives of multi-sector portfolios. Below we highlight several developments that will impact multi-sector portfolio strategies and their ability to meet these goals going forward.

Rising Correlations Between U.S. Treasuries and Credit Sectors. As discussed above, duration management—via exposure to risk-free assets like U.S. government bonds—has been a key contributor to volatility reduction in multi-sector portfolios. This strategy is most efficient when the correlation between U.S. Treasuries and risk sectors—such as investment grade credit, high yield or emerging markets bonds—is relatively low or, ideally, negative. However, as Figure 3 below highlights, correlations between these sectors have been steadily rising over the past three to five years.

FIGURE 3. CORRELATIONS BETWEEN RISK ASSETS AND TREASURIES HAVE BEEN TRENDING HIGHER

Monthly Returns Correlations



Source: Bloomberg, Neuberger Berman.

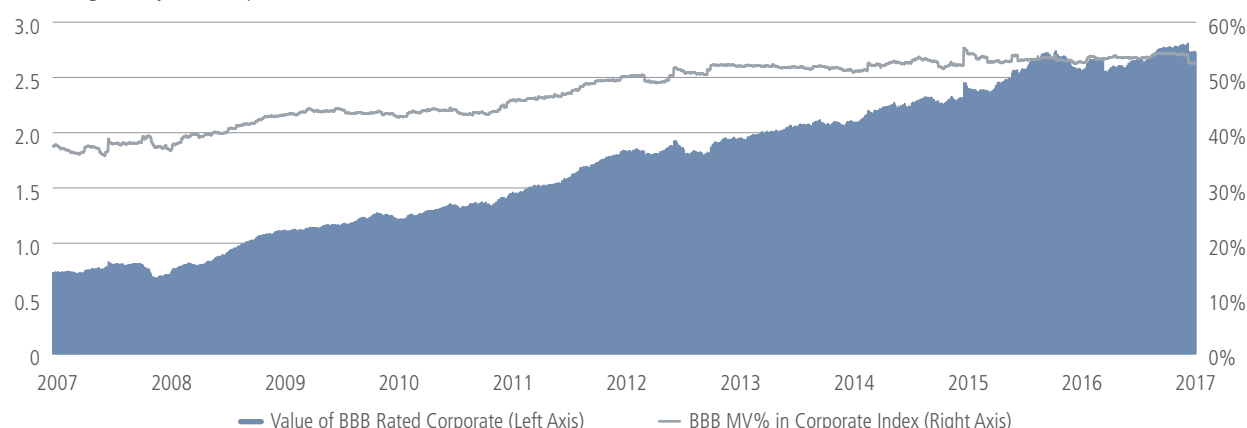
Note: U.S. Treasury = Bloomberg Barclays U.S. Treasury; U.S. High Yield = ICE/BAML U.S. High Yield Constrained; U.S. IG Credit = Bloomberg Barclays U.S. Credit; Hard-Currency EMD = JPM EMBI Global Diversified Index.

Rising correlations have two important implications for multi-sector fixed income strategies. First, high correlations combined with rising interest rates compromises the ability of multi-sector portfolios to generate positive total returns. Second, high correlations also limit the diversification benefits a multi-sector strategy typically provides to a broad portfolio of assets. The risks associated with rising correlations largely have been masked by an environment of falling interest rates and tightening credit spreads. While these factors challenge virtually all fixed income portfolios in the current environment, multi-sector portfolios are particularly exposed to sudden shifts in correlations given their cross-sector exposure.

Deteriorating Credit Quality in U.S. Investment Grade Credit. Investment grade credit is among the larger exposures of multi-sector fixed income strategies. BBB rated corporate debt in the Bloomberg Barclays U.S. Corporate Index has risen by about 250% in dollar terms since 2007 and now accounts for 52% of the index (see Figure 4). The deteriorating credit quality of U.S. issuers suggests that even a static allocation to these bonds over time has resulted in progressively “riskier” fixed income portfolios.

