Unconstrained Bond Funds Struggled in Good Times. But They Might Just Be the Answer as Yields Rise.

Be careful what you wish for. Bond investors, who have spent the past decade bemoaning the difficulty of finding yield, are now contending with losses caused by rising yields in their bond funds. The solution may come from an unloved sector—unconstrained bond funds.

Like liquid alternatives, unconstrained bond funds emerged in the wake of the financial crisis, as fund managers anticipated that the economic recovery would cause the Federal Reserve to raise interest rates, driving up Treasury yields and pushing down prices of long-term bonds.

The idea was that star bond fund managers—once freed from the constraints of traditional style boxes—would be able to go further afield than traditional core bond funds, which usually limit themselves to high-quality government and corporate bonds. Instead, unconstrained (also called nontraditional) funds were designed to protect investors against losses that come with rising yields by making unconventional calls, such as betting on Treasury-market losses and delving into riskier and more esoteric corners of debt markets, sometimes even owning stocks.

It didn't work out that way. While the category saw assets grow more than tenfold between 2008 and 2015, according to S&P Global, it was soon beset by concerns about high fees, risks introduced by the unusual level of manager autonomy, and the inherent difficulty of evaluating a diverse category without a clear benchmark or theme. The category's assets now total $148 billion, according to Morningstar, only about 6% more than they had in 2015, when Josh Brown of Ritholtz Wealth Management wrote that investing in the category was "the biggest mistake" investors were making.

"The next time the [stock] market goes offsides, I want Treasuries," says Michael Batnick, director of research with Ritholtz Wealth Management. "If rates do continue to rise and we get a regime change, this would be a better opportunity for non-traditional bond funds, because the past five years have been pretty tough."

In other words, if there were ever a time for unconstrained bond fund managers to prove their worth, this is the year. Bond markets have been hammered by rising Treasury yields. Safer corporate and government bond markets have near-record levels of duration, or sensitivity to increases in benchmark yields. In fact, the non-traditional bond fund category is up 0.7% so far this year, compared to a loss of 3.2% for corporate bond funds, according to Morningstar.

"Unconstrained bond funds can be a lot more tactical, can dial down the duration, and opportunistically go into markets like emerging-market debt or high yield when those sectors make sense," says Bob Michele, chief investment officer for fixed income at J.P. Morgan Asset Management.

Nontraditional funds' flexibility is important today because investors don't have many good options in fixed income. "Safe" bonds, which investors typically use for capital preservation, have experienced significant losses as Treasury yields rise. For example, the $1 billion JPMorgan

Unconstrained Debt fund (ticker: JSIAX), which Michele manages, had investment-grade corporate bonds and mortgages as its biggest allocations earlier this year, which are relatively sensitive to yields. The fund has posted a 0.2% loss so far this year, according to Morningstar. While that lagged behind the category, it still easily beat the 2.6% loss posted by core intermediate bond funds.

High-yield bonds remain fairly attractive, Michele says, as riskier companies should keep benefiting from the recovery. His fund has 28% of assets in high-yield or unrated bonds.

"Nothing is cheap," says Gene Tannuzzo, head of global fixed income at Columbia Threadneedle Investments. "In many rising-rate environments, you can substitute credit risk for interest-rate risk and perform better. There's some truth to that still, but you have to be careful when your starting point is that credit spreads are already tight." He compared today's markets to the first nine months of 2018—while there was no pandemic overhang, there was plenty of concern about the economy overheating, which drove up long-term bond yields.

Tannuzzo helps manage the $6 billion Columbia Strategic Income fund (COSIX), which has been buying residential mortgages that aren't guaranteed by agencies, since they offer better valuations than the high-yield bond market more broadly.

Treasury yields are expected to keep rising—for a while, at least—as the government's $1.9 trillion in Covid-19 aid boosts the U.S. recovery. Losses in the iShares 20+ Year Treasury Bond exchange-traded fund (TLT) have added up to nearly 13% this year.

