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SYSTEMATIC FIXED INCOME

APRIL 2024

EXECUTIVE SUMMARY

SYSTEMATIC FIXED INCOME IS AN ALTERNATIVE APPROACH TO INVESTING IN HIGH YIELD. IT APPLIES WELL-RESEARCHED QUANTITATIVE TOOLS, CREATED BY INSIGHT'S EXPERIENCED TEAM, SEEKING TO OFFER ATTRACTIVE RISK/RETURN BENEFITS AND OUTCOMES TO OUR INVESTOR CLIENTS.

THIS PAPER AIMS TO EXPLAIN THE GENESIS OF SYSTEMATIC FIXED INCOME, HOW INSIGHT APPLIES ITS APPROACH, SOME OF THOSE KEY BENEFITS, AND ITS PLACE IN THE BROAD SPECTRUM OF ACTIVE AND PASSIVE APPROACHES TO INVESTING IN HIGH YIELD.

THE BENEFITS OF TAKING A SYSTEMATIC APPROACH TO FIXED INCOME INVESTING

We believe taking a systematic approach to fixed income has the capacity to bring a number of attractive benefits to investors:

- **Return potential:** Applying rules-based structures to investing may mean more attractive returns can be achieved, as it enables better access to the full credit risk premium, as well as utilising differentiated alpha drivers.
- **Cost savings:** A growing framework employed for transactions in corporate bonds, credit portfolio trading (CPT), may allow material savings to be made on transaction costs. Those savings could potentially be greater than 50% compared to a traditional trading approach.
- **More diversification:** A systematic approach could exhibit lower correlations with active managers, which may opt for similar positions in seeking to outperform.
- **Enhanced liquidity:** Innovation in our portfolio construction and modern trading technology (CPT) mean we can execute trades for as much as US$500 million in the high yield market in just a few hours.
- **Bespoke approach:** Scalable and customisable solutions.

INTRODUCING SYSTEMATIC FIXED INCOME

We are all quantitative in nature to some extent. We gather and assess the available data before deciding on how to proceed in many aspects of life. In the world of bond investing, investors aim to assess numerous things, such as default risk and valuations to help determine our investment decisions.

The systematic approach we employ, looks to take a large data set and creates well-tested rules-based structures for the investment decisions we take. Those structures, or models, provide a framework to unlock the value buried in less efficient segments of the bond market.

A key focus for us is the high yield market as it typically exhibits clear inefficiencies. Issuers may be smaller in scale, less well-known and researched, and can be subject to lower levels of, and rapidly changing, liquidity. All these features mean it can offer ripe opportunities to capture value using our systematic approach.

Our approach to systematic investing is not driven by artificial intelligence (AI), where causality may be less easy to identify. The models we build are rooted in understandable economic and market theory and in fundamental, intuitive fixed income principles.

50 YEARS OF DEVELOPMENT IN QUANTITATIVE APPROACHES

1970s - 1980s – Emergence of quantitatively-driven equity index funds.

1990s – Factor-based investing. Professor Eugene Fama of the University of Chicago described a three-factor model, ascribing returns to different attributes, or factors, of stock markets.

2000s – Throughout the 2000s equity-related factors proliferated. However, for fixed income, a more parsimonious approach with fewer factors has been adopted and typically applied in investing practice. In 2001, our Systematic Fixed Income Team began to build its capabilities, translating the ideas and approaches used to analyse equity markets and applying them to fixed income.

2010s – Greater development and identification of bond market factor modelling in academia, with factors including value, quality, momentum, low volatility and carry. Interest in systematic approaches built slowly during those years but from 2016 onward, we noted a step-change in investor acceptance. Insight launched its first systematic fixed income strategy in 2012, called **Efficient Beta**, an approach to investing in high yield markets.

2020s – In recent years there has been increasing widespread adoption of systematic fixed income approaches to investing. Insight introduced its **Systematic Alpha** strategy.

