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Actively navigating rising rates

PIMCO Low Duration US Corporate Bond Source UCITS ETF Strategy Spotlight by Lillian Lin and Anna Dragesic

In the following Q&A, portfolio manager Lillian Lin and product strategist Anna Dragesic discuss why the actively managed PIMCO Low Duration US Corporate Bond Source UCITS ETF may be an attractive solution for investors seeking credit exposure in an environment of changing monetary policy.

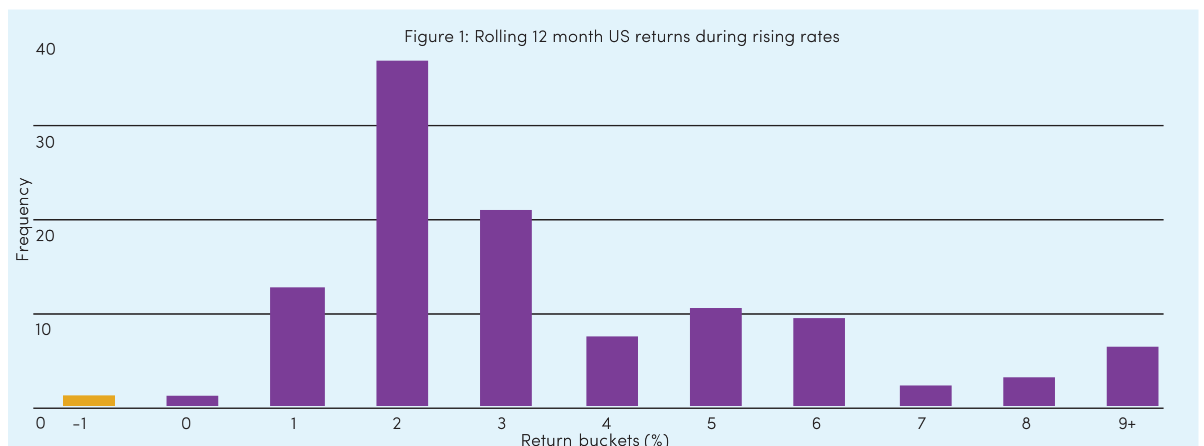
Q: What are the implications for credit investors of a rising rate environment?

Lin: Given rising interest rates, we are taking a more neutral view on investment grade (IG) credit overall. We see that the tailwinds from tax reform (positive technicals from reduced issuance and more debt buyback activity) and healthy IG corporate fundamentals are balanced by recent spread tightening and potential headwinds from rising hedged foreign yields. Given all this, we feel that new corporate bond issuance should decline, and we should see more active tenders (i.e. debt buybacks) for high-coupon bonds. At the same time, we believe demand for credit-related assets from investors should increase due to higher yields and improving technicals. However, investment grade spreads have already tightened in the never-ending search for yield, limiting the potential for further spread tightening. For investors who still need income but prefer less exposure to interest rate risks, one possible solution is to reduce longer-maturity credit risk and interest rate risk by investing in short-dated corporate bonds.

Q: What are the key potential benefits of short-dated corporate bonds?

Lin: Short-dated corporate bonds may reduce interest rate sensitivity and have the potential to outperform long-dated Treasuries and the broad corporate market at times when rising interest rates spur market volatility, along with liquidity challenges from the resultant outflows. Short-dated corporate bonds have higher Sharpe ratios than intermediate or long-dated corporate bonds, indicating a generally more favourable risk-adjusted return profile. These bonds occupy a unique part of the credit curve where the duration is close to the yield. With a duration typically between two to three years, the ICE BofA Merrill Lynch 1-5 Year US Corporate Index has less than half the interest rate sensitivity of the full corporate bond universe and therefore will likely feel less of an impact when rates rise. And given the higher yield per unit of duration for this index, it tends to make up any negative impact sooner, leading to fewer negative rolling-12-month returns during periods of rising rates (see Figure 1).

Negative rolling-12-month returns have been rare for short-dated bonds when rates are rising



Source: PIMCO and ICE as of 31 December 2017, reflecting data from December 1996–March 2016
Benchmark: ICE BofA Merrill Lynch 1-5 Year US Corporate Index

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Short-dated corporate bonds also offer higher coupons compared to government bonds and are a more defensive way to take credit exposure: The drawdown since mid-2000 has been approximately 60% of the full-maturity credit index, represented by ICE BofA Merrill Lynch Corporate Index.

In sum, we believe short-duration corporate bonds offer a number of potential advantages, including income, liquidity and reduced volatility compared to longer-dated bonds.

