

## Transcript

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#### **Episode 1.25 – Alexa, invest in fixed income**

*Janelle Woodward* - We're not here to say the trend of passive must stop. We get why some people do it; we understand that that trend is in play. The important thing is for investors to think about the consequence. You're still owning risk, and you're owning market risk, and you may wake up 10 years from now just as if we were to look back 10 years and realize that the risk profile of what you own is very different. And these are factors that all investors should be thoughtful about, when they're either selecting a benchmark as part of an active management program or they're looking at passive strategies.

*Ben Jones* - Welcome to Better conversations. Better outcomes. presented by BMO Global Asset Management. I'm Ben Jones.

*Matt Smith* - And I'm Matt Smith. In each episode we'll explore topics relevant to today's trusted advisors, interviewing experts and investigating the world of wealth advising from every angle. We'll also provide actionable ideas designed to improve outcomes for advisors and their clients.

*Ben Jones* - To learn more; visit us at [bmogam.com/betterconversations](http://bmogam.com/betterconversations). Thanks for joining us.

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*Ben Jones* - Today on the show we talk about potential structural implications that may result by a trend towards passive fixed income investing. The trend toward passive investing over the last several years has been unmistakable, but today we take a closer look at this trend with respect to fixed income and what issues it could lead to for investment advisors and their clients into the future.

*Matt Smith* - Our guest is Janelle Woodward. Janelle is the president of TCH and part of their portfolio management team. TCH is a specialized fixed income team within BMO GAM. She co-authored an article titled "Alexa, Invest in fixed income". The article focused on the growing trend of passive implementation of fixed income. Janelle titled the article after the Amazon Echo device that responds to the name Alexa, and will carry out everyday tasks for you, such as adding items to your grocery list or ordering more laundry detergent. On a personal note, I had to turn off my Amazon Alexa in order to record this narration, because Alexa just kept trying to answer my questions as I was recording this narration. As technology and automation tools are changing the way we live, Janelle and her team took a careful look at what that means for the fixed income space.

*Janelle Woodward* - The reality in the marketplace is there is a trend towards passive investing and we didn't want to write a piece that tried to defend per se active investing or lay out the pros and cons of active versus passive investing. We've been an active manager in the marketplace for three decades. We believe in it, it's fundamentally what we do, and we think it offers a lot of

value to investors. However, as we looked at some of the dynamics of the marketplace what's going on at the index level, what's going on in terms of monetary policy, we realized that this trend towards passive investing and the implications of it really had broad consequences across the fixed income marketplace both for active and passive investors. The tie-in to Alexa Amazon Echo was one of the hottest new technologies during the fourth quarter and it came out right as we were researching and writing this piece. And I, like many other people jumped on the bandwagon and bought an Amazon Echo. But it didn't take me too long to realize that there were definitely limitations of what Alexa can do for us, and this concept that Alexa would solve everything and do everything quickly faded. I recall an instance where I asked Alexa in early January when Alabama was playing Clemson and she told me she didn't understand the question. And it really resonated with me as we went through this thought process of thinking about how passive investing works within fixed income and really the limitations on what it can offer, even while there-- there may be value in the context of the broader marketplace.

*Ben Jones* - We explore a few of the implications that Janelle and her team have detailed in the article, such as how bond indexes are constructed, how passive investing affects them, and the questions advisors should consider when looking at fixed income options for their clients' portfolios. But first we need a baseline understanding of what defines active and passive fixed income investing. Let's start with passive.

*Janelle Woodward* - Passive investing is just investing in a way that mirrors an index and mirrors the returns and the risks of a particular index. Fixed income is different than equities because unlike the S&P 500 where you have a clear set of 500 specific issuers to own, the issuers and the issues within the fixed income market are constantly evolving, and so what this means is that any passive investor is unlikely and does not own every single instrument within the index, but rather owns some representative portion to reflect the risks of the underlying index. And we've seen this be anywhere from 1,500 to 8,000 of the 10,000 securities depending on the manager's approach. So it is very different than what you see on the equities side.