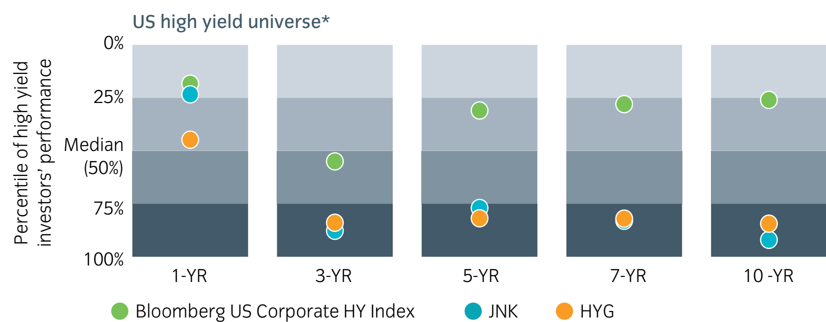
THE CASE FOR USING A SYSTEMATIC APPROACH FOR HIGH YIELD

In our view, high yield has offered an attractive alternative to the stock market. Since the end of 1999, high yield markets have generated equity-like returns, and with much less volatility.

Over longer time periods, such as five, seven or 10 years, traditional active managers have struggled to achieve better returns than the broad agnostic US high yield index, as Figure 1 shows.

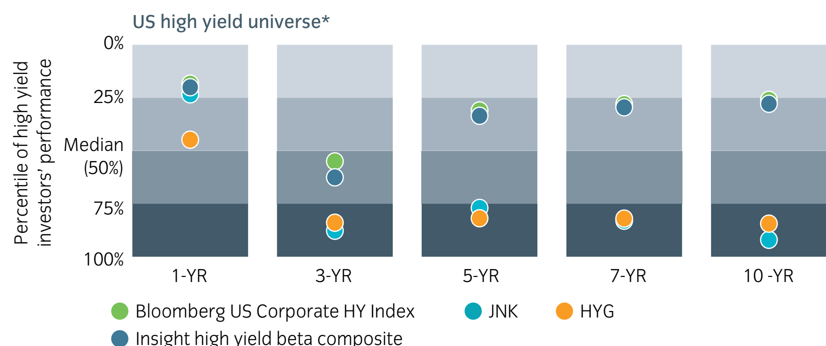
In addition, it is clear that a passive approach to high yield (in the US at least) may not be the answer either, as the historical achievements of two of the largest ETFs in the US high yield market show. Over longer time periods each of those languishes in the bottom quartile of performance in the competitor universe. This is not because they are poorly managed; it is primarily related to the fact that the ETFs have less ability to access the smaller and/or less liquid areas of the market, which generally offer the best value and are thus more attractive.

Figure 1: Traditional active and passive approaches typically fail to achieve what investors seek[1]



Systematic fixed income strategies are well placed to take advantage of this well-diversified but relatively inefficient asset class. If, as our track record demonstrates, we can achieve returns, after costs, that are closer to the returns of the broad index, we believe that would be appealing to high yield investors (Figure 2).

Figure 2: A well-considered systematic solution may produce better results than traditional active or passive approaches[2]



[1, 2] Source: eVestment Alliance. Data in USD. HYG = iShares iBoxx $ High Yield Corporate Bond ETF and JNK =SPDR Bloomberg High Yield Bond ETF. Composite expenses, including management fees and other expenses were deducted from these returns. Insight high yield beta composite is shown net of 21bp management fee. The composite's representative portfolio summary risk indicator is 3 out of 7. * Number of observations in the universe: 150 (3 years), 143 (5 years), 129 (7 years), 103 (10 years).

HOW TACKLING TRANSACTION COSTS CAN BOOST PERFORMANCE

We believe a good proportion of the performance drag suffered by active managers lies in the costs of transacting.

Even in a regular, benign market environment, without undue volatility, the traditional bid/ask spread on over-the-counter (OTC) high yield bond trades can be about 50 to 70 basis points (bp). In the process of executing regular active investment trades or portfolio rebalancing, that could translate to paying away 0.3% to 0.5%, or more, of performance over the course of a year. That drag creates a hole which has to be made up with alpha, increasing the challenge facing active managers tasked with generating sufficient returns to satisfy clients.

We have built our own technology to harness one of the best features that ETFs have brought to the market – CPT.

The benefits of credit portfolio trading

CPT is trading large baskets of bonds in single transactions and is a more efficient transaction methodology. It can allow us to execute trades for large numbers of bonds in large volumes quickly and cheaply. The typical bid/ask spread we see for our CPT is much lower than for traditional OTC, about 15bp for broad high yield. The transaction costs saved are a direct proxy for alpha and can flow straight into portfolio performance.

