Efficient Core Strategy: Academic Rationale

**EFFICIENT CORE STRATEGY**

To reduce the volatility of their overall portfolio, many investors allocate a portion of their overall portfolio to a single investment that exposes them to a broad portion of the investment grade bond market, frequently referred to as **core fixed income**.

- Many active core managers use the Bloomberg Barclays US Aggregate Index ("Bloomberg Barclays Agg") as their investable benchmark
- Our research suggests that understanding the sources of active manager excess returns is important to avoid unexpected volatility that can counter the primary objective

LGIMA analyzed sources of excess return, including asset class rotation and security selection within each asset class. We found:

- Active asset class rotation typically leads to significant volatility without commensurate excess returns
- Security selection within credit offers strong excess returns with minimal tracking error
- Within the Bloomberg Barclays Agg, government and securitized sectors offer more limited security selection opportunities

**LGIMA’S APPROACH TO EFFICIENT CORE**

Based on these findings, investors seeking an active core portfolio that will deliver excess returns with minimal tracking error would be well served by a hybrid active/passive approach.

The LGIMA Efficient Core strategy offers a low fee hybrid approach, blending a passive and active core strategy to harness higher risk-adjusted returns.

- The LGIMA Index team maintains index exposures to government and securitized
- Uses active management within credit
- The Active Fixed Income team takes advantage of inefficiencies
- Focuses on corporate sector rotation and security selection based on fundamental research

**DIFFERENTIATORS**

The strategy is a hybrid approach, where Active management is focused on the credit component where there are more inefficiencies to take advantage of from an alpha generation perspective. The asset allocation between the sectors is passive with the securitized and government components managed passively as well.

Our research indicates there has been a higher information ratio (top 5%) historically from security selection rather than asset class rotation for managers that manage a fixed income strategy relative to the Bloomberg Barclays Agg. The historical return and information ratio for the credit component relative to the overall Bloomberg Barclays Agg has also been higher.

1 Evestment as of June 30, 2015.

**SECURITY SELECTION**

- We believe security selection is a more effective way to deliver alpha in the core fixed income portfolio
- Median security selection excess returns and information ratios are much higher in the credit sector than in other asset classes
- Logical conclusion is that the credit sector offers most active security selection opportunities
- Likely due to lower transparency, less liquidity, actual credit risk (as opposed to government guaranteed), and higher transaction costs

**Information ratio of highly skilled managers (top 5%)**

**Median security selection return**

- 0.31% for Barclays Aggregate
- 0.28% for US Credit

**Median security selection information ratio**

- 0.72 for Barclays Aggregate
- 0.54 for US Credit

**Source:** Evestment data as of June 30, 2015.
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SECTOR ROTATION VS. SECURITY SELECTION

LGIMA separates active decisions against the Bloomberg Barclays Agg across two dimensions

- Sector rotation: manager takes a macro view to over- or under-weight a sector class
- Security selection: manager takes an active view on individual securities within an asset class

Based on the data, active managers are rarely good at both

- Intuitively this makes sense, as it is difficult to have expertise in every sector and understand every issuer intimately without a tremendous amount of resources (and related costs)

SECTOR ROTATION

Sector rotation typically incorporates a macro view, but can be limited in a Bloomberg Barclays Agg mandate by:

- Correlation between asset classes
- Constraints in moving away from benchmark

We found that sector rotation can lead to concentrated risks without commensurate excess returns. Persistent overweights to credit are common.

These positions perform well in calm markets but poorly during periods of volatility, and they are arguably just a form of market exposure or beta. Based on these findings, the Efficient Core product will maintain benchmark allocations.

EFFICIENT CORE TEAM

- Experienced portfolio management
- Focused team of research analysts
- Organized to create greater sector depth

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Key risks: Strategy subject to various risks including duration, credit and default risk.