Buy and maintain considerations in a changing fixed income environment

With buy and maintain becoming more popular in the UK, MFS' Owen Murfin explains what he looks for in a 'perfect' security and provides thoughts on how to judge the success of a manager

How does MFS view buy and maintain strategies versus buy and hold?
These are two similar concepts but with key differences relating to the 'hold' and 'maintain'. Both are low turnover strategies, but 'hold' really implies very low turnover. To us, buy and hold is when you hold a cluster of bonds around a specific maturity or liability, and you allow the portfolio to mature with minimal interaction, other than the anticipation of credit deterioration or ratings downgrade. So the bonds roll down the curve to maturity and you collect the cash from the principal at maturity as well as the coupons.

This is slightly different to buy and maintain where, similar to a normal benchmark, you're more trying to keep a constant maturity. This means it requires a watchful eye from the manager as the average maturity will decrease over time, so we need to reinvest the coupons and maturities. We see buy and maintain as an ongoing portfolio that can meet a client's need for steady returns without a specific timeframe.

Is this approach different to traditional active management?
It's really very different. First of all, there is rarely a benchmark to consider; this is a benchmark agnostic strategy. The turnover is also considerably lower than that of a fully active mandate.

Buy and maintain portfolios tend to have more of a home country bias. That's because even if you hedge the foreign currency back to your domestic currency, you are still uncertain about the potential return of that bond over the long term. That said, we would be open to issuers outside of the home country issuing in the domestic currency, such as US issuers issuing in GBP.

The other key difference is the holding periods here are much longer, and so that requires more conservatism. Given this difference of holding securities for the long-term rather than shorter periods, we have enhanced the investment process to include a specific designation for analysts to decide whether a name is buy and maintain eligible and over what specific period.

Buy and maintain also tends to focus on investment grade rated credit as it's quite hard to get visibility from companies over the long term, particularly in high yield.

What role does ESG playing in such a portfolio?
We believe ESG is very consistent with the ability of a company to pay its coupons and principal maturities over the long term and in a timely manner. This makes ESG factors an extremely important part of our surveillance, particularly over the long term as some ESG factors become far more material. For example, if a production cycle requires a lot of water, it might not be a meaningful risk in the short term but in the future there could be more water disruptions and this could imperil the whole production process. As part of building client portfolios, we also screen out companies from buy and maintain portfolios that have very poor ESG scores from third-party vendors such as MSCI, underlining the importance we place on ESG.

Is there a perfect type of name for buy maintain portfolios and how do you filter from the huge universe of securities in the overall credit market?
Typically, we start with a very large, almost overwhelming number of issuers within the credit markets. From these, we need to filter this down to a far more dedicated and concentrated portfolio.

Initially, it's the client that directs the parameters. We would speak to the client to see if they have any preference in terms of minimum credit quality or maximum maturity, for instance.

Secondly, and critically, we then run a proprietary quantitative framework. This reduces the universe to a far lower number than what the client eligible universe is. This becomes the starting point for our fundamental assessment and the analysis by the portfolio

managers and credit analysts.

The quantitative frameworks look to optimise yield while applying very prudent constraints. For example, we would have a maximum percentage per sector or a maximum weight a name can be. As well as helping to optimise the portfolio, we think it also makes it a far more prudent and diversified portfolio.

With regards to a perfect security. We believe there is such a thing for buy and maintain portfolios. Essentially, it needs to meet three criteria. First, it would clearly need to designated buy and maintain eligible by the analyst. Second, it would also need a reasonable valuation. Third, the bonds would have tie in with the time horizon of the client's mandate.

So we would not buy any security if it didn't have a designation. Sometimes a security would merit a debate between the portfolio manager and analysts to discuss exactly which ones should go in the portfolio. For example, where the designation is in place but the time horizon doesn't match exactly while the valuation does, or alternatively we find bonds with the right time horizon but the valuations are quite expensive.

Finally, any thoughts on how clients can measure the success of buy and maintain managers?

This is a key point because as opposed to traditional active mandates, where you might apply an alpha objective relative to a benchmark, buy and maintain is more complicated. Again, it is very much client directed and we would look to work with the client on what their preferred measure of success was. That said, generally, we think four criteria are appropriate.

The first is clearly the avoidance of default; the client should not experience any default over the time horizon of their portfolio.

The second is the avoidance of downgrades, particularly if this is important for the client since many clients would potentially have a capital charge if there was a downgrade. These clients would be very keen to measure managers' ability to avoid downgrades in the portfolio, especially relative to a broader universe.

The third measure is looking at the yield of the portfolio relative to the universe of bonds or some index. This helps clients to check if the manager can regularly maintain the yield above that of the overall market, while still benefiting from all the characteristics of a buy and maintain portfolio.

Lastly, does that return in the medium to long term reach the client's expectations? If the client expectation was for 2.5-3 per cent return, for example, has the manager been able to achieve that over the medium term?

For more information about MFS' buy and maintain or fixed income capabilities, please contact Madeline Forrester on MForrester@MFS.com.

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