We can, and do, take this a stage further. We have created optimisation engines that seek to reverse the tables. Rather than paying broker-dealers to find liquidity, we aim to utilise the large, diversified pool of capital that we have invested in high yield on behalf of our clients, to our clients' additional benefit. We can optimise for what our market intelligence tells us are the liquidity issues of the wider investment community (the 'street'), where their long positions and short positions are, and marry that with our needs. As a consequence, we can then build our trades such that the 'street' effectively pays us, and thus reduce overall transaction costs, in some cases creating a trading gain, or income.

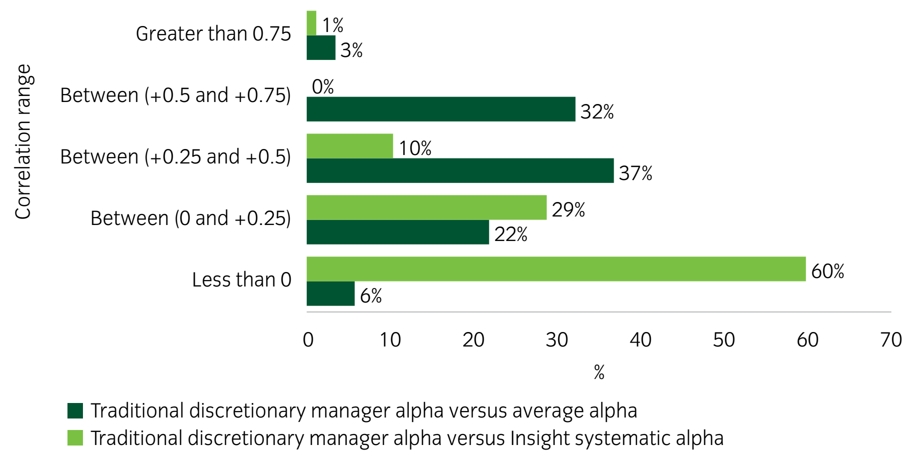
This approach benefits from enhanced liquidity. Our CPT approach allows us to execute trades for as much as US$500 million in the high yield market in just a few hours.

HOW A SYSTEMATIC APPROACH CAN BOOST DIVERSIFICATION

Traditional discretionary active managers often employ the same type of approach to generating alpha as their competitors, with screening from credit analysts and portfolio manager tilts along duration, sector, and rating categories. Accordingly, seeking to achieve outperformance, they may often hold the same sorts of positions. Unsurprisingly, that means their alpha streams can be positively correlated to some extent. In our analysis, about 35% of discretionary managers have their alpha streams significantly correlated (r-squared is greater than +0.50) with the broad average of the group, and more than 90% exhibited positive correlation (see Figure 3). That suggests a multi-manager approach to investing in high yield may not offer investors the degree of diversification they seek.

However, when we consider the correlation of returns from our systematic fixed income approach with those of the broad pool of discretionary active high yield managers, Insight's alpha has a negative correlation to about 60% of traditional managers, and a low correlation (less than +0.25) to almost 90% of traditional managers. This suggests our systematic approach offers greater potential diversification of returns relative to the broad universe of active high yield managers in a multi-manager investment approach.

Figure 3: Systematic fixed income can offer attractive diversification relative to traditional active approaches[3]



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Insight's systematic fixed income approach can offer valuable diversification benefits.

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[3] Source: eVestment data (April 2013 – March 2023), Insight calculations as at 31 December 2023.

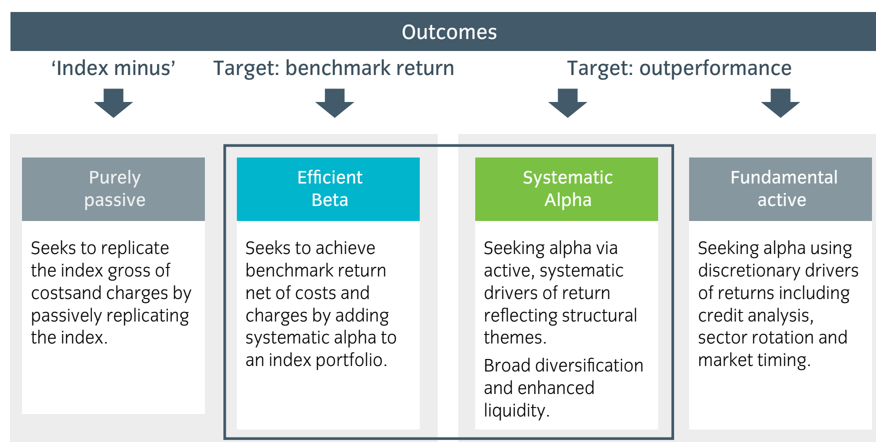
WHERE SYSTEMATIC FIXED INCOME FITS IN

When we consider investor outcomes, we tend to think of four different buckets.

