FIXED INCOME FOCUS:

NAVIGATING A CHANGING WORLD

A new paradigm in fixed-income markets

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Seeking income in a low-yield environment

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WRITTEN BY SALMAN AHMED, CHIEF INVESTMENT STRATEGIST, LOMBARD ODIER INVESTMENT MANAGERS

Challenges in the new investment paradigm

Investors are facing a number of important challenges when it comes to global fixed-income investing:

Widespread low or negative yields in key developed markets

Investors are facing a material cost of negative carry in their fixed-income allocation and this is forcing them to search for yield. Even though the US election alleviated some pressure, the fundamental drivers of low rates in non-US developed markets remain.

Increased market risk

Investors have extended duration (figure 1) to find positive yields and now face a heightened sensitivity to moves in interest rates. Bond markets are also now providing lower diversification benefits given the increased correlation with equities. Furthermore, as investors are increasingly forced into taking the same positions given the shrinking investment universe described below, this herding effect raises the likelihood of future liquidity incidents, in our view.

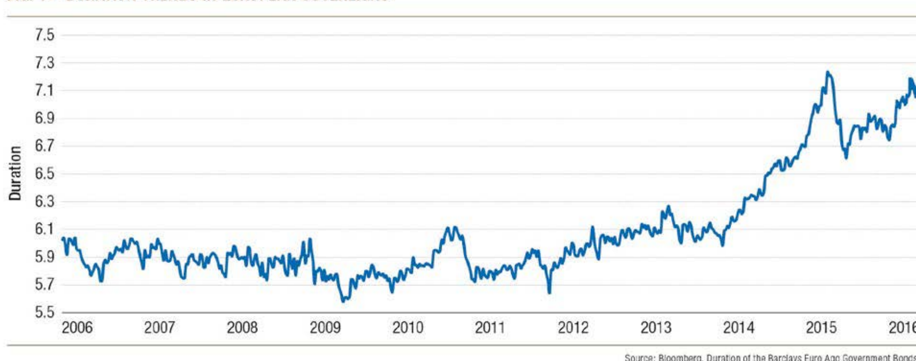
Fractured liquidity

Investors should be under no illusion – liquidity is fractured in fixed income markets stemming from two main causes: (i) the unconventional monetary policies of central banks mean they have bought and hold up to 30 per cent of all outstanding government debt, therefore reducing the free-float of major sovereign bond markets; and (ii) tightening regulation such as Basel III is strongly reducing banks' ability to hold and trade fixed income. The data in figure 2 evidence a sharp drop in corporate bond inventories held by the banking sector relative to the size of the market. Banks are acting more like brokers than principals.

The nature of duration has changed

Further to the above, we believe investors must also reassess duration. While history has been supportive of long-term returns from duration exposures, a key driver of this has been a fall in interest rates; the direction of monetary policy points to limited potential for rates to move lower, damaging the return potential of duration.

In the US, sentiment on rates has turned distinctly hawkish following the election result; the probability of fiscal interventions has increased, creating negative pressure around duration dynamics. In Europe, monetary policy continues to be dovish with the European Central Bank expanding its quantitative easing programme to include credit, hence extending the



direct influence of monetary policy beyond duration. We believe the possibility of yield curve control is more likely now in Europe, given the spillover from the US election. This would mean that duration ceases to adequately perform any of the key functions it has historically been associated with, namely: long-term returns, capital preservation, diversification and liquidity.

Time for a rethink

Selecting an appropriate investment approach

We think investors need to change their approach to account for the new paradigm in fixed-income markets by building quality-driven portfolios and trading less.

In a world where you cannot easily trade, the starting point, when it comes to portfolio construction becomes a critical decision. Today, the vast majority of investors apply traditional market-cap bond indices as their starting point. This represents a significant issue as market-cap indices reward leverage and give a higher weight to the most indebted issuers – a design flaw that we think is amplified in the current fractured liquidity environment. Often investors turn to active managers to mitigate the flaws in market cap, but we can expect increasing pressure on higher turnover active management as higher trading costs and lack of frictionless trading erodes performance.

