HSBC Global Asset Management

Blending MMFs with Low and Short Duration Fixed Income

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by Will Chao, Vice President, Americas Liquidity Products

For Institutional Clients Only

Blending MMFs with low and short duration fixed income portfolios have historically provided volatility-adjusted yield pick-up opportunities.

The purpose of the following analysis is to review historic returns and volatility when blending near-zero duration, 'AAA' credit rated government Money Market Funds (MMFs) with low or short duration US corporate credit fixed income indexes. Results of the analysis may help captive insurance managers observe risk-adjusted opportunities to marginally increase duration and credit exposures in their investment portfolios to enhance investment returns. The search for yield pick-up opportunities may be more pertinent for asset allocators that are projecting protracted low-for-long cash rates.

For captive insurance investment portfolios, tolerance for duration and credit exposures are aligned with the frequency and severity of insurance claims. A proxy allocation table is shown below:

	Allocation		
	MMF	**Custom Fixed Income**	**Insurance Claims Frequency and Severity**
A	100%	0%	Captive is unsure on their claims activity or expects high frequency and high severity in claims
B	75%	25%	Higher severity and low frequency in claim expectations
C	50%	50%	Medium severity and low frequency in claim expectations
D	25%	75%	Low severity and low frequency in claim expectations
E	0%	100%	Funds untied to any claims expectations

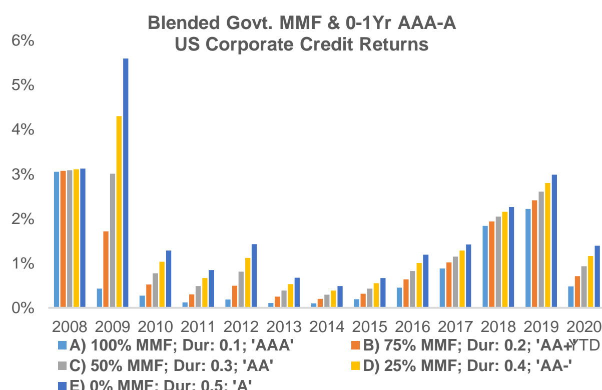
MMF: Crane US Government Instiutional MMF Index (gross basis) used in all analysis instances

Example 1

US Government MMF is blended with a US corporate credit fixed income index that has 0 to 1 year in issues maturity—low duration, AAA to A in issues credit ratings, an index duration of 0.5, and an index average credit rating of 'A (flat).'

Spanning over 13years (and including two major market 'crisis' scenarios, 2008 and 2020), the graph to the right shows how total return increased with increased allocation to the fixed income index.

The financial crisis of 2008 saw severe credit spread widening, resulting in lowered marked-to-market pricing on credit bonds. However, a market recovery in 2009 saw a sharp reversal in total return as interest rates fell and credit spreads narrowed.



Corporate Credit: ICE BofA 0-1 Year AAA-A US Corporate Index (C01A)
YTD: 7/31/2020; non-annualized returns. Source: Bloomberg at July 31 2020

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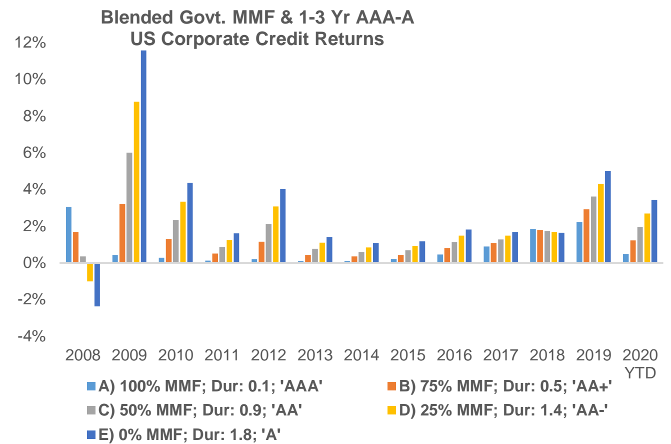
Example 2

US Government MMF is blended with a US corporate credit fixed income index with a similar credit profile as in example 1, but maturities in the portfolio are from 1 to 3 years – short duration. The short duration fixed income index has duration of 1.8 (versus 0.5 in example 1).

The return dynamics begin to shift. Annual portfolio returns become more volatile. Here, in 2008, portfolios with a high concentration of the fixed income index resulted in negative annual returns. However, the reversal to positive returns in 2009 was also more pronounced, resulting in much higher returns as capital markets normalized.

Another difference occurs in 2018 where greater fixed income concentration resulted in incrementally lower portfolio returns due to an uncommon phenomenon where credit spreads widened while interest rates increased.