*Ben Jones* - Okay, so let's shift gears here to active. When you use the term "active management", could you describe what this means and how this differs from a passive approach?

*Janelle Woodward* - Sure. Fixed income markets are inefficient and the role of active management and the value of active management is really twofold. One, to look at what's happening from a top-down perspective in terms of macroeconomic trends, in terms of monetary policy, and what the implications will be on different aspects of the fixed income market. And the second piece is to use bottom-up fundamental research to identify opportunities and inefficiencies, and mispricing across various issuers and securities. As we look at the breadth and the depth of fixed income market and certainly the evolution that we've seen take place over the last decade, we think there continues to be very much a role for active managers. And one of the challenges of any piece of technology and we go back and we talk about Alexa, or Ai, is that it can only be backward looking. It's human-programmed, and it can only respond to what has happened. The role of the active manager is to take this knowledge base for us, three decades of investing experience, but also look forward and say we are in a different world, a different fixed income environment. What are the implications, and what could be the implications of some of these policy changes that we see, fiscal policy, monetary policy, what could be the implications going forward and it's possible in this context that we see ourselves again in a changing evolving market that we've never seen before. That passive or backward-looking approaches wouldn't be able to capture.

*Matt Smith* - Janelle discussed the evolving nature of fixed income markets.

*Janelle Woodward* - There have been a lot of changes in the fixed income market over the last decade and certainly the last year is no exception. We've seen significant impact from monetary policies; given low yields we've seen corporate investors in particular borrow more money than they have in the past. And with yields also being lower, we've seen investors both the treasury as well as corporate issuers extend out issuance, and issue longer-duration securities. And so what would be seen if we looked back over the last decade is definitely a change in the landscape of the fixed income marketplace, and we see this in duration, certainly, the current duration is approaching six years which is about 30% above where it was 10 years ago. At the same time we've seen significant changes to sector mix. 10 years ago, treasuries were 25% of the index. Today they're at 36%, and that's one of the factors that certainly jumped out to us as we considered some of the non-index items and what the implications could be, and then we've also seen a mix and a shift towards more corporate issuers. Both domestic as well as Yankee or non-US issuers into US dollar securities.

*Ben Jones* - And tell me a little bit about kind of some of the challenges this presents for advisors as they try to invest their clients' fixed income allocations.

*Janelle Woodward* - I think fixed income indices are very different than equity indices, in terms of the parameters. If we look at the Barclays aggregate index as a primary index that's used by both passive and active aggregate or core strategies, while there are constraints in terms of liquidity, and issuer size, etc., what we don't see are constraints around some of the risks. Interest rate risks and credit risks specifically. And what this means is that the index tracks what issuers are doing. And so there's a little bit of an irony to this. We've heard it talked about a lot and we see it talked about a lot in terms of corporate issuers where the most indebted issuers are the largest percent of the index. But this is also true when we look at the government and its issuance. And so what happens is that the index effectively has a mind of its own; it becomes the markets, it defines itself over time, and defines the investment set and the opportunity. And why this can be challenging is that I think that there can be an association that "passive" means low-risk, and one thing we would highlight is passive doesn't mean no risk, it simply means that you don't have-- you have a low tracking error to the index. But passive strategies that own an index still have market risks. They still have the beta component, and you're subject to how the market is transitioning and evolving over time.

*Ben Jones* - To fully understand the fixed income space and passive investing's potential impact on it, we need to discuss the way that fixed income indexes are constructed. So let's shift gears for a minute to the meat of your article, and let's talk for a minute about kind of the convergence of Fed support, passive investing, and longer maturities. So that our audience can level set a bit on this let's start with the way that the index is actually constructed.

