

Strategy in depth

Long duration with a focus on credit

Implementing an effective long duration strategy has gained greater significance for defined benefit plans in the U.S. since the passage of the Pension Protection Act of 2006 (PPA). The PPA established new, minimum funding standards for corporate defined benefit pension plans in the U.S.

Capital Guardian has managed a government/credit-plus long duration strategy for more than a decade. We recently introduced a new long duration strategy focused on credit partly to meet the need of clients who need a tighter match between assets and liabilities. The existing long duration government/credit strategy is wider in scope, investing in corporate bonds and government securities for greater flexibility, but with a looser match to liabilities. Both the credit and government/credit long duration strategies are also offered in “plus” variations, expanding the universe of investments to include global high-yield bonds. Capital’s long duration strategies focus primarily on cash fixed-income securities, using interest rate derivatives sparingly and primarily for yield curve management and duration positioning.

Investment strategies

- Capital Guardian offers two long duration strategies: credit and government/credit.
- The two strategies are also offered in “plus” variations.
- The long duration credit strategy is designed to achieve a tighter match between assets and liabilities.
- Long duration government/credit is wider in scope and generally has a looser match to liabilities.
- These strategies focus primarily on fixed-income securities, using interest rate derivatives sparingly.
- The strategies are offered via collective investment funds and separate accounts.

The long duration credit strategy invests primarily in corporate bonds, making only tactical allocations to government bonds, some non-U.S. credits and the debt of quasi-sovereign entities. Under the PPA, the rate used to discount pension liabilities is derived from long corporate bond yields. Hence, a portfolio consisting primarily of corporate bonds will likely provide the best match between assets and liabilities.

The long duration government/credit strategy invests primarily in credit and government bonds. The government bond allocation in this strategy will be more strategic than in the long duration credit strategy. It will also invest in non-U.S. corporate bonds and taxable municipal bonds such as the recently issued California general obligation bonds. These bonds are often highly rated and provide good diversification within the portfolio. It is worth noting here that the two benchmarks used for long duration portfolios — the Barclays Capital Long Credit and Long Government/Credit indexes — have 15% to 17% in government-related non-corporate securities.

Both strategies — the long duration credit and the long duration government/credit — currently have duration targets of 12 years, matching the duration of the two Barclays Capital benchmarks. Nevertheless, clients have the flexibility of setting a longer or shorter duration target than that of the strategy, based on their needs and based on the duration of their liabilities. In the plus variations, managers can also tactically allocate up to 20% to Capital Guardian's Global High Income Opportunities Fund, which provides exposure to U.S. high yield and emerging markets debt. The strategies are offered via a collective investment fund or a separate account.

Team

A team of five portfolio managers is responsible for long duration portfolios. David Lee, Ellen Carr and Andy Barth are the three portfolio managers specializing in credit markets, while Wesley Phoa and Kevin Adams are responsible for interest rate markets.

David's strength is the investment-grade corporate bond markets. He has a deep understanding of a broad swath of industries and companies in the investment-grade universe. Ellen's expertise is in both high-yield and investment-grade securities and she likes to invest across the capital structure of companies. Andy's background is in equity research; he also has extensive knowledge of financial companies. On the interest rates team, Wesley specializes in U.S. government bonds as well as quasi-government debt, including agency bonds. Kevin follows both U.S. and non-U.S. government bond markets and inflation-linked securities.

Investment process

The investment process for managing long duration portfolios mirrors the approach we use for managing all fixed-income portfolios. Research consists of four elements: economic analysis, interest rate research, credit research and quantitative analysis.

Investment decisions are made at two levels. Three macro decisions are made by a team consisting of portfolio managers and experts: (1) duration, (2) sector positioning among credit and U.S. government bond markets, and (3) tactical asset allocation to global high yield, where appropriate.

Once the broader duration, sector positioning and asset allocation decisions are made, the three credit portfolio managers make investment decisions on industry and credit selection. Managers believe that combining top-down and bottom-up approaches and Capital Guardian's extensive macro and micro research capabilities allows for optimal portfolio construction. Following are details of how the individual elements of our portfolio construction process work.

