Lula Tadesse: Regardless of the type of fund you invest in, knowing how a fund achieves its performance is information worth knowing. This is even more so when it comes to global active bond funds, where there are often several factors at play. How much of a fund’s return can be attributed to risk factors and how much of it can be attributed to a fund manager’s security selection?

Hello, and welcome to Vanguard’s Investment Commentary Podcast Series. I’m Lula Tadesse. In this month’s episode, which we’re recording on September 11, 2018, we’ll discuss global active bond funds, key factors that explain their performance, [and] questions you should consider before investing in them.

We’re joined today by Daren Roberts, an investment analyst with Vanguard Investment Strategy Group and coauthor of the Vanguard research paper Global active bond fund returns: a factor decomposition. Daren, thanks for being here.

Daren Roberts: Thank you, and good to be here as well.

Lula Tadesse: Daren, Vanguard has written about active bond funds before but not global active bond funds. Tell us why you decided to focus on them in this paper.

Daren Roberts: Well, we focused on global active bond funds for a couple of reasons. I think the first is just a greater investor interest in the category, and you could argue that’s a general comfort in looking beyond one’s investor domestic bond market.

The other reason is, there are different types of investment strategies within that category, and we wanted to help advisors and investors, generally speaking, navigate that landscape. And then, we wrote about U.S. active bond funds before and we found that there was a persistent tilt toward credit. But for global bond funds, we wanted to understand a little bit more beyond that. We wanted to understand the potential role that foreign currency could play in explaining performance.

Lula Tadesse: You analyzed 15 different types of global active bond funds. What were you really trying to find out?

Daren Roberts: We were looking for what explained the performance of the average global active bond manager. And one common way to look at performance, broadly speaking, is to look at whether the fund outperformed or underperformed the benchmark. But for most managers, they’re not just limited to the securities that are within the benchmark, and so if you were to use excess return in that concept, as a proxy for alpha, it can be misleading.

So if we just looked at the fund return, right, and we decomposed it: How much of that is factor exposure, and how much of that is manager security selection and timing?

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Now, the most efficient way to answer that question of what expands the performance would be to use a factor-based regression framework.

*Lula Tadesse:* So what are the main factors that you found were behind an active bond fund’s performance? Can you briefly describe each one?

*Daren Roberts:* So, in terms of the approach, we regressed the 10-year performance of the 15 types of global active managers, using four factors: term, credit, high yield, and currency. Now all four—term, credit, high yield, and currency—these are all reasonable levers for a global active bond manager to pull. So there is the intuition behind that.

So, term is a proxy for maturity risk or duration risk or interest rate sensitivity. Credit, as a factor, is a default risk premium coming from corporates.

Now, in the academic and factor investing world, term and credit—they’re well known, they’re well-researched factors. So [there’s] nothing new there. Where we tried to contribute to the conversation [was by] adding high yield and currency.

High yield, as a definition, is exactly what it sounds like. This is high yield—anything that’s below investment grade. And the reason why we added that was because we felt that investment-grade funds, in theory, could invest outside of the benchmarks, so they could dip into high yield to boost the returns.

And then currency is a basket of currencies, or foreign currencies, outside of the local manager’s currency.

*Lula Tadesse:* So, the two factors that you kind of focused on were currency and high yield exposure. Let’s take a closer look at your findings. How does currency play a role?

*Daren Roberts:* Right. So, when we looked at our model and we added high yield and currency, we found that, you know, in statistical terms they were very, very significant. They improved the explanation of the return of the funds. So that’s one.

And then, how it played a role. I think, let’s look at global active bond managers and their return streams. You have one return stream coming from the bonds, and you have another coming from currencies.

Well, in the currency bucket, it could be a whole host of things. It could be carry trade, it could be momentum strategies, it could be partially hedged, fully hedged. And the point here is that the interpretation is plentiful, right? So, there’s a lot of things under the hood. Which is why, in terms of the factor definition, we made it intentionally broad. But, for the purposes of an advisor, it’s an important question to ask.

If the bulk of the returns, for example, are coming from currency, what does that mean? And for an advisor, they have to view this as being an important question to ask the fund manager. And interestingly enough, like I said, currency actually increased the explanation of where returns were coming from in terms of our model. And maybe saying it a different way, an investor can expect investing in global active bond funds, in our research, as having some portion of the return coming from currency.