FIGURE 4. DECLINING CORPORATE CREDIT QUALITY EXPOSES MULTI-ASSET STRATEGIES TO GREATER RISK

Bloomberg Barclays U.S. Corporate Index, \$ Trillions

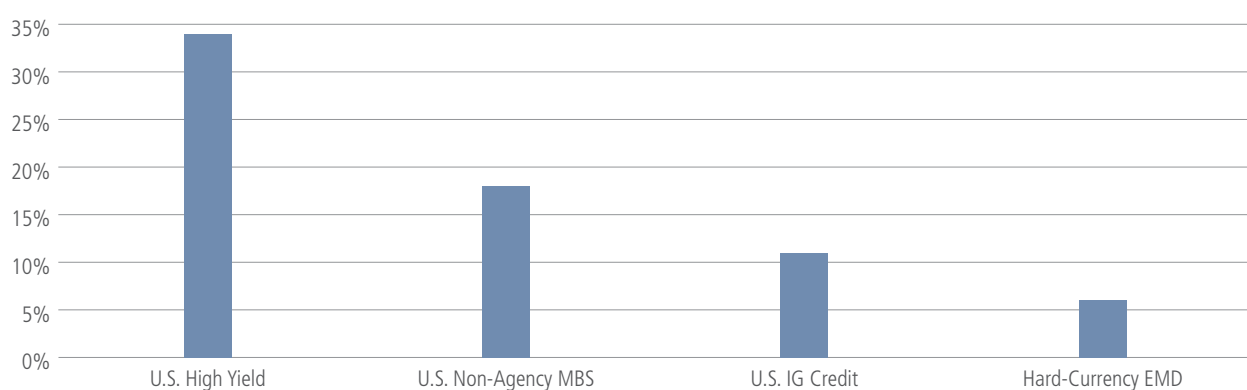


Source: Bloomberg, Neuberger Berman.

Heavy Reliance on a Limited Number of Strategies for Income. Our work on the multi-sector strategy universe suggests that portfolios are generally constructed with an emphasis on two to three income-producing sectors beyond U.S. investment grade credit: high yield bonds, non-agency mortgages and emerging markets debt (see Figure 5). In essence, multi-sector fixed income strategies have been and continue to be quite reliant on a limited number of sectors to generate income and total return, suggesting that any weakness in these markets would have a negative impact on multi-sector strategies.

FIGURE 5. MULTI-SECTOR PORTFOLIOS ARE HEAVILY WEIGHTED IN A FEW SECTORS

Average Multi-Sector Fixed Income Mutual Fund Allocation, 2015–17



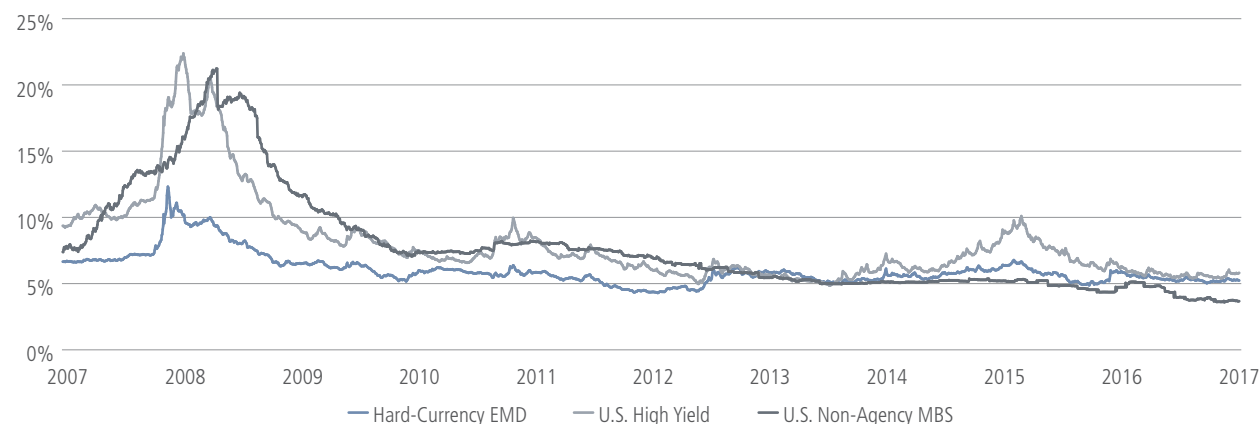
Source: Morningstar, Neuberger Berman.