Macro decisions

Duration: Since the aim of the strategies is to minimize duration risk and volatility in the funded status of the overall plan, the team typically does not vote for any strong views on duration. But there are occasions when the fixed-income team believes it to be highly likely that the yield curve is going to steepen or interest rates will move higher or lower. In such instances, it might vote for a longer or shorter duration than the target. Once the target is set, the two managers responsible for interest rates — Wesley and Kevin — will implement the duration vote in the most efficient manner possible. They evaluate relative value among Treasuries, futures, zero coupon bonds and interest rate swaps to achieve best execution. The effort is always to use cash securities and make minimal use of swaps. Clients can also have a customized duration target that is different from that of the fund or the benchmark.

Sector positioning: In the long duration government/credit strategy, the allocation to corporate bonds versus U.S. government bonds is also a key component. Historical data shows that in most normal market cycles, credit generally provides a yield advantage, or spread, over Treasuries. In longer maturities, the yield spread can be even wider. Over long periods, the allocation to credit could provide substantial income and total return. Mispricings or extremes in valuations can occur due to the interest rate cycle, monetary policy, inflationary pressures or specific credit events. In such periods, sector allocation can be an important source of excess return.

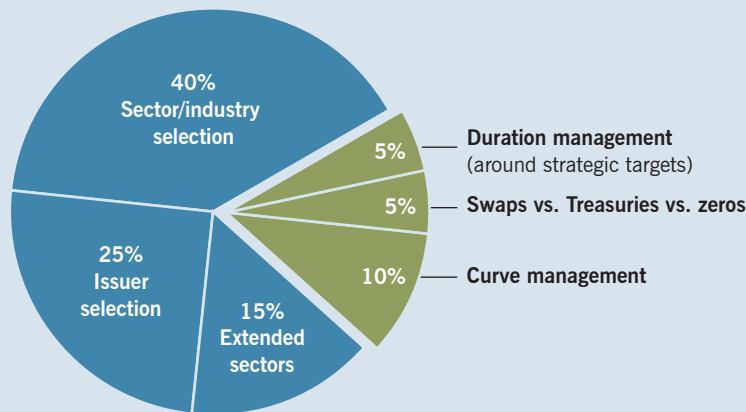
Allocations to the extended sectors: In the plus strategies, the allocation to global high yield is tactical and driven by valuations. Over longer periods, global high yield can be an effective source of total return and diversification. Although this component of the return is likely to be more volatile, it should provide valuable diversification. Often, managers vote to layer in small amounts of global high yield in a gradual process where the risk and return are in smaller increments and will have a lesser impact on the overall return profile.

Micro decisions and research

Credit management and research: Credit investment is at the core of managing long duration portfolios at Capital Guardian, and we expect it to be the largest source of excess return. The three credit managers are responsible for industry, issuer and security selection. They are supported by a team of more than 20 credit analysts who conduct research across sectors and industries.

Bond management can add value

Focus on bond management to maximize total returns



Source: Capital Guardian Trust Company
For illustrative purposes only.

The credit research process benefits from Capital Guardian's full spectrum of coverage of companies across equities, bonds and bank debt. It allows managers and analysts to evaluate securities across the capital structure of a company and across companies in an industry. The collaboration between economists and bond and equity analysts also enables them to build both micro and macro views of the economy. Observing developments at the company level, economists often collate what individual analysts are observing and cross-check that with what macroeconomic data is depicting.

The decision-making process within the credit sphere has several layers. At the highest level, managers decide on the subsectors to emphasize, such as utilities, financials or industrials. The second decision is on industry selection — for instance, within utilities, should we invest in the pipelines or electric utilities?

The next step — traditional bond picking — is arguably the most important part of the process. This is where we bring our credit analysis to bear and where our managers benefit from the depth and breadth of that research. Within wireless telecommunications, for example, this would mean comparing and contrasting the likes of AT&T, Verizon or Sprint. It also involves looking at where to invest within the capital structure of a particular company.