- **Purely passive** is effectively an 'index-minus' approach, as it is targeting index returns, before the effects of costs are felt. After costs, investors are unlikely to have exceeded the returns of the benchmark index, as the chart in Figure 1 indicates, has historically been the case.
- At the other end of the spectrum, a **fundamental active** approach is a true alpha-seeking approach, using discretionary drivers of returns to seek outperformance of the index. As Figure 1 showed, only a minority of high yield managers have been successful in that task over longer time periods.
- Between those two poles, our systematic fixed income approaches include **Efficient Beta**, which seeks to achieve benchmark index returns, even after incurring costs and charges, with a high degree of certainty and high liquidity. The ingredients for achieving this are keeping costs low and employing a small risk budget for generating systematic alpha.
- Similar to fundamental active discretionary strategies, **Systematic Alpha** targets outperformance. It seeks to achieve alpha after costs via a larger use of risk budget allocation to systematic drivers of returns (as opposed to discretionary) while maintaining broad diversification and enhanced liquidity.

A systematic fixed income approach can be adapted to help an investor build a customised portfolio, with the approach scalable to suit an investor's requirements over the long term.

Figure 4: Considering outcomes[4]



Systematic fixed income has the capacity to offer attractive risk-adjusted returns, material savings on transaction costs, enhanced liquidity and improved diversification – and all through scalable and customisable solutions. We believe this approach can be particularly attractive for investors in high yield markets, where traditional passive and active managers can struggle to fulfil investors' expectations.

[4] Source: Insight. As at March 2024. For illustrative purposes only.

CONTRIBUTOR

Paul Benson
CFA, CAIA – Head of Systematic Fixed Income, Insight Investment

Paul has 30 years' experience in the investment industry. He joined BNY Mellon Investment Management affiliate, Mellon Investments, in 2005 and has been Head of the Systematic Fixed Income Team since 2015. In September 2021, Mellon Investments' fixed income strategies, including the Systematic Fixed Income Team, formally joined Insight. Based in San Francisco, Paul and his team of portfolio managers, researchers and traders pioneered the development of highly implementable systematic fixed income strategies by combining innovative model-driven alpha research with cutting-edge trading technology. Before becoming Head of the Systematic Fixed Income Team, Paul was a senior portfolio manager responsible for the yield curve arbitrage strategy within global asset allocation portfolios. Additionally, he engineered and built the process to automate fixed income portfolio rebalancing and improve operational risk control. Prior to joining Mellon Investments, Paul was a senior fixed income portfolio associate at Pacific Investment Management Company (PIMCO), where he analyzed, implemented and managed active US and global fixed income portfolios. Previously, he was a trader at Westdeutsche Landesbank Tokyo, where he built the interest rate swaps trading desk, and a trader at Bankers Trust Tokyo, where he ran the Japanese government bond book. Both positions included market making and proprietary trading. Paul received a BA from University of Michigan at Ann Arbor. He is a CFA charterholder and is a member of the CFA Institute.

IMPORTANT INFORMATION

TEN-YEAR PERFORMANCE RECORD TO 31 DECEMBER 2023

	Calendar year returns									
	2023	2022	2021	2020	2019	2018	2017	2016	2015	2014
Insight High yield beta composite (gross)	13.55	-10.97	5.20	7.43	14.63	-1.87	7.89	17.06	-3.61	1.98
Insight High yield beta composite (net)	13.21	-11.20	4.88	7.11	14.28	-2.16	7.57	16.71	-3.90	1.67
Bloomberg US High Yield Index	13.44	-11.19	5.28	7.11	14.32	-2.08	7.50	17.13	-4.47	2.45