*Janelle Woodward* - There are a number of fixed income indices out there that reflect different quality constraints, different sector constraints, different maturity constraints. What we see most core aggregate strategies measured against is the Barclays Aggregate Index. And while there are constraints in terms of issuer size, a 250 million minimum, as an example in credit quality, there are not constraints from a sector perspective or a duration perspective and so what this means is over time the index will evolve to reflect the issuers within the index. One of the other interesting pieces of the index creation methodology relates specifically to treasuries. When the decision was made to include or exclude treasuries when the index methodology was set, the decision was made that any treasuries held by the Fed on its balance sheet would be excluded from the index. At that time the Fed did not hold many treasuries and certainly did not hold

treasuries with durations. There's no real risk to that component. Why this is interesting is we're in a period where we're beginning to see the normalization of monetary policy. We've certainly seen that with the increase in the Fed funds target rate over the last year and the expectation that will continue. As part of that as we look forward, we're not trying to make a call on the timing, per se, but recognize that as part of that the Fed will need to begin winding down its balance sheet. And if we look at its balance sheet it's driven by two components, one, treasuries, and two, mortgage backed securities. The treasuries are most interesting to us in the context of the index methodology. We'll look at the Barclays Agg as an example, currently there's just under 7 trillion in treasuries represented in the index. When we look at the Fed's balance sheet the Fed's holding about 2.3 trillion in treasuries. So when you think about what that means, as the Fed pulls back on its holdings, those will become added to the index, and so back of the envelope we look at currently treasuries represent 36% of the index over time that could, if that 2.3 trillion is added, climb to something like 44%. And what's also interesting here is this is just looking at the monetary policy component. We also need to be thoughtful about what's happening from a fiscal policy standpoint, as we go through an administration change, the likelihood of fiscal stimulus, of tax cuts, etc., increase. When we combine that with 100 billion that the treasury will no longer be receiving from the Fed's holdings of treasury securities, this would suggest that the issuance of treasuries in and of themselves may increase.

*Ben Jones* - And so basically what you're saying is just because a change in their balance sheet or a policy the index could shift significantly towards holding more treasuries and there's nothing in the methodology itself that would cap the amount of treasuries that the index holds.

*Janelle Woodward* - That's right. That's exactly what we're saying. And we think that this is interesting and especially when you think about it on a percentage basis. And why this is interesting is we think about the trend towards passive is the fact that passive investors are going to be the natural buyer of those securities as they look to mirror the index.

*Janelle Woodward* - And so you mentioned in the paper that this kind of puts passive investors in a situation where they might actually be fighting the Fed. And I know it's considered common wisdom or knowledge on Wall Street to not fight the Fed. What does this really mean and how does this put passive investors into this position?

*Janelle Woodward* - You're right, I think that it's long been said, don't fight the Fed, and the adage reflects the fact that investors have been advantaged to align themselves with monetary policy and what the federal reserve is doing versus investing against it. What's ironic about this is that as the Fed winds down its balance sheet they are in fact selling treasuries. However, these treasuries will then be added to the benchmark, which passive investors will in turn be buying. And so that's the interesting piece of this. Passive investors will be taking up their interest rate risk at the exact time that the Federal Reserve is reducing it.

*Ben Jones* - Interesting. Now one of the other points that you make is that this may lead to longer dated maturities coming out of the Fed in the future. Why is this the case, and what is the appetite out there currently for 50 or 100-year paper?

*Janelle Woodward* - I think the reason we highlight the 50 and 100 year data is that it reflects a different type of evolution in and of the index and it is a way from what the Fed is doing in particular in a way for monetary policy changes. But it does reflect this increased and this captive demand that an issuer can find in a passive investor. As I mentioned earlier, the goal of the passive strategy is really to reflect the risk factors of an index but when the treasury comes out and issues 50 or 100-year debt that may be hard to reflect in shorter-term securities

prompting passive investors to buy them. One of the challenges we've always had as fundamental investors with 50 and 100 year securities is that it is very hard to forecast out 5 to 10 years, let alone 50 or 100. Spain's issuance of 50-year debt stood out to us in particular. I think it was just about a year ago and it was interesting because they issued 50-year debt, we've seen it out of a number of the other European sovereigns, but when you rewind the clock back 50 years and think about where Spain was in the midst of Franco's dictatorship, it's interesting to project then forward 50 years. And so when we think generally about 50 and 100 year debt we would expect as you pull forward those uncertainties that investors need to be compensated more, and either: A. They're not going to buy 50 or 100-year debt or B. They're going to demand more compensation for it. However, when you have a captive audience that's buying it, to reflect an index where the securities are being added, it means that those yields may be lower than you would otherwise expect.