*Lula Tadesse:* And currency exposure varies significantly by fund manager, doesn’t it?

*Daren Roberts:* Yeah. And currency, I think, can be viewed much like all the other factors, as being either a positive or a negative contribution to returns. So for instance, one of the things we pointed out in the paper is that during the 10-year period, we saw, you know, certain managers utilize it, [in] some ways more [positively] than others.
So we found that sterling managers—so managers [whose] base currency was in the pound sterling—had benefited from those currency decisions. And, again, that currency decision could be a multitude of things, but in other words, they still were able to leverage that factor in their favor. On the other hand, we found that Swiss franc managers—not so much. But that’s neither here nor there.

I think the real point is that if advisors are allocating to this category, you can expect that the average manager is leveraging currency to some degree.

**Lula Tadesse:** Let’s take a look at high-yield exposure. What does that tell us?

**Daren Roberts:** Well, surprisingly a lot. And I would say this for most of the factors—term, credit, high yield, and currency: They were statistically significant across all the 15 types of global active bond managers.

And the reason why I say high yield was surprising is because these were investment-grade funds [that] had an investment-grade mandate. So, the fact that high yield was statistically significant—and we saw that some return was coming from high yield—meant that either there was an investment in some high-yield securities, or that the bonds that they were investing in were highly correlated with the high-yield factor.

**Lula Tadesse:** Now we’re talking about active bond funds, and investors expect these funds to outperform. In your findings, to what extent was a global active bond fund’s performance based on these risk factors we just discussed, or alpha, meaning a manager’s security selection and market timing?

**Daren Roberts:** For the 15 types that we looked at, they varied. And I would say it was a combination of both the factors as well as the alpha. The good news here is that for the majority of the global funds, many of them had statistically significant gross alpha. So, they have some manager selection ability, or timing ability, if you will.

So if [we] looked on a gross basis, and an equal-weighted basis, we saw that 10 out of the 15 types—and then on an asset-weighted basis, 7 out of 15—were positive. Good news.

On a net basis, the alphas were generally statistically indistinguishable from zero.

**Lula Tadesse:** So in plain talk, what does that mean?

**Daren Roberts:** All things being equal, lower expense ratios would give you a higher chance for positive net alpha. So in layman’s terms: Finding low-cost managers is critical.

**Lula Tadesse:** Now at Vanguard, we know that. So now that we’ve covered what’s behind a global active bond fund’s performance, what are some of the key takeaways for investors and advisors in addition to finding a low-cost manager?

**Daren Roberts:** The first—and probably one of the major takeaways—is knowing how a fund achieves [its] return is information worth knowing. In this paper, we used the factor decomposition. We view that as the starting point for the due diligence. But what we found is that through this approach, you could understand how a manager’s return could be explained. How much of it is factors? How much of it is managers’ security selection and timing?

And for the investor and the advisor, they can decide: Am I comfortable with these risks? Is there overlap in my portfolio? Does the profile align with my objectives?

And I think for an investor, if we think about it in terms of the steps that they should take, I think probably the same thing: Talking with the advisor, making sure they’re asking the right questions.
So for instance, if you have an investment-grade mandate, I think it’s a fair question to ask the advisor, “How much of my return is coming from outside of the benchmark?” We know that fund managers are not limited to the benchmark. And so to the extent that you have the returns, you have the means of doing so, it’s good to have that as part of your decision tree.

**Lula Tadesse:** These are really helpful insights. Daren, thanks for joining us for this Vanguard Investment Commentary Podcast and sharing your insights.

**Daren Roberts:** And thank you for having me.

**Lula Tadesse:** To learn more about Vanguard’s thoughts on various financial topics, and to read the paper, *Global active bond fund returns: a factor decomposition*, check out our website. And be sure to check back with us each month for more insights into the markets and investing. Remember, you can always follow us on Twitter and LinkedIn. Thanks for listening.

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There is no guarantee that any particular asset allocation or mix of funds will meet your investment objectives or provide you with a given level of income.

Diversification does not ensure a profit or protect against a loss.

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