Although credit default swaps are a part of the credit markets, Capital Guardian has made the decision to not invest in them. The counterparty risks in credit default swaps are not insignificant. Moreover, liquid credit default swaps do not extend beyond the five-year maturity in general, making them even less useful in

long duration portfolios. Managers prefer to construct portfolios with cash corporate credits as much as possible. In our view, there is sufficient market capitalization and liquidity at the long end of the credit curve to meet current market needs for long duration portfolios.

Interest rate research: Interest rate research is a key component of managing government bond portfolios in the long duration government/credit strategy. The research also provides important input in our overall view of the interest rate cycle and what that means for the economic backdrop.

The positioning along the yield curve is often the most important decision.

Managers spend considerable time with the research analysts and economists to get a comprehensive view of the shape of the yield curve, especially at the long end. Managers will ask questions such as: Are there any unintended consequences because we could not find a 22-year off-the-run bond? Are there any holes in our positioning along the yield curve that could have negative consequences? In such cases, interest rate swaps can play an important role in managing yield curve risk and filling any gaps along the yield curve.

Within the allocation to Treasuries, managers will often express a view on particular points within the longer-dated part of the yield curve, whether they expect it to steepen or flatten. The work of the quantitative group as well as the macroeconomists has a significant input into this decision-making process. While the duration positioning is done by a team vote, the actual yield curve positioning is a manager decision. Finally, the two government bond managers will also make relative value selections within the interest rate sectors — whether to invest in government agency debt or inflation-linked bonds over Treasuries, for example.

Quantitative analysis

Dedicated quantitative analysts are responsible for identifying anomalies within interest rate markets, including government, agency debt and mortgage-backed securities. Analysts look at several variables, including break-even inflation, spline regressions and other estimations of forward curves. Two dedicated quantitative analysts focus on the interest rate markets and are supported by a wider group of technology and quantitative specialists.

Manager decision process — credit security selection



David Lee
Portfolio manager

Inputs

Example:

Telecommunications company bond

<p>1. Big picture Forms an opinion on the broader economy, inflation and interest rates outlook, and sets a duration target</p>	<ul style="list-style-type: none"> • Capital Strategy Research • Personal views 	 <p>Darrel Spence Economist</p> <p>A team of macroeconomic and quantitative analysts helps set the big picture framework</p>
<p>2. Industries Identifies industries that are either structurally or cyclically attractive</p>	<ul style="list-style-type: none"> • Research analysts • Research clusters 	 <p>Telecom cluster</p> <p>Analysts covering telecommunications help shape a global industry view.</p>
<p>3. Companies Focuses on companies to own</p>	<ul style="list-style-type: none"> • Research analysts 	 <p>Scott Sykes Fixed income</p> <p>Company insights from both bond and equity analysts</p>  <p>Jin Lee Equity</p>
<p>4. Bonds Identifies specific bonds in which to invest</p>	<ul style="list-style-type: none"> • Research analysts • Traders 	 <p>Frances Sweeney Trader</p> <p>Input on market technicals and valuation</p>

For illustrative purposes only.

Conclusion

A long duration strategy with an emphasis on credit securities can provide a good match to pension fund liabilities and will likely help improve the funded status of a corporation's pension fund over time. This can be achieved by shifting some fixed-income assets from regular bond portfolios to long duration credit or government/credit portfolios. In addition to providing a better match to liabilities, long duration corporate bonds also generally provide a significantly higher yield than a core bond portfolio. This is reflected in the broad market benchmarks. For example, the Barclays Capital Aggregate Index yielded 3.5% as of the end of the first quarter of 2010, while the yield on the Barclays Capital Long Credit Index was about 6.1%, allowing for a yield pickup of 260 basis points.

Capital Guardian has more than a decade of experience managing long duration portfolios. The advantages we offer are: (1) extensive depth and breadth of research that spans the credit and interest rate sectors, (2) an experienced team of portfolio managers and analysts, (3) ease of delivery through collective investment funds or a separate account, and (4) low use of derivatives. ■

For more information on our long duration strategies, please visit capitalguardian.com.

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