Q: What are some of the potential risks?

Dragesic: Investors should remember that short-duration corporate bonds are not risk free. As with other corporate bonds, they have credit or default risk – the risk that the borrower fails to repay the loan and defaults on its obligation. They are also subject to spread risk, which is the risk that credit spreads widen, and although short-dated, they may still be exposed to potential losses if interest rates rise. PIMCO seeks to mitigate these risks via robust credit research and an active investment approach.

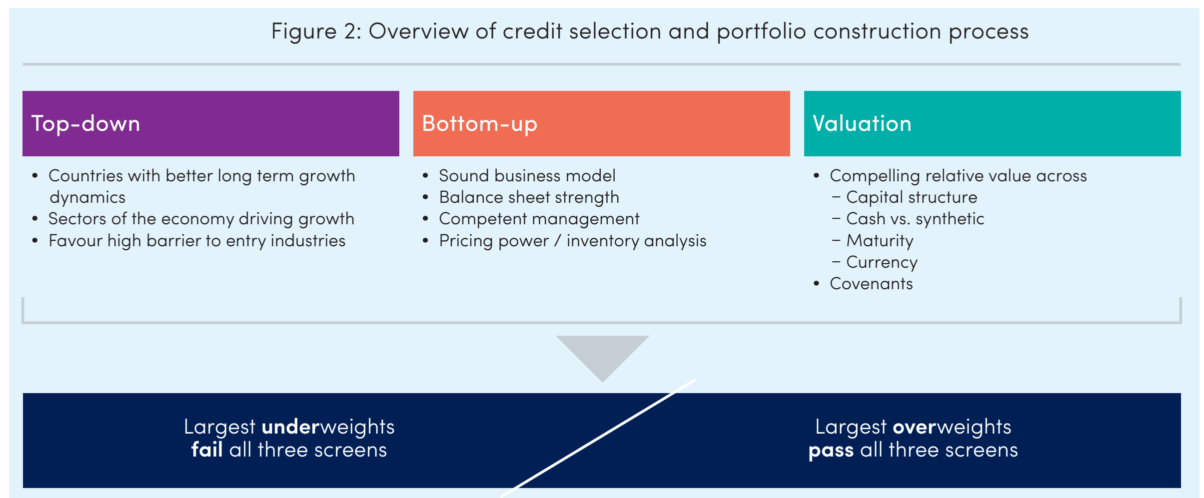
Q: What is PIMCO's process for selecting short-dated corporate bonds?

Dragesic: PIMCO's approach to investing in short-dated corporate bonds involves a three-step process in which we evaluate top-down considerations, bottom-up fundamentals and valuations. Through this process, we aim to identify sectors and companies with high barriers to entry, superior growth potential, strong pricing power and favourable asset quality, along with management teams that support bondholders.

The process is anchored by PIMCO's Secular and Cyclical Forum process, which provides the framework for overall industry allocations and the level of credit risk. In addition, our global investment team of more than 60 credit analysts and over 50 credit portfolio managers enables us to perform in-depth bottom-up credit research, thereby seeking to reduce default risk and avoid overvalued credits. Moreover, as a large lender, PIMCO offers the distinct advantage of being able to engage in reverse inquiries.

In one recent example, PIMCO negotiated an exclusive private placement with a large U.S. company looking to fund an acquisition – a sizable transaction for which spreads have since tightened by 40%.

Figure 2: Overview of credit selection and portfolio construction process



Q: How can an active approach potentially enhance yields?

Lin: Shifting to a low duration strategy typically involves a compromise: Yields may be attractive on a risk-adjusted basis, but they tend to be lower than for the broad market. An active strategy can help to narrow this gap and provide a yield closer to that of full-maturity credit, with much lower duration. For example, the PIMCO Low Duration US Corporate Bond Source UCITS ETF – an active strategy investing primarily in investment grade U.S.-dollar-denominated corporate bonds with less than five years to maturity – has a yield similar to that for the full-maturity U.S. corporate index.

We attribute this to our focus on identifying particular sectors and specific issuers that offer opportunities for enhancing yield while avoiding segments of the market that we view as unattractive on a risk-adjusted basis.

Today we are targeting a yield advantage by favouring oil and gas pipelines and building materials companies, which are less likely to issue one- to five-year debt. We also have a constructive view on the consumer sector. We favour issuers who are on a steady deleveraging path, with select bonds priced at a discount to similarly rated bonds. Valuations are also stretched in certain sectors around the globe due to industry-specific dynamics, such as pricing and competitive pressures and risks of product obsolescence. As a result, we remain cautious on many companies in these sectors, which include technology and metals & mining (commodities).