Corporate Credit: ICE BofA 1-3 Year AAA-A US Corporate Index (C110)
YTD: 7/31/2020; non-annualized returns. Source: Bloomberg at July 31 2020

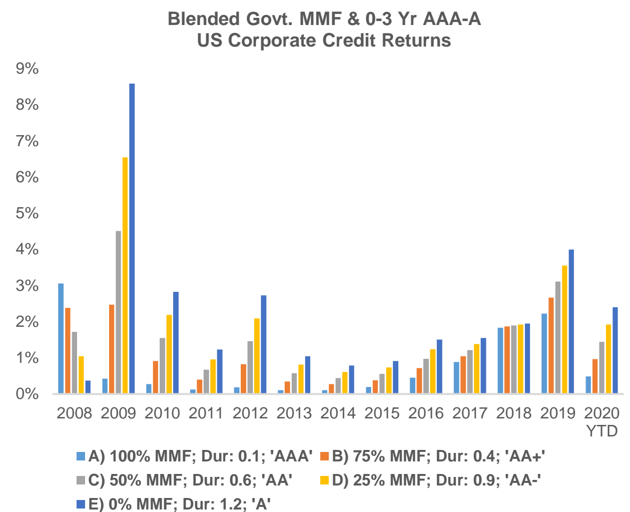
Example 3

Here we show the ability to create custom fixed income portfolios that can be blended with MMF allocations. Two fixed income portfolio indexes are combined for a median range portfolio duration to help manage volatility expectations.

Customization of fixed income portfolios allows investment risk profiles to be tailored, and therefore adds flexibility over MMF investments alone. Fixed income portfolio construction can be adjusted at any point during the investment lifespan to meet liquidity and credit profile needs.

Although in this example average portfolio credit quality migrates lower with greater fixed income concentration, custom fixed income portfolios can be constructed to maintain stable overall portfolio credit quality even with greater concentrations of fixed income.

Fixed income portfolios can be more risk diversified relative to MMFs. Diversification can be constructed across industry sector, geographic risk location, and issuer selection. Further, portfolios can be constructed with additional themes such as ESG commitments or low carbon score targeting.



Corporate Credit: 50% ICE BofA 1-3 Year AAA-A US Corporate Index (C110)
50% ICE BofA 0-1 Year AAA-A US Corporate Index (C01A)
YTD: 7/31/2020; non-annualized return. Source: Bloomberg at July 31 2020

Exhibit A

We illustrate total returns for the five portfolios described in example 3. Each portfolio begins 2008 at a market value of $1,000. The market value is then tracked over time with re-investment of coupon payments, re-investment of bond maturities, and portfolio marked-to-market.

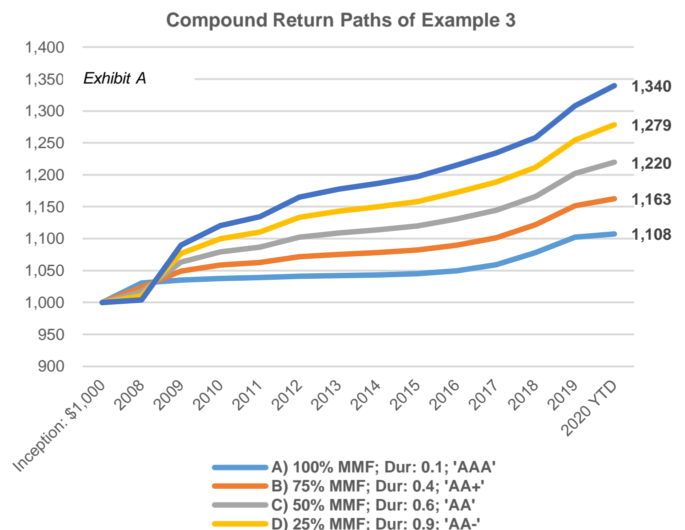
Total return dispersions can be increasingly observed as portfolio assets are compounded.

Annualized returns from 1/1/2008 to 7/31/2020 are:

A	B	C	D	E
0.75%	1.11%	1.47%	1.83%	2.18%

On a shorter and recent investment horizon, annualized returns from 1/1/2016 to 7/31/2020 are:

