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Fixed-income arbitrage

One study showed FIA funds posted weak returns

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In today's environment, some financial advisors have undoubtedly been attracted to the high yields being offered by some fixed-income hedge funds. As fixed-income arbitrage strategies can possess unforeseen risks, the portfolio research team at my firm, Tacita Capital Inc. of Toronto, has delved into their performance. On the surface, FIA strategies are simple — go long in an underpriced fixed-income security while taking an offsetting short position in an overvalued security. However, as the respective price differential between the positions, as measured in yield, may be only as slight as a few basis points, significant leverage typically is deployed to exploit the mispricing. The trade is closed when the yield spread between the securities narrows (or widens, in the case of shorting lower-quality credits) and a profit is booked.

The simplest of these strategies involves going long in high-yield or investment-grade corporate bonds and shorting government bonds to eliminate the interest rate risk. In essence, a credit spread is being isolated. Leverage is deployed to magnify this spread, with the goal of generating steady income with modest volatility. It is the leveraging of this credit spread that creates the allure of an 8%-10% yield on equities.

In theory, if the offsetting long and short positions have similar maturity dates, a profit seems virtually assured. But the reality can be quite different. If spreads shift dramatically before maturity and margin calls from the prime broker require equity capital infusions, positions may have to be closed at a loss. Spread shifts can occur, due to an unanticipated deterioration in the creditworthiness of a long position, changes in liquidity and, most dramatically, external shocks such as the global credit crisis.

Changes in prime broker lending requirements, as well as major redemptions, can also force inopportune sales.

Canada lacks a market-wide index that includes all hedge fund managers and strategies. However, a 2009 study undertook a comprehensive review of Canadian hedge fund strategies. That study found that Canadian FIA funds had a monthly average return of only 0.25% from January 2005 to June 2009. This was well below the 0.38% and 0.61% monthly returns of Canadian corporate and high-yield bonds, respectively, as measured by the Bank of America Merrill Lynch corporate bond and BofA ML high-yield Canadian issuers indices.

Although FIA funds were almost 30% less volatile than high-yield bonds, FIA funds were twice as volatile as corporate bonds. The maximum drawdown of FIA funds of 15.7% over a lengthy 18-month period starkly portrays the risk of this strategy in a period of credit crisis.

Longer-term data in the U.S. paints a more attractive but still modest return picture. One study calculated that FIA funds had an annualized return of 6.6% from 1995 to 2009. Still, this was slightly below the 6.8% annual return of U.S. bonds, as measured by the Barclay's Capital aggregate bond index. FIA hedge fund fees, estimated to run 3.1% annually, were a major drag on return performance.

The attractive yields of FIA funds are only part of the story. The credit spread, default, margin call and leverage risks associated with these funds, as well as their fees, need to be considered. **IE**

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