In order to tackle some of today's challenges, we strongly recommend that investors trade less and build safer portfolios that exhibit quality. To achieve this, investors should install explicit default risk mitigation at the heart of their portfolio construction process; investors need to consider fundamentals-driven portfolio construction approaches within a low turnover framework that focus on credit default mitigation.

Sourcing yield

To find yield in the new investment paradigm we believe investors should continue to move prudently down the credit spectrum. The changed nature of duration provides a further reason for reassessment. Increasing exposure to credit risk through an allocation to corporate credit is a sensible option for investors, in our view.

However, investors need to look beyond the investment grade segment of the corporate credit market where the dominance of duration will limit potential returns, in our view. We believe that to sufficiently increase their credit risk exposure investors should move further down the credit spectrum.

The so-called crossover universe[1] – which spans the lower quality investment grade (BBB) and higher quality high yield (BB) rated issuers – provides significant return enhancement relative to investment grade issuers while not exposing investors to the excessive default risk that is a feature of high yield (rated B and below) debt, in our view. The inclusion of 'fallen angels' – corporate credit that has been downgraded from investment grade and is initially undervalued due to market inefficiencies – is a key driver of the attractive spread returns seen in the BB segment and therefore captured by the crossover universe.[1]

Seeing the bigger picture

While a quality-driven, low-turnover crossover credit portfolio can help investors to meet their yield and capital preservation objectives, what about their need for a highly liquid portion of their portfolio? For this, we believe investors need to accept that fixed income is no longer the answer and instead explore strategies that are better able to provide liquidity in the new investment paradigm; in our view, this includes liquid multi-asset strategies that combine both traditional and alternative risk premia.

Conclusion

The new investment paradigm poses serious and lasting consequences, forcing investors to rethink how fixed-income investing can work for them as they pursue their objectives. ■

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[1] *We focus here on spread returns as – unlike yields or spreads – this measure accounts for losses from downgrades and defaults which may be especially significant for lower rated portfolios.*

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Seeking income in a low-yield environment

Since the financial crisis, yields on European government bonds have fallen dramatically, some into negative territory. Sally Ling **looks at the issues faced by pension schemes and the strategies they are adopting in the search for new sources of income**

WRITTEN BY SALLY LING, A FREELANCE JOURNALIST

Over the past decade, European pension schemes have increased their allocation to fixed income, often in response to the need to de-risk a defined benefit promise. But some of the characteristics that made government and other investment grade bonds suited this purpose can no longer be taken for granted; yields have fallen – to below zero in some cases – and bond markets are increasingly moving in the same direction as equity markets rather than in the opposite direction. As a result, many pension funds have needed to reassess how they invest in fixed income and the role it has to play in their investment strategy.

Greater diversification

One key theme that has emerged in recent years as pension funds seek yield from their fixed-income portfolios is a move into a broader range of assets. Aon Hewitt fixed income manager researcher Paul Whelan says: "The major thing we've seen in the past three years is a trend towards diversification of fixed-income assets with more of the growth portfolio allocated to this area."

Lombard Odier Investment Managers chief investment strategist Salman Ahmed expands on this point, saying that as part of the increased allocation to fixed income there has been continued diversification into areas such as US credit, high yield, emerging-market debt and illiquid asset types, all of which have provided yield.

The search for greater yield typically involves taking on greater credit risk, but tends to be a gradual process. Henderson Global Investors fund manager Tom Hanson states that he has seen a general migration downwards in terms of credit quality in recent months. But, he adds: "I would think it is unusual for an investor to jump from the top of the capital structure to the bottom. I think it would be a more natural progression to come down from investment grade into high yield, rather than say government bonds straight to high yield."

Range of strategies

Having accepted the need to diversify and take on more credit risk, schemes have a number of approaches and strategies to choose from. Mercer European director of strategy research Phil Edwards says that private debt is one particular area that has seen increased attention from pension schemes since the financial crisis. He explains that this approach allows schemes to lend to corporates or proxy owners without necessarily taking on huge amounts of credit risk; in accepting some degree of illiquidity they typically achieve a higher yield on these assets.