A	B	C	D	E
1.28%	1.58%	1.88%	2.18%	2.48%



Source: Bloomberg at July 31 2020

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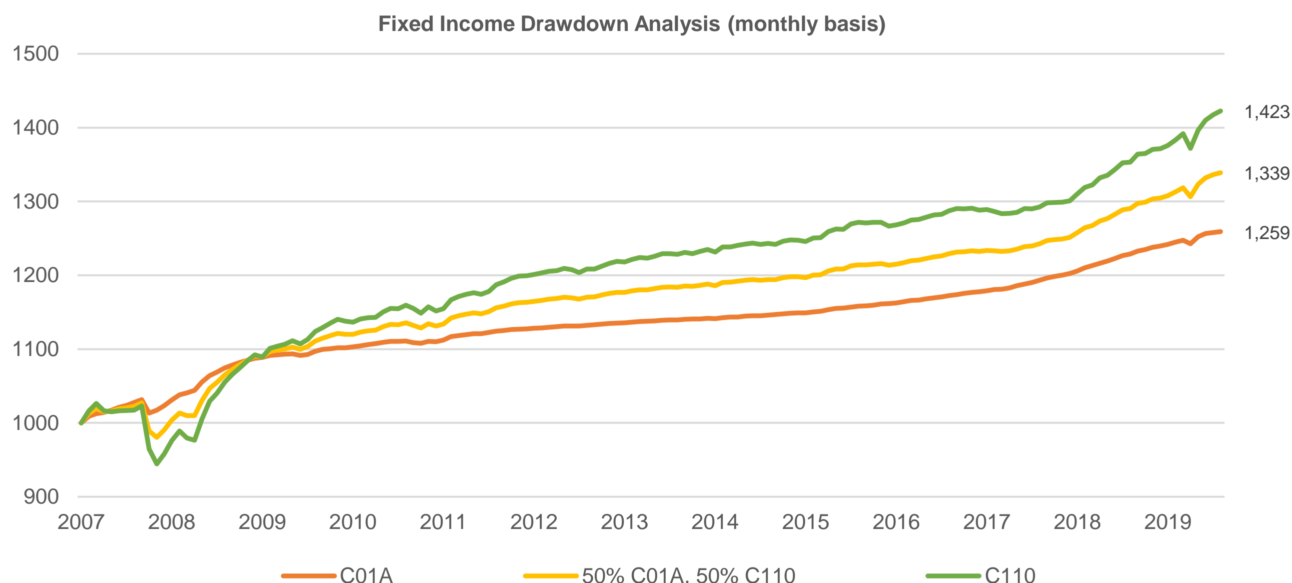
Summary

Combining low or short duration fixed income portfolios with MMF allocations have historically provided regular yield pick-up opportunities with limited drawdown instances. Drawdown risks were tested against 2008 and 2020 financial market shocks.

In order to properly introduce additional portfolio duration and credit risk, the frequency and severity of insurance liability cash flows should be projected and actively refreshed. Doing so can allow for more optimized investment portfolio risk and return management.

Additional data

The data below examines fixed income index drawdown analysis at monthly time steps for more granular analysis.



C01A ICE BofA 0-1 Year AAA-A US Corporate Index

Low Rank	Drawdown	Date	Drawdown Months
1	-1.75%	09/30/2008	5
2	-0.38%	03/31/2020	2
3	-0.27%	09/30/2011	5
4	-0.17%	05/31/2010	3
5	-0.04%	12/31/2014	2

C110 ICE BofA 1-3 Year AAA-A US Corporate Index

Low Rank	Drawdown	Date	Drawdown Months
1	-7.97%	10/31/2008	15
2	-1.45%	03/31/2020	2
3	-0.93%	09/30/2011	6
4	-0.55%	02/28/2018	9
5	-0.48%	06/30/2013	5

50% C01A, 50% C110

Low Rank	Drawdown	Date	Drawdown Months
1	-4.57%	10/31/2008	8
2	-0.91%	03/31/2020	2
3	-0.60%	09/30/2011	6
4	-0.41%	03/31/2008	4
5	-0.28%	05/31/2010	2

C01A: ICE BofA 0-1 Year AAA-A US Corporate Index

C110: ICE BofA 1-3 Year AAA-A US Corporate Index

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Key risks

The value of an investment in the portfolios and any income from them can go down as well as up and as with any investment you may not receive back the amount originally invested.

- Exchange rate risk: Investing in assets denominated in a currency other than that of the investor's own currency perspective exposes the value of the investment to exchange rate fluctuations.
- Derivative risk: The value of derivative contracts is dependent upon the performance of an underlying asset. A small movement in the value of the underlying can cause a large movement in the value of the derivative. Unlike exchange traded derivatives, over-the-counter (OTC) derivatives have credit risk associated with the counterparty or institution facilitating the trade.
- Emerging market risk: Emerging economies typically exhibit higher levels of investment risk. Markets are not always well regulated or efficient and investments can be affected by reduced liquidity.
- Operational risk: The main risks are related to systems and process failures. Investment processes are overseen by independent risk functions which are subject to independent audit and supervised by regulators.
- Real estate risk: Cost of acquisition and disposal, taxation, planning, legal, compliance and other factors can materially impact real estate valuation.
- Liquidity risk: Liquidity is a measure of how easily an investment can be converted to cash without a loss of capital and/or income in the process. The value of assets may be significantly impacted by liquidity risk during adverse market conditions.

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