	12-month rolling returns									
	2023-2024	2022-2023	2021-2022	2020-2021	2019-2020	2018-2019	2017-2018	2016-2017	2015-2016	2014-2015
Insight High yield beta composite (gross)	13.55	-10.97	5.20	7.43	14.63	-1.87	7.89	17.06	-3.61	1.98
Insight High yield beta composite (net)	13.21	-11.20	4.88	7.11	14.28	-2.16	7.57	16.71	-3.90	1.67
Bloomberg US High Yield Index	13.44	-11.19	5.28	7.11	14.32	-2.08	7.50	17.13	-4.47	2.45

Please refer to the following risk disclosures. The performance results shown are net and gross of investment management fees and reflect the reinvestment of dividends and/or income and other earnings. The Insight High yield beta composite is in USD. Inception date: 01 October 2012. Gross of fees performance results do not reflect the deduction of investment advisory fees; as such, client's returns will be reduced by the investment advisory fees and other expenses. The quoted benchmark does not reflect deductions for fees, expenses or taxes. The benchmark is unmanaged and does not reflect actual trading. There could be material factors relevant to any such comparison such as differences in the volatility, and regulatory and legal restrictions between the index shown and the strategy. Investors cannot invest directly in any index. The Bloomberg US High Yield Index is being shown for comparison purposes only and is not an official benchmark for this strategy.

RISK DISCLOSURES

Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

The performance results shown, whether net or gross of investment management fees, reflect the reinvestment of dividends and/or income and other earnings. Any gross of fees performance does not include fees, taxes and charges and these can have a material detrimental effect on the performance of an investment. Taxes and costs incurred when purchasing, holding, converting or selling any investment, will impact returns. Costs may increase or decrease as a result of certain currency conversions, such as currency hedging, and exchange rate fluctuations.

Any target performance aims are not a guarantee, may not be achieved and a capital loss may occur. The scenarios presented are an estimate of future performance based on evidence from the past on how the value of this investment varies over time, and/or prevailing market conditions and are not an exact indicator. They are speculative in nature and are only an estimate. What you will get will vary depending on how the market performs and how long you keep the investment/product. Strategies which have a higher performance aim generally take more risk to achieve this and so have a greater potential for the returns to be significantly different than expected.

Any projections or forecasts contained herein are based upon certain assumptions considered reasonable. Projections are speculative in nature and some or all of the assumptions underlying the projections may not materialise or vary significantly from the actual results. Accordingly, the projections are only an estimate.

Portfolio holdings are subject to change, for information only and are not investment recommendations.

ASSOCIATED INVESTMENT RISKS

Fixed income

Where the portfolio holds over 35% of its net asset value in securities of one governmental issuer, the value of the portfolio may be profoundly affected if one or more of these issuers fails to meet its obligations or suffers a ratings downgrade.

A credit default swap (CDS) provides a measure of protection against defaults of debt issuers but there is no assurance their use will be effective or will have the desired result.

The issuer of a debt security may not pay income or repay capital to the bondholder when due.

Derivatives may be used to generate returns as well as to reduce costs and/or the overall risk of the portfolio. Using derivatives can involve a higher level of risk. A small movement in the price of an underlying investment may result in a disproportionately large movement in the price of the derivative investment.

Investments in emerging markets can be less liquid and riskier than more developed markets and difficulties in accounting, dealing, settlement and custody may arise.

Investments in bonds are affected by interest rates and inflation trends which may affect the value of the portfolio.

Where high yield instruments are held, their low credit rating indicates a greater risk of default, which would affect the value of the portfolio.

The investment manager may invest in instruments which can be difficult to sell when markets are stressed.

Exposure to international markets means exposure to changes in currency rates which could affect the value of the portfolio.

Where leverage is used as part of the management of the portfolio through the use of swaps and other derivative instruments, this can increase the overall volatility. While leverage presents opportunities for increasing total returns, it has the effect of potentially increasing losses as well. Any event that adversely affects the value of an investment would be magnified to the extent that leverage is employed by the portfolio. Any losses would therefore be greater than if leverage were not employed.

While efforts will be made to eliminate potential inequalities between shareholders in a pooled fund through the performance fee calculation methodology, there may be occasions where a shareholder may pay a performance fee for which they have not received a commensurate benefit.

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16040-04-24