A newer development that Edwards has seen coming to market in the past six to 12 months is secured finance. Under this strategy managers have quite a broad mandate to invest in credit assets of roughly investment-grade credit quality, but the types of asset are more complex and less liquid than traditional corporate bonds. Holdings might include asset-backed securities, collateralised loan obligations, private debt and bank

loans. Some strategies include real assets at the lower end of the risk spectrum, such as infrastructure debt and long-lease property. Returns are driven by compensation for complexity and illiquidity risk.

Broader outlook

In the search for yield there is evidence that schemes are becoming more comfortable investing in non-domestic credit. One such example is European high-yield bonds, a market that has grown substantially in recent years. This has different characteristics from the much larger US high-yield market, which might make it more attractive to European pension funds. Hanson explains: "European high yield is a distinct asset class … it has a much higher weighting of BB-rated bonds in the index.Whereas a US index would have a higher weighting of CCC-rated bonds, European high-yield indices typically only have about 5 per cent in CCC."

According to Ahmed, changes in bond yields have had an impact on liability-driven investment (LDI) strategies, which have led investors to look beyond their domestic markets. He says: "The LDI model is being challenged as bonds no longer effectively preserve capital and provide liquidity, especially at extended durations. To mitigate this problem, a trend is emerging of investors moving from domestic-bond LDI to a global-mixed LDI and a separation between the interest rate management function and the yield generation function of an LDI portfolio."

Manager flexibility

Another theme that has emerged points towards greater reliance on asset managers' skills rather than market movements. According to Edwards, schemes are moving away from traditional benchmark-constrained investment-grade credit mandates and giving managers more flexibility. This is particularly the case with multi-asset credit strategies, where a single manager will invest across the whole spectrum of fixed-income assets, offering a greater opportunity to generate returns from alpha.

Edwards explains: "Managers do this typically by security selection within each of the underlying markets they are accessing, but also by dynamically allocating assets across the different underlying asset classes."

He adds: "These strategies might invest in high yield, conventional bonds, loans, emerging-market debt and some of the more exotic parts of credit spectrum, such as stressed or distressed debt."Absolute-return bond strategies are an extension of the multi-asset credit approach, which is also attracting attention. These aim to deliver a very stable 'cash plus' return over time and once again are very much reliant on managers adding value rather than market beta.

Additional flexibility gives the manager scope to adapt to changing markets.Whelan says: "At a time of perceived market risk the manager might allocate towards a more liquid, less risky strategy such as short-dated government bonds or high quality asset-backed securities. When there is greater confidence in the market, the manager will allocate away to the sub-investment grade bond universe or emerging-market debt."

Whelan adds that there is a risk in placing greater reliance on manager skills to read the market timing right. While he believes that there are managers who can do this across the cycle, he warns that this approach is "not a panacea".

Regional variations

Although pension schemes across Europe face the same economic and market challenges, the way schemes have responded to these is largely down to differences in regulation and models of pension provision across the European area. Ahmed says: "We find that non-euro-denominated countries invest mostly in their domestic government bonds, while euro-denominated countries invest most heavily in the core euro economies' government bonds."

He adds: "In the UK, inflation risk is actively hedged using index-linked gilts and inflation swaps; while in continental Europe there is not such emphasis because of a presumably weaker link to inflation in pension guarantees and in some countries, such as the Netherlands, benefits can be clawed back in adverse situations."

Whelan notes that the Netherlands embraced LDI before even the UK did, so schemes there are more familiar with derivatives and fixed income strategies. As a result, in much of the Dutch marketplace clients are more willing to embrace fixed income strategies on both the growth seeking and liability hedging sides. He adds that he is currently seeing more interest in less traditional growth strategies from the Irish and German markets.

Future threat?

The UK's vote to leave the EU and the unexpected election of Donald Trump as US president have heralded a period of political uncertainty, which is unsettling for financial markets. But whatever the future holds, schemes will need to make sure that their fixed-income strategies are flexible enough to adapt. ■

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