"That's equity-like returns, but in the wrong way," says Rick Rieder, chief investment officer of global fixed income at BlackRock, who manages the $39 billion BlackRock Strategic Income Opportunities fund (BASIX). "People don't expect AAA-rated assets to be down [that much] in three months."

The near-term outlook isn't much better for other highly rated bonds. Corporate debt valuations are near, and in some cases richer than, levels from before the pandemic. And the investment-grade bond market's duration, or its sensitivity to changes in Treasury yields, reached an all-time high last year. It is still higher than it has been at any time before 2020, after companies issued record amounts of debt with low coupons and long maturities to refinance debt sold to weather the pandemic.

Even with the recent rise, bond yields remain very low relative to inflation: The ICE BofA Corporate Bond Index yields 2.2%, while market gauges reflect inflation expectations around 2.6% over the next five years.

Yields are so low that Rieder is buying stocks; they make up more than 5% of assets. He says stocks provide a free-cash-flow yield that easily beat yields on Treasuries—and stocks aren't going to keep posting quarterly losses if yields rise further. Rieder is also bullish on floating-rate loans, bank debt, floating-rate preferred shares, and plays on the recovery.

Rieder isn't alone venturing into equities, which creates questions about the role of unconstrained funds in a portfolio; fixed income is often seen as a portfolio hedge to offset stock market declines. But as the market's interest-rate sensitivity has climbed in recent years, the performance of more staid sectors have seemed unusually volatile. Corporate bond funds, for example, lost 2.5% in 2018, and then returned 13% and 9.2% in 2019 and 2020, respectively.

Unconstrained managers say they can help diversify and offset losses investors might experience in years like this one, because the funds are meant to provide exposure that isn't strongly correlated with the broader bond market.

“We wouldn’t be pounding the table for people to get out of traditional [bond] funds, but to look for diversifiers, or enhanced flexibility in an overall portfolio,” says Marc Seidner, manager of the $3.7 billion Pimco Dynamic Bond fund (PUBAX).

One larger reason for caution is that unconstrained managers are able to make larger, more concentrated bets that can go wrong. The $13.8 billion Templeton Global Bond fund (TPINX) saw a 4.4% loss last year after betting that the Treasury market would fall, before yields dove during the pandemic. The firm closed the bet in the first quarter of 2020, but still experienced the most outflows of any fixed-income fund last year, according to Morningstar.

While it is difficult to anticipate a pandemic, the losses do highlight a risk of active management that’s ever-present in unconstrained funds: Managers have the ability to make large bets that can go wrong. And broadly, investors need to do extra research before buying nontraditional funds, which don’t fit neatly into style boxes or invest in a single market.

For example, some invest primarily in international debt, such as the $4.3 billion T. Rowe Price Dynamic Global Bond fund (RPIEX). Others, such as the MetWest Unconstrained Bond fund (MWCRX), are invested in investment-grade residential mortgage-backed securities—some sectors offer higher carry because of technical quirks, says manager Steve Kane.

Some of the funds in the category are focusing on securitized markets, which can provide extra yield because of their complexity and difficulty of access. The $370 million FPA Flexible Income fund (FPFIX) was launched in 2019 as a slightly riskier companion to the $10.5 billion FPA New Income (FPNIX) profiled by Barron’s last year; it is also invested in auto loans and collateralized loan obligations with low durations.

It is important to note that investors can now find more protection from an economic slowdown—if not inflation-adjusted yield—in higher-quality bonds than they could at the beginning of this year. Pimco’s Seidner has been tiptoeing back into longer-term debt after this year’s selloff.

“It’s not inconceivable to see a 10-year yield above 2%, but we’re starting to enter the zone where longer-term value is being created in the bond market,” he says, in areas like higher-quality debt and Treasuries. Yields are also likely to top out at lower levels than in the past, he says, thanks to longer-term trends like demographics and technology changes.

Broadly, investors should keep in mind that any higher-yielding funds they buy—no matter which category they’re in—are getting their yield from some type of risk. And this year’s selloff in long-term debt should remind investors that defaults aren’t the only problem bonds can face: Interest-rate risk can be a problem too. When managed well, unconstrained funds may help contain it.

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