Blending Quant and Fundamental Portfolio Construction Inputs

The SSAG model provides a sector allocation framework.

August 2021

KEY INSIGHTS

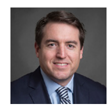
- The sector strategy advisory group (SSAG) model can be helpful in distilling the extensive fundamental and quantitative research from the SSAG into a portfolio construction context.
- We customize the SSAG model by incorporating the insights of our credit analysts on individual securities as well as our own views and outlooks.
- We consider the broader risk target for an entire portfolio and our conviction in different forms of risk exposure to help determine sector allocations.

Because our multi-sector strategies have the flexibility to invest across many fixed income sectors, we use a range of quantitative and fundamental inputs to inform our sector allocations. The sector strategy advisory group (SSAG) model is one of these tools. It is important to keep in mind that the strategies are not "black boxes" that blindly follow the signals produced by a particular model. We use the SSAG model as a complement to other quantitative inputs, the fundamental views of our credit analysts, and our own qualitative outlooks for the economy and financial markets. However, the SSAG model can be helpful in distilling the extensive fundamental and quantitative research from the SSAG into a portfolio construction context.

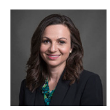
Sector Strategy Advisory Group

The SSAG consists of portfolio managers with expertise in individual fixed income sectors ranging from securitized credit to bank loans to emerging markets debt, as well as multi-sector portfolio managers, traders, and members of the quantitative research team. Every month, the SSAG meets to discuss broad sentiment toward risk in fixed income markets and conditions in various sectors to provide ideas on where to allocate risk exposure.

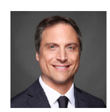
The members develop outlooks for each sector that they convey to T. Rowe Price's multi-sector portfolio managers along with rankings of relative attractiveness by sector. The results of these discussions help inform positioning in our multi-sector credit strategies.



Christopher Brown, CFA
Cochair, Sector Strategy Advisory Group



Anna Dreyer, Ph.D., CFA
Head of Fixed Income Risk and Portfolio Construction Research Team



Kenneth Orchard, CFA
Cochair, Sector Strategy Advisory Group

Risk-Optimized Portfolio of Sectors

We developed a model in seeking to create a risk-optimized portfolio across credit sectors. The model incorporates the SSAG's views on the risk environment and relative attractiveness of credit sectors, incorporating both market information and fundamental views to provide a reference point for portfolio managers as they determine how to allocate risk exposures within their strategies across sectors.

To this end, the SSAG model incorporates inputs from a pair of proprietary models. The first is an internally developed risk model designed to determine whether to characterize the current risk environment as generally positive (risk on) or negative (risk off) by applying indicators, including the level of risk asset volatility and investor positioning. It also uses data from a sector ranking model developed by the SSAG that incorporates relative valuations, our economists' outlook for the economic environment, estimates for credit spread[1] changes under various scenarios, and conviction scores from sector portfolio managers to rank the set of credit sectors from most to least attractive in the current environment.

Strategic and Tactical Model Recommended Allocations

The SSAG model generates a strategic portfolio, or recommended credit sector allocation, and a tactical portfolio. The goal of the strategic model portfolio is to maximize carry, or interest income in excess of the risk-free rate, per unit of volatility without incorporating the risk environment or the SSAG sector outlooks. The strategic model portfolio represents a potentially optimal credit portfolio when sector views and risk appetite are broadly neutral. This diversified foundational portfolio is designed with a goal of being durable across market cycles.

The SSAG tactical model portfolio takes the optimization process a step further and incorporates the risk environment view as well as the expected spread moves implied by the sector rankings to generate a model portfolio designed to try to take advantage of current market conditions and sector views. Both SSAG model portfolios allow wide latitude for sector allocation ranges, but they apply some constraints on overall sector exposures and risk levels in an effort to generate diversified portfolios with realistic boundaries.

Reference Point for Allocating Credit Risk

The SSAG recommended allocation is an important consideration for developing positioning across credit sectors. However, we use it as a source of ideas internally for structuring the multi-sector portfolios, not as an ironclad rule. The recommended allocations provide a reference point for determining the level of overall risk to take in the multi-sector strategies as well as how to allocate that risk among the various credit sectors.

We also view the amount of risk taken in sector positioning in relation to other risks in the broader strategies. These can include interest rate risk, both in terms of duration[2] and positioning along the yield curve. For example, the higher our conviction in our outlook for rates or yield curve changes, the more risk we will likely allocate to our rates exposure versus sector positioning—and vice versa.

Credit Analysis Still Essential

At a more granular level, collaboration with our global team of credit analysts can lead us to modify the SSAG model credit sector allocations. Fundamental analysis at the credit level is still a critical component of the T. Rowe Price fixed income research process. For example,

[1] Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.
[2] Duration measures a bond's sensitivity to changes in interest rates.

a high-conviction call on an individual high yield credit (or multiple credits) could cause us to overweight high yield bonds relative to the SSAG model's recommended allocation.

The SSAG model is an important element of our portfolio construction toolkit, providing a useful framework for strategic and tactical sector allocation decisions.

WHAT WE'RE WATCHING NEXT

Our sector specialists and traders continually monitor liquidity in various sectors, particularly as many global market participants take vacations and holidays in the summer months. Liquidity conditions are an important factor in the SSAG's views on the relative attractiveness of sectors.

INVEST WITH CONFIDENCE℠

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

T. Rowe Price®

ID0004446 (08/2021)
202108-1752735