What We Are Hearing And Seeing

Envestnet | PMC (PMC) performs the research and due diligence that drives the selection of asset managers on the Envestnet platform. This gives PMC tremendous visibility and insight into the broadest possible range of asset managers and investment types.

Our daily commutes to the office, Starbucks coffee runs, and adhoc team discussions have changed to a remote work environment. However, the roles and responsibilities of Envestnet | PMC's research team hasn't. PMC's analyst team, consisting of 28 members, is divided among four teams: Equity, Fixed Income, Liquid Alternatives, and Multi-Asset. Here is what the team is hearing and seeing in their discussions with some of the world's top asset managers.

Sarah Abernathy

Did this Bear Break the Bond ETF?

A historic divergence between market prices and net asset values for bond ETFs occurred in March 2020. The Vanguard Total Bond Market ETF (BND) closed at a more than 6% discount to NAV on March 12, only to trade at a premium of more than 1% less than a month later. Both statistics are telling outliers for an ETF whose market price has spent 90% of its trading days between a 20-basis-point discount and a 40-basis-point premium to NAV since inception, according to Vanguard. The divergence was not sector-selective, as ETFs tracking other bond sectors, like the VanEck Vectors High Yield Municipal Index (HYD), also traded at discounts not seen since the 2008-2009 Global Financial Crisis. Although March's mismatch between market price and NAV is certainly a wakeup call for ETF holders lulled into premium/ discount complacency, it is not unexpected, given market dynamics and the structural aspects of the bond ETF vehicle itself.

It is helpful to take a step back and remember the functional aspects of the ETF. A bond ETF's NAV is determined once a day by ETF pricing specialists who use actual transaction data from bond markets to value the ETF's holdings. On the other hand, market price is determined in real time by ETF investors transacting on exchanges, as well as market makers who act as middlemen working to ensure that market prices closely track the value of underlying holdings through arbitrage activities.

These functions all work in harmony in a normal market environment, but March 2020 was a far cry from normal. Even as ETF volumes soared, liquidity in the underlying bond market took a hit amid rising uncertainty and accompanying volatility stemming from the fallout of the global pandemic. Diminishing liquidity made it more difficult to properly value underlying bond holdings, as ETF pricing specialists were calculating NAVs on fewer current transactions in an already thinly traded market. Market makers also became reluctant to pursue arbitrage opportunities, given uncertainty about the ability to lock in a profit.

However, even as the NAV pricing and arbitrage aspects of the process faced headwinds, ETF investors continued to trade with record volumes, creating real-time market prices and highlighting the ETF's value as a price-discovery vehicle. Because of this ongoing trading activity, market prices for ETFs reflected the actual fair market value investors were willing to pay for debt issues based on quickly evolving macroeconomic and market developments. Not surprisingly, market prices diverged from NAVs that were being calculated only once a day and based on an increasingly stale drip of transactions. NAV simply did not keep pace with the real-time appetite for bonds.

In this sell-off, ETFs acted as an effective price-discovery vehicle and provided needed liquidity for investors in a notoriously illiquid asset class. Instead of breaking the bond ETF, this bear may have highlighted its value for the fixed income space.

Beau Noeske

Three Ways Active Managers are Finding Opportunities

"Rhythms of daily life are stuttering."

Quotes like these from our ongoing dialogues with investment managers highlight the uncertainty investors are facing. However, perhaps the most important question facing investors today is: How are active managers positioning client dollars for future success?

Most active equity managers seem to fall into one of three categories regarding their response to current market volatility: those using the Q1 downturn to upgrade the quality of their portfolio holdings; those taking advantage of pricing opportunities to reposition their portfolios for a recovery; and those employing lessons learned from coronavirus to broaden their investment perspective and sharpen their process.

Managers upgrading quality have focused on balance sheet stability. In March, the chickens came home to roost for portfolios overexposed to cyclicals and firms with highly levered balance sheets. As noted by one such PM, "High debt levels haven't been a problem for a decade, and everyone forgot that leverage is risky." These managers largely have purchased names that have shown resilience across different environments, and in turn have lowered their exposure to cyclicality and leverage thus far in 2020.

Other portfolios have shifted toward out-of-favor areas of the market, which have led historical market rebounds. These PMs have spent their time analyzing the sustainability of the types of companies the quality-focused managers have mostly avoided, including small-caps, travel, leisure, hotels, and cyclicals. "We have to make sure companies in these areas will have the staying power to get to the other side," noted one PM. "It's a little bit of contrarian thinking, but those that do can present spectacular opportunities." Interestingly, even PMs in this "blood in the streets" category have generally remained pessimistic on beaten-down retail stocks, as the survival hurdle may be harder to clear in an environment so thoroughly dominated by Amazon.

"It's irresponsible not to be thinking from a new perspective now versus back in December," said one PM, highlighting the third category, consisting of managers who have incorporated lessons learned from this downturn into their evaluation methodology moving forward. One PM expressed that the COVID-19 crisis has prompted them to factor companies' ability to service debt into their screening criteria, and another challenged the idea of simple mean reversion plays based entirely on history, stating, "We're seeing that people are incredibly adaptable. Reversion to the mean often relies on behaviors returning to the old normal. We need to consider that the longer this situation persists, the more these temporary human behaviors, like working from home and shopping primarily online, become permanent, and reversion won't occur as much as it has historically."