Note: Analysis based on funds in Morningstar’s Multisector Bond category. Average weighting is calculated by a mapping process based on fund disclosures.

Declining Yields for Key Credit Sectors. There are only so many ways for investors to increase yield or income in generally efficient markets: increase duration, increase credit risk, short volatility or use leverage. As highlighted above, multi-sector fixed income portfolios for the most part have relied on the credit lever for increased income. The significant decline in yields in recent years presents a challenge going forward, however; with key credit sectors yielding 3.75% to 5.25% (as shown in Figure 6), there is simply an upper bound to expected performance for strategies built on the traditional pillars of multi-sector portfolios.

FIGURE 6. YIELDS ON CREDIT INSTRUMENTS HAVE FALLEN SHARPLY POST-CRISIS

Yields to Worst



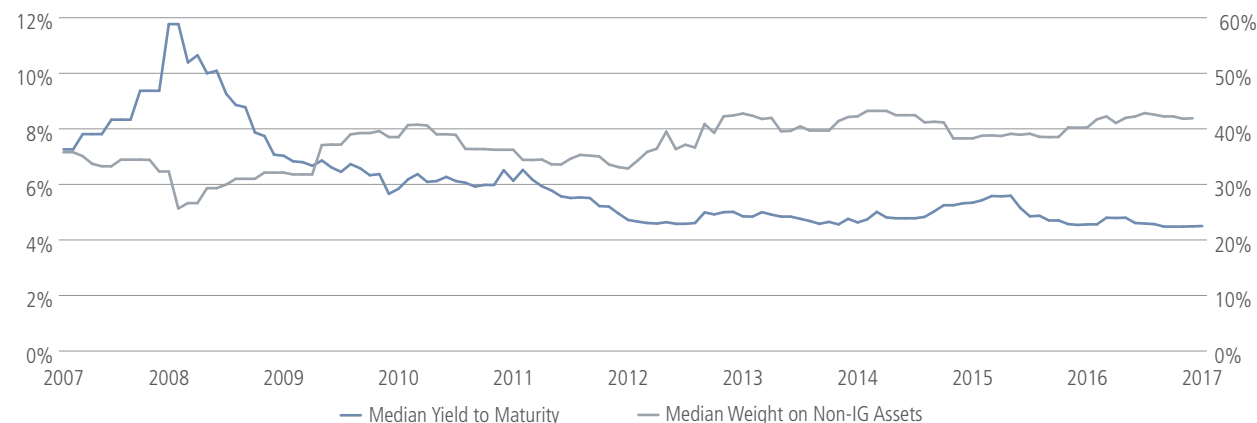
Source: Bloomberg, Neuberger Berman.

Note: Hard-Currency EMD = JPM EMBI Global Diversified Index; U.S. High Yield = ICE/BAML U.S. High Yield Constrained; U.S. Non-Agency MBS = ICE/BAML U.S. Mortgage-Backed Securities Index. Some U.S. Non-Agency MBS yield data reflect internal Neuberger Berman assessments of yields.

Increasing Drift in Sector Allocations. The median yield of multi-sector fixed income portfolios has been relatively stable over the past five years, fluctuating in a range of 4.00% to 4.50% (based on our analysis of Morningstar's Multisector Bond category). How does that stability square with an environment of generally declining interest rates and tightening credit spreads? As one may expect, the median fund has responded to broad market conditions by increasing allocations to income-generating sectors. Based on our calculations, over the past five years the median multi-sector fund has hiked its high yield exposure from approximately 33% to 41% (see Figure 7). From a credit perspective, multi-sector fixed income strategies are on average riskier today than they have been in the past.