*Matt Smith* - As we wrap our heads around how the future may look for fixed income markets you might be wondering how should I talk with my clients about this subject. Without a deep knowledge of the Fed, balance sheets and monetary policy, it would be easy for a client to get lost.

*Janelle Woodward* - I think the first question is what is your expectation for fixed income and for a fixed income strategy in the context of your portfolio? Do you want it to be defensive in a rising rate environment? Do you want it to provide income? Do you want it to be very low risk or just track treasuries? What is your -- what is the expectation, what is the role you expect your fixed income allocation to play?

*Ben Jones* - Do you have any advice or kind of actionable ideas that you think our advisors could consider, when discussing or implementing fixed income ideas with their clients?

*Janelle Woodward* - Yeah, I think the first thing is is that any time you have new technology, or a new approach to investing immerse it's important to understand what you really are buying, and just like Amazon Echo was a hot topic, passive investing is a hot topic. But you do have to understand what you're buying, what the risks are, and what it is capable of. I think the one thing we want to highlight, back to my earlier comment, is you are still buying market risk and you're still buying whatever direction the fixed income market in that index goes. And are you comfortable and are you aware of some of the large trends and the implications that that may have on what you're actually owning.

*Ben Jones* - Fixed income is a hot topic right now and with potential interest rate increases on the horizon, if you're talking to your clients about their fixed income portfolios I would highly recommend that you read Janelle's article. A link to the article can be found on our show notes page, at [bmogam.com/betterconversations](http://bmogam.com/betterconversations). Janelle stressed throughout our interview that the article's intent was not to advocate or defend one approach or another, but rather to make sure that advisors and investors have a clear view on what they're buying into when they implement with a passive or an active approach.

*Matt Smith* - But now the question remains, how would Amazon's Alexa answer the question, Alexa, invest my portfolio?

*Janelle Woodward* - She said I'm sorry, I do not understand the answer to that question. I actually did but after she told me she didn't know when Clemson was playing Alabama I was pretty sure she wasn't going to be able to tell me how to invest my fixed income portfolio.

*Ben Jones* - And last, If you could put a warning label on your advice in our discussion today, what would it say?

*Janelle Woodward* - I think the warning label is just know what you're buying. Be educated and ask questions. I think the second piece would be, we can't just be backward looking. We can't just look at what's in the index today and assume that that is a model of the risks going forward. We have to be thoughtful about issuance trends and monetary policy. We have to be thoughtful about other aspects and market dynamics that can impact what we think to be a lower risk investment.

*Ben Jones* - Thanks for joining me today Janelle, I really appreciate it.

*Janelle Woodward* - Thank you for having me, Ben.

*Matt Smith* - Thanks for listening to this episode and for supporting our show. If you like the show, please show your support by leaving your reviews and ratings on iTunes, it really helps. You can find all the links from this episode in the show notes at [bmogam.com/betterconversations](http://bmogam.com/betterconversations). That's [bmogam.com/betterconversations](http://bmogam.com/betterconversations). Thanks again to Janelle for discussing the subject with us. We really appreciate it, Janelle. And thanks to our team at BMO, which includes Pat Bordak, Gayle Gibson, and Matt Perry. And to the team at Freedom Podcasting, which includes Jonah Geil-Neufeld and Annie Fassler.

*Ben Jones* - Thanks for listening to Better conversations. Better outcomes. This podcast is presented by BMO Global Asset Management. To learn more about what BMO can do for you, go to [bmogam.com/betterconversations](http://bmogam.com/betterconversations).

*Matt Smith* - We hope you found something of value in today's episode, and if you did, we encourage you to subscribe to the show and leave us a rating and review on iTunes. And of course the greatest compliment of all is if you tell your friends and coworkers to tune in. Until next time, I'm Matt Smith.

*Ben Jones* - And I'm Ben Jones. From all of us at BMO Global Asset Management, hoping you have a productive and wonderful week.

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