Through such a diverse offering of high-conviction strategies vetted by the Envestnet | PMC Research Team, these various perspectives illustrate that there is no shortage of options to choose from when it comes to finding active managers whose approach best aligns with clients' own visions and objectives.

Mike Wedekind

Everybody Hates Oil

On March 20, the price of oil, specifically the NYMEX May West Texas Intermediate (WTI) crude oil futures contract, fell below $0 per barrel for the first time in history. Then it kept falling before bottoming at *negative* $37.63. Although the contract eventually finished in positive territory the following day, the futures markets have gotten fresh attention as investors try to avoid a repeat. We all saw the headlines, but what does it mean?

Futures contracts for WTI, the means by which most investors access the oil market, are settled via physical delivery in Cushing, Oklahoma. As the final day of trading (April 21) approached, many of the unfortunate long investors in the May WTI contract had to pay for the privilege of "rolling" out of the near-term contract into one with a longer maturity to avoid the logistical and financial headache of securing limited storage space.

As they had prior to April 20's drop into negative territory, most large investors are preemptively moving into longer-dated contracts, which in itself may make another plunge below $0/barrel less likely. With June WTI contracts trading at just above $12/barrel on April 28, and Brent contracts near multidecade lows, the market appears to have digested the scarcity of buyers and storage space. However, if production continues to outstrip supply, or if there is another stampede for the exits in a near-term contract, we now know oil prices can plumb the depths of negative prices.

Cynthia Crandall

Global Macro: A Flexible Approach

During the first quarter, leading equity indices around the globe sustained losses, with the S&P 500 Index (-19.6%), MSCI World Index (-20.9%), and MSCI EAFE Index (-22.7%) reporting some of their largest quarterly drawdowns on record. Similarly, fixed income was fraught with its own bout of volatility amid liquidity-driven technical pressure and redemptions. Notably, 10-year Treasury yields fell to as low as 54 basis points (March 9), structured credit markets declined between 30-50%, and both investment grade and high yield credit experienced peak-to-trough declines in the midteens to low 20s. A volatile quarter indeed.

And yet, global macro was a bright spot in the turmoil. The HFRI Macro Total Return Index ended the quarter relatively unscathed, up seven basis points. A go-anywhere approach, global macro strategies are designed with the ability to harvest best ideas across asset classes and regions, employing long and short positions in equity, fixed income, currency, and commodities to capitalize on a broad number of opportunities and trends in areas like interest rates, currencies, and sovereign credit. The mandate's flexibility is particularly advantageous in periods of uncertainty, in which the expanded global footprint and ability to short and use instruments like futures, forwards, and swaps afford these strategies an edge over traditional approaches.

Given that COVID-19 may continue to present significant challenges for the next 12-18 months, a strong case can be made for adding diversifying liquid alternative strategies such as global macro to investor portfolios. Although the extent to which the pandemic will precipitate a global slowdown in supply and demand is uncertain, particularly given the vigor and strength of accommodative international monetary response, global macro strategies should be well equipped to take advantage of the volatility and invest in trends, themes, and pockets of relative value in the months to come. The breadth, flexibility, and opportunistic nature of their approach allow them to adapt dynamically to a wide range of scenarios and pivot to areas of value in the market, offering investors a true avenue for absolute return.

Alfie Manuel

Short Term Instruments: Standing Tall Against the Odds

The short end of the fixed income market, which typically acts as an anchor when equity markets are choppy, has been feeling the heat of late, with investors redeeming close to $23 billion from short-term fixed income products in the first quarter of 2020. Short government was the only category with positive inflows, attracting close to $12 billion in capital over the same period. With risk-off sentiment prevailing, safety led the way, as the Bloomberg Barclays 1-3 Year US Treasury Index generated a return of 2.76% for the first quarter, whereas the 1-3 Year Government/Credit Index posted a modest 1.69% return.

Many active managers in the short-term bond category underperformed amid the pandemic-driven conditions, which can be attributed to being overweight spread sectors and underweight Treasurys. The magnitude of spread widening recently witnessed by markets is the most since the 2008-2009 Global Financial Crisis, with option-adjusted spreads (OAS) increasing by 544 bps in high yield and 179 bps in investment grade corporates in the first quarter. The credit sectors were badly hit, as highly-levered entities sold off, and anything related to Energy hurt returns. Despite the challenging performance for corporate bonds during the month of March, the sell-off has presented opportunities for active short-duration managers with solid fundamental credit research to add value.

Additionally, many managers PMC covers are quite optimistic about valuations in the securitized side of the market. Fundamental concerns about the deteriorating quality of lower-rated CMBS tranches and consumers' ability to repay the auto and credit card loans pooled in ABS have been alleviated by the CARES Act. Meanwhile, the Federal Reserve's buying program of AAA-rated ABS, CMBS, and CLOs has alleviated liquidity concerns. Regulators certainly are wary that extreme losses at the front end of the curve can lead to a collapse of the financial system due to the knock-on effects on longer-term debt and equity, and therefore are putting their best foot forward to avoid any major disruptions. With this fundamental support in place, the spread widening in the securitized sectors has created additional opportunities for short-term focused active managers.

Overall, PMC finds that the managers who have weathered the storm best are those who had constructed their portfolios with ample liquidity buffers to meet redemptions, and those who consistently take incremental risk with a focus on balancing income generation and capital preservation.