FIGURE 7. MULTI-SECTOR FUNDS HAVE INCREASED WEIGHTINGS TO NON-INVESTMENT GRADE BONDS

Based on Funds in Morningstar's Multisector Bond Category



Source: Morningstar, Neuberger Berman.

The Future of Multi-Sector Fixed Income

Given the trends mentioned in the previous section, we see three primary challenges for multi-sector fixed income over the next five years:

- How to maintain income levels without significant increases in U.S. credit allocations or a deterioration in the quality of those allocations
- How to maintain positive expected total returns in an environment of low interest rates, tight credit spreads and relatively high correlations between risk assets and Treasuries
- How to ensure fixed income exposures contribute to overall portfolio diversification rather than detract from it

In our view, multi-sector fixed income—as a product, a solution and a strategy—is entering a transitional phase, as managers reposition themselves to meet the above challenges. Those that are successful in doing so will have a different orientation than they do today, likely incorporating many of the key elements we discuss below.

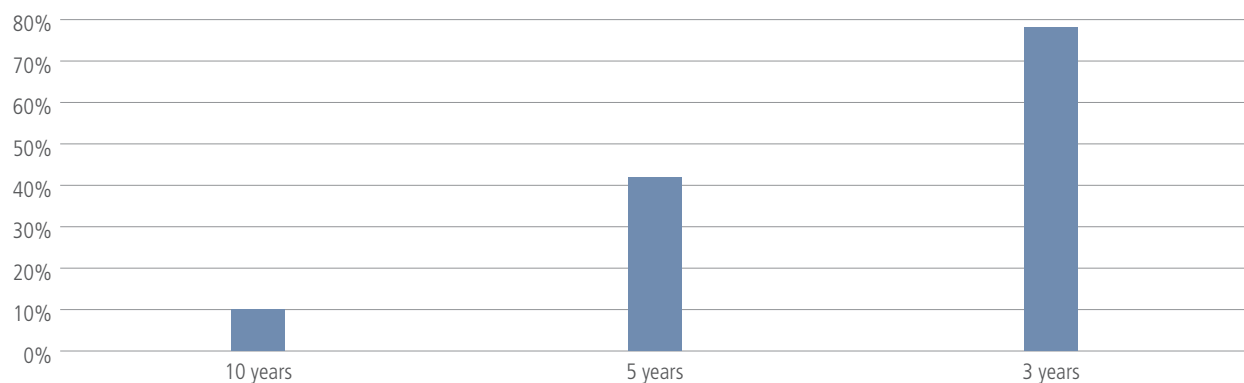
A Significant Expansion in the Range of Investable Assets. To manage multi-sector portfolios in a world of lower yields and rising correlations, investors will need to look beyond the usual levers of U.S. non-agency mortgages, U.S. high yield and hard-currency emerging markets debt. While these sectors will remain key components of multi-sector investing, additional sources of risk will be needed to generate income and total return while managing portfolio correlations.

While solutions will vary by client objectives and constraints, there are a number of sectors we expect to become more prevalent within multi-sector portfolios:

- *U.S. Municipal Securities.* An allocation to municipal bonds—in the forms of both high-quality Treasury substitutes as well as more credit-oriented issues that offer superior income potential relative to U.S. corporate credit—can help maintain a multi-asset portfolio's income level while providing access to a unique correlation structure. Meanwhile, recent U.S. tax law changes over time may enhance the bonds' portfolio diversification benefits.
- *Global Investment Grade and High Yield Corporate Credit.* For U.S. and Asian investors, investment grade and high yield markets in Europe and corporate credit in emerging markets offer attractive, currency-hedged yields. The attractiveness of these markets has risen significantly with their expansion to offer exposure to a broader array of credits and companies.
- *Local-Currency Emerging Markets Debt.* Because of its relatively attractive yields on a currency unhedged basis, local-currency EMD has seen modestly rising allocations within multi-sector portfolios. However, the relatively high volatility of this sector—and its recent high correlation to U.S. government bonds (see Figure 8)—has limited its attractiveness. We see both these characteristics changing over time, however. As developed market quantitative easing policies unwind, for example, we expect greater divergences between growth and interest rate cycles in economies across the world. Investing in local-currency emerging markets that can offer income within a differentiated growth or rate cycle will need to become a larger focus of multi-sector portfolios.

