Discussion Notes "Fixed Income Management: Evolution or Revolution?" by Susan Buckley, QIC Discussion Notes by Howard Pender

This paper deals with the "old age" issue of the attractiveness of active versus passive management of a portfolio. However the context is the less commonly discussed one of fixed interest portfolio management.

I intend discussing:

- The parts of the story I believed and parts I was sceptical about. I imagined myself a trustee in addressing these issues;
- How long I thought active fixed income management would add alpha. In this regard I thought more of myself more as an academic finance economist.

Firstly I want to make it clear I have no issues with Susan's criticism of the benchmark strategic asset allocation approach to fixed interest portfolio management. The criticism she makes has immediate analogies in the equity funds portfolio management space.

Similarly, if I accepted the proposition "over a sustained period" an individual fixed interest portfolio manager could successfully "instrument pick" I had no problem with any other part of the paper. It was the implicit "we can be successful long term fixed interest instrument pickers" that I was more sceptical about. If that proposition is accepted then I think most of the rest of the paper follows and quite an elegant exposition of the implications of accepting this proposition. However, I didn't feel all that well convinced by the paper that successful instrument picking was likely and repeatable. So I still felt a bit of a Vanguard index manager sort of a person in this context having read the paper.

There are four reasons which made me a bit dubious about the "successful long term picker" feasibility proposition. Firstly, the fact as emphasised by Susan of the depth and sophistication of the derivatives/synthetic markets. The paper contains a number of tables and prose pointers to the rapid growth of the credit default swap market, the close link between physical and synthetic credit spreads etc. These are indicators to me of efficient, arbitraged, well informed markets. So they heighten my scepticism about the possibility of a lot of individual stock picking value add.

The second reason I remained sceptical was the absence of much discussion as to why it was likely one manager would be able to successfully adopt macro or global credit strategies as described in figure 10. Take the various boxes under the "global credit strategies" heading. Now suppose an active manager says, beating his chest, I can beat the Lehman global aggregate by far superior credit analysis of the 10,000 issuers included. I've got the documentation from all these issuers and I've got an expert system which poses the question If the issuer says to their lawyers – "I want to default rank the possibility the issuer will get away with it?"

I'd say OK I can see how your are adding some intellectual value to portfolio management task until someone else has got such a system I can see your claim you can "add alpha" stacks up.

Perhaps understandably in Susan's paper there is very little description of how she suggests managers should go about this task which left me feeling a bit dubious as to the probability it can be done in a repeatable fashion.

Thirdly taking more the social scientist/academic finance perspective CAPM relies on a degree of stability in this stochastic properties of the distribution of instrument returns and the cross correlation matrix. As Susan notes in this context we are dealing with instruments where performance will often be linked to more "tail events" than maybe it is in the equities case.

My last source of scepticism reflects personal experience more than the intellectual previous three concerns. For many years I worked as a macro modeller and commentator. I often stood up and spoke to groups of people like this telling them my views on future likely movements in the yield curve, inflation, future financing requirements of the Commonwealth etc. I have also done a bit of stock picking of small cap listed Australian companies and my confidence in an individual investment analysts capacity to profit from sound judgement was much higher in the latter case.

Word Count: 695