Q: How can short-dated corporates help navigate a rising rate environment?

Dragesic: Short-dated corporates have a structurally lower duration than a traditional corporate bond portfolio, which helps to naturally defend against rising rates. The PIMCO Low Duration US Corporate Bond Source UCITS ETF allows for the ability to adjust duration between zero to four years depending on our forecast for interest rates; this allows PIMCO to potentially limit the downside impact of interest rate changes even further when we anticipate higher rates. For example, from the beginning of September 2017 through the end of January 2018, the yield on two-year Treasuries increased by around 80 basis points (bps), while the PIMCO Low Duration US Corporate Bond Source UCITS ETF managed to mitigate negative performance, outperforming the benchmark by 65 bps (see Figure 3 for since inception performance).

Figure 3: Performance

As of 28 February 2018	Since incept 17 Nov 2014	3 Yrs	2 Yrs	12 Mon	Ytd	2017	2016	2015
Fund After Fees (%)	2.63	2.61	3.52	1.91	-0.38	3.32	4.70	1.26
Benchmark (%)	1.79	1.70	2.11	0.95	-0.81	2.64	2.96	1.27
After Fees Alpha (bps)	84	91	141	96	43	68	174	-1

Source: PIMCO as of 28 February 2018.

Past performance is not a guarantee or a reliable indicator of future results. Benchmark: ICE BofA Merrill Lynch US Corporate 1-5 Year index. Partial year performance from 17 November 2014. All periods longer than one year are annualised.

Moreover, the strategy's focus on credit instruments means that it will empirically behave as if it has less interest rate risk than might be initially estimated. This is because there are factors other than interest rate movements, such as credit spreads, that will drive price movements. Given our focus on companies and industries that are experiencing above-average growth, improving fundamentals and tightening spreads, investors may still be rewarded with bond price appreciation even if interest rates were to rise.

Q: Where could the fund fit in an investors' portfolio?

Dragesic: The PIMCO Low Duration US Corporate Bond Source UCITS ETF offers a potential solution for actively managing the impact of higher U.S. interest rates. Specifically, it may fit within an investor's low duration fixed income allocation. The strategy will have more risk and volatility than a traditional low duration government portfolio; however, investors with exposure to short-term government bonds may consider moving part of this allocation into credit to diversify their exposure while seeking to maintain elevated yields. Alternatively, this strategy might be used as part of a credit allocation for investors who seek to benefit from global growth but want a high-quality credit alternative with less price volatility relative to what a traditional corporate bond portfolio (with its higher duration) generally delivers. An active approach to managing low duration exposure is one way for investors to be more vigilant with their fixed income investments in today's market.

Investment Risks

Counterparty risk: Other financial institutions provide services such as safekeeping of assets or as a counterparty to financial contracts such as derivatives. The fund is exposed to the risk of bankruptcy, or other type of default of transaction counterparties.

Fixed Income risk: There is a risk that the institution which issued the securities will fail, which would result in a loss of income to the fund. Fixed income values are likely to fall if interest rates rise.

Liquidity on secondary market risk: Lower liquidity means there are insufficient buyers or sellers to allow the fund to sell or buy the fund's Investments. On-exchange liquidity may be limited due to suspension of Reference Index pricing, a decision by one of the relevant stock exchanges, or a breach by one or more market makers of respective stock exchange requirements and guidelines.

Risk of using derivatives: In order to reach its investment objective, the fund may use swaps, including futures and forwards. Such derivatives may result in gains or losses that are greater than the original amount invested.

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UCITS ETF's units / shares purchased on the secondary market cannot usually be sold directly back to UCITS ETF. Investors must buy and sell units / shares on a secondary market with the assistance of an intermediary (e.g. a stockbroker) and may incur fees for doing so. In addition, investors may pay more than the current net asset value when buying units / shares and may receive less than the current net asset value when selling them. In no way should Source UK Services Limited or PIMCO Europe Limited be deemed to be holding itself out as a financial adviser or a fiduciary. PIMCO Source ETFs constitute exchange traded funds issued by an Irish domiciled company, PIMCO Fixed are available at PowerSharesETF.com. German investors in Source ETFs may obtain the offering documents in paper or electronic form free of charge from the German information and paying agent (Marcard, Stein & Co AG, Ballindamm 36, 20095 Hamburg, Germany). 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