FIGURE 8. THE RECENT SPIKE IN CORRELATIONS BETWEEN LOCAL EMD AND TREASURIES SHOULD EASE

Monthly Returns Correlations between U.S. Treasuries and Local-Currency EMD



Source: Bloomberg, Neuberger Berman.

Note: U.S. Treasuries = Bloomberg Barclays U.S. Treasury; Local-Currency EMD = JPM GBI-EM Global Diversified.

- *China Debt.* While the pace of liberalization remains uncertain, the world's second largest economy is opening its financial markets to overseas investors. This is a significant development for global markets, and its importance is only going to increase over time. While credit research will be critical in the space, we see two key advantages for China debt within a multi-sector portfolio. First, the need for capital in this large and still-developing economy necessitates that relatively attractive yields be paid to attract investors. And second, while data is inherently sparse, our suspicion is that over time China's growth and interest rate cycles may have limited correlation to other markets, which should lead to portfolio diversification benefits for debt out of the country.
- *U.S. and European Private Debt.* The attractiveness of private debt from a yield perspective is clear. In many cases, yield and return objectives can be in the 7–12% range for U.S. private debt and in the 3–6% range for European private debt. We also believe these markets can offer significant diversification benefits to investors; for example, most private corporate debt strategies provide capital to a different type of credit than is accessible in the public markets. Meanwhile, the ability to use leverage and the flexibility in capital deployment also shape a differentiated return profile, which may be advantageous for multi-sector portfolios.
- *Alternative Income Strategies.* As mentioned earlier, multi-sector portfolios in recent years have relied primarily on the credit lever to add income and return to portfolios. However, we are seeing a broader range of non-credit strategies increasingly integrated into multi-sector mandates. For example, relative-value currency overlay strategies can provide additional total return with negative correlations to credit markets. Short-volatility or option-writing strategies allow investors access to another form of risk premium in the fixed income markets. And finally there's leverage; we expect some investors to consider whether a modest amount of leverage applied to a high-quality fixed income portfolio will generate superior total returns going forward relative to a more credit-oriented strategy.

Figure 9 summarizes our expectations for yields, total returns and correlations for the above sectors.

FIGURE 9. MULTI-SECTOR FUNDS ARE LIKELY TO EXPAND THEIR INVESTMENT UNIVERSE

Sector	Sector Yield / Return View	Correlation to U.S. Fixed Income	Comments
U.S. Municipals	2%-5%	Moderate	A substitute for both high- and medium-quality credit, with diversification benefits
Global IG and HY Credit	2%-6%	Moderate	Offers access to different types of corporate credit, quality and geographies
Local-Currency EMD	5%-10%	High, but likely moving lower	Higher income, and we expect lower correlations as global economic cycles diverge
China Debt	4%-6%	Modest positive	A differentiated fixed income asset class offering diversification benefits
Private Debt	3%-12%	Zero to small positive	Higher yields and a different type of credit exposure
Alternative Income	2%-4%	Negative to zero	Non-credit sources of risk premium may boost income and return

Source: Neuberger Berman.

A More Advanced Toolkit to Protect Principal. Given that in the current environment even a modest rise in interest rates or widening of credit spreads can quickly result in negative total returns for a wide range of fixed income assets, principal protection is a key concern of multi-sector investors. With market valuations somewhat stretched, this anxiety obviously is more acute today than at any point in the past five years.

