For professional clients only
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Buy and Maintain

Avoiding index-based pitfalls with a buy and maintain strategy

In this article, Lionel Pernias, Fund Manager of the AXA Sterling Buy and Maintain Credit Fund, answers five questions and discusses his Buy and Maintain strategy and where he is seeing the best opportunities in IG bonds.

Lionel Pernias, Fund Manager, AXA Sterling Buy and Maintain Credit Fund

1. Could you explain your buy and maintain strategy and how it differs from normal passive funds?

Both are low cost investment strategies and both aim to provide investors with 'efficient' exposure to the relevant asset class (in this case, investment grade credit). This is where the similarities end however.

A normal passive fund is tied to an index (which typically rebalances at the end of each month) and is managed according to a rules-based approach. It is estimated that following these rules costs a typical passive fund 25 basis points per annum in unnecessary transaction costs[1]…leading us to believe they are not so 'efficient' after all. On top of that, investment is based on market capitalisation, with no regard for fundamentals – by definition leading to an overweight of the most indebted companies/sectors. We believe the notion that a passive fund is well diversified therefore deserves further scrutiny.

Our buy and maintain strategy was designed explicitly to avoid the pitfalls of rules-based passive investing and deliver truly efficient, long-term exposure to the asset class. We take an index-agnostic approach, and instead use a bespoke top-down framework which aims to mitigate downside risk through careful diversification across sectors, regions and issuers. This is combined with rigorous bottom-up fundamental analysis, with the aim of investing strictly in quality companies whose bonds can be held to maturity – thus avoiding unnecessary transaction costs. The result is low cost exposure to investment grade credit, with less downside risk than an investor in a passive fund would typically be exposed to.

2. How does it avoid the inefficiencies in passive or index-tracking approaches?

In spite of the strategy name, our portfolio construction and risk monitoring processes are very much 'active' and pragmatic – and not at all rules-based.

For example, anytime a bond is downgraded to sub-investment grade ("high yield"), a typical passive fund is forced to sell it – irrespective of price. So not only does it sell bonds that may never default, it also sells them when the market makers are expecting it (and have adjusted their prices accordingly).

[1] Source: Barclays Research as at 31/01/2017. Analysis over a period of 16 years in the world's largest investment grade credit market (USD) which found that forced selling by passive funds cost an average of 25 basis points per annum in unnecessary transaction costs.

Passive funds also sell when a bond reaches one year to maturity, missing out on any "pull to par" performance.

We do not automatically sell on downgrade if credit quality is sound, nor when a bond is approaching maturity. This leads to lower turnover, which minimises performance leakage.

We also avoid the biases of the index (e.g. exposure to sector 'bubbles') through our framework which aims to mitigate risk. This is complemented with thorough bottom-up research which helps us avoid the most stressed or overvalued parts of the market – something a passive fund simply doesn't benefit from.

Finally, many passive funds are unable to participate in the new issue market, missing out on attractive concessions versus secondary levels. We aim to maximise our use of this low-cost entry point, and strive to cultivate strong relationships with underwriters in order to receive good allocations.

3. Does a buy and maintain approach circumnavigate various issues like liquidity and higher transaction costs?

Yes – this is exactly what they were designed to do.

The decline in liquidity since the crisis combined with historically low yields has meant the cost of trading is increasingly punitive: a decade ago the average bid-offer spread on a sterling investment grade bond represented less than 10% of the annual yield; today it's over 30%. Generating alpha from active trading is therefore much more difficult. By holding quality bonds to maturity, a buy and maintain approach is able to dramatically reduce transaction costs – thus limiting performance leakage.

In order to actively refresh buy and maintain portfolios without the need to sell bonds, we carefully ladder maturities in order to have steady 'organic' cashflow to reinvest. This allows us to benefit from new opportunities and maintain the desired portfolio characteristics of the fund over the long term without incurring unwanted transaction costs.

4. Where are you seeing the best long-term opportunities in IG bonds?

The rapid expansion of central banks' balance sheets over the last decade has meant that bond markets have benefitted, primarily, from technically-driven performance. This looks set to change with the end of quantitative easing, when fundamentals will begin to take precedence once again. We are closely watching for late-stage cycle signs of corporate activities, like shareholder-friendly activity.

Given the long-term nature of our strategy, we have always placed a strong emphasis on fundamentals and take a forward-looking approach when assessing opportunities.

We are currently very cautious on (supposedly) defensive sub-sectors which have problems adjusting to rapid technological changes or new consumer patterns (for instance, companies within the retail sector which struggle to generate online revenues).

When we have the opportunity to reinvest natural cashflow within our portfolios we focus primarily on sectors like UK utilities, where the regulatory oversight is seen as the global benchmark. We also favour investment in well-positioned corporates, like the leading mining companies given their diversification in terms of commodities as well as their impressive geographic exposure with assets spread across the globe. We also like some parts of the financial sector, which is now better-regulated and has gone through recapitalisation post the Crisis.

5. How is a Buy and Maintain fund likely to complement a fixed income portfolio? Do you view it as a cheaper alternative to a core or active IG bond fund?

We view it as a cost-effective alternative to a long-term 'core' investment grade bond allocation.

In our experience, investors are increasingly focussed on the fees that they pay, and whether these represent true 'value for money' when manager performance is taken into account. By adopting a low-cost, conservative strategy such as buy and maintain for their core allocation, an investor can free up more of their fee and risk budgets for higher-octane 'satellite' strategies, resulting in a more efficient overall portfolio – and better value for money.

Investing in buy and maintain strategies involves risks, including the loss of your capital.

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