We see multi-sector strategies increasingly employing two broad solutions to seek to preserve principal:

- *Tactical Duration Overlay Strategies.* With interest rates low and relatively range-bound in the post-crisis years, the duration decision has been of minimal importance; portfolio performance was far more dependent on credit sector, industry and geographic allocation decisions. While we continue to expect those decisions to be critical differentiators, we do expect duration positioning to grow in importance quickly over the next five years as global quantitative easing policies ebb and interest-rate volatility begins to rise. Tactical duration overlay strategies are one response to this dynamic that we believe will become more common. We expect higher-frequency trading strategies that generate signals to shorten duration—and thus attempt to better protect principal—either will become explicit standalone strategies or will be better integrated into multi-sector portfolios. A capability in these processes likely will be a prerequisite for a successful multi-sector strategy.
- *Unconstrained and Credit Long/Short Strategies.* Out of favor by investors because of disappointing returns and their general complexity, unconstrained and credit long/short strategies should see a resurgence in interest in combination with income-oriented multi-sector mandates. At one level, better integration of traditional fixed income approaches with more dynamic strategies represents the continued blurring of the line between traditional asset management and hedge fund-like strategies. However, unconstrained and credit long/short strategies are conservative in nature, as they are designed explicitly to forgo upside potential in return for downside protection. Integrating the principal protection of these approaches with broader, income-focused mandates likely will help in the pursuit of investor objectives going forward.

Greater Focus on Asset Allocation Decision Making. The final area in which we see multi-sector fixed income evolution centers on the asset allocation decision. Most institutions and individuals retain some asset allocation decision-making responsibility (deciding, for example, between developed markets versus emerging markets fixed income allocations) while outsourcing other asset allocation decisions via multi-sector-type mandates. As it diversifies risk for investors, this type of distributed approach will persist; however, we see a slow but increasing bifurcation between these two approaches, mainly due to the evolution of the markets. Increased information and technology, globalization and market integration, and frequency of short-term market perturbations will create a premium on both thoughtful long-term strategic allocation and shorter-term tactical allocation.

What will this mean in practice?

First, multi-sector fixed income mandates that employ only two or three sectors will be increasingly challenged in their search for high-quality alpha, and many investors will view their opportunity set as too narrow for the globalized fixed income universe. Investors will increasingly look to unbundle such limited mandates into single-strategy approaches focused on adding value through security selection.

Second, the value-add asset managers deliver to clients also will need to become more bifurcated. For clients that wish to maintain a high degree of control over their asset allocations, the ability to provide thoughtful and comprehensive strategic asset allocation advice will be a necessity for managers. For clients comfortable outsourcing most asset allocation decisions, managers will need to focus on the implementation of very broad multi-sector mandates with an increased emphasis on tactical positioning.

In our opinion, there is no “right” way to address these issues. On one hand, providing asset managers with greater latitude and more tools to pursue client objectives seems almost inherently a good idea—but that doesn’t eliminate the risk of a manager failing to meet these objectives. On the other hand, the increased speed and complexity of markets is creating demand for tactical asset allocation with the flexibility to generate excess returns. However these issues evolve, we are confident that they are only going to increase in importance, forcing both clients and asset managers to adjust to the new environment.

Conclusion

Over the past 40 years there has been significant change in the financial markets and the techniques used to extract value from them. We've seen U.S. long-term interest rates as low as 1.5% and as high as 20%. We've seen the creation of the euro and the rise of China and emerging markets as market powers. We've seen a generational financial crisis, the government response to which put in place a strong positive tailwind for investment strategies geared toward stable interest rates and falling credit risk premiums; multi-sector fixed income grew up in this world and delivered strong results for investors as a result.

But nothing lasts forever. Highly accommodative interest rate policies are slowly turning in a more neutral direction, while current high credit sector valuations almost certainly will prevent investors from reaping the same total returns over the next five years that they realized over the past five. Change is the natural order, however, and these and other developments merely point toward the need for a corresponding evolution in multi-sector fixed income investing. While the timing and speed of transition may not be known, the direction is clear to us.

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