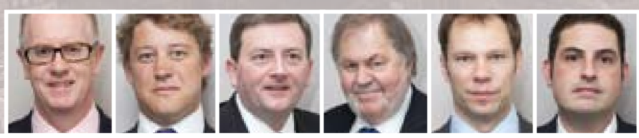
FIXED INCOME

From gilts to emerging markets: making the most of the asset class during the European debt crisis



In conversation:

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Barry Parr | Martyn Simpson | Chris Panteli

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From left to right

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What are the key risks facing fixed income investors at the moment?

Brain: The biggest uncertainty for us is the unknowns that we're faced with every day: the binary situation in the eurozone; is it going to fail or succeed? Also, when it comes to the macro-economic outlook, the situation in China is probably one of the hardest things to analyse. To build portfolios based on two very significant macro events that may or may not happen is extremely difficult. If China is slowing down, will that lead to a hard landing which would have a significant impact on the world economy? And is the eurozone going to stay together or fall apart? If it stays together does that lead to a prolonged recession-type environment in the eurozone?

So I think the key risk is the fact that we just don't know the solutions to those or the conclusions to those two significant macro-economic stories.

Drewienkiewicz: It's quite interesting, this inflation tipping point we seem to have been sitting on for the last couple of years where people have been uncertain about whether you're going to get very rapid inflation or deflation. And the Bank of England's obviously been saying it's very much in the deflation camp and with the stats that have come out in the last couple of weeks it looks like it may have held its nerve just long enough. So from an inflation point of view I think the risk is certainly diminishing. With rates you'd have to say there's not too much immediate risk on the horizon and certainly from a point of view of credit product arrangement we tend to look at all credit product on a spread basis rather than on an absolute yield basis, so we would always isolate credit spreads from the absolute level of yields.

From that point of view you would say credit spreads are probably still relatively attractive, whereas obviously absolute yields are very low, but that's a result of very, very low benchmark yields.

If the Bank of England was to raise the rates, what implications would it have for gilts?

Martin: You pick on a very live issue which we're currently debating very hotly. I suppose what we're talking about now is gilts in a rising rate environment. I still think that's a long way off, it'll be a couple of years or so, but it's all about a capital loss in gilts and a substantial one. It's a question of whether you want duration at this point in time or do you take that trade off?

I know for pension funds we're always talking about de-risking but is this more a question of an environment where you want to re-risk, take profits from gilts or put more in, or perhaps more importantly take action now from gilts and put it somewhere else where it can be more defensive rather than having the risk of regret in two to three years time and saying 'It was obvious'. Things are always obvious with hindsight [so] take action now.

In the immediate term I would say it may not be popular, but the risk is that gilt yields go even lower and substantially so in the next year or so. Who knows, would we face a Japanese -type scenario with gilt yields of 2% for a considerable period of time? So to me the risk is that we're just seeing a lower rate environment that'll rain on for a period of time with very low gilt yields and that becomes the norm, say, for the next five years.

I think a lot of people who have been talking about rising rate environments in the last two years have been substantially caught out. They left that risk on the table and are probably saying 'If only we'd done something'.

And what do pension funds do if rates stay so low?

Parr: The position from a pension fund point of view is probably split into two camps. Firstly you have the traditional defined benefit (DB) camp, much of which has been following an LDI-type of philosophy for a period of time. And clearly the concern there is that the deficit is still not reducing, there's considerable evidence to suggest that LDI is not a particularly successful strategy. It may calm some FD nerves, but

Paul Brain

The problem with fixed income markets is bond indices are counter-intuitive. If a country or a company is doing poorly its weight goes up. Paul Brain

it doesn't appear to dramatically change the financial position of many DB pension schemes. But there is another risk and that's the regulatory risk. Obviously with fixed income in mind the discount rate that might be used by DB schemes is perpetuating the deficit and that is a very very big issue. By contrast I would say with defined contribution (DC) – and bear in mind that DC is probably now attracting as much new money as DB and will take over from that in a short period of time – typically DC schemes are slow to respond and are following their advisers and the sense at the moment is that advisers are somewhat lost as to know what to recommend.

Martin: You say people may be structured short of duration, but to an even greater extent people have been systemically structurally short of inflation protection. The elephant in the room is inflation will be higher than people suspect. There's been a lot of talk that inflation is cheap or cheaper to buy, not just linkers. So now would be the time to start taking some of that risk off the table.

Drewienkiewicz: I think we have to get used to negative real yields. That is an environment we are comfortable with because we're in a massive deleveraging situation which is much bigger than Japan and is happening a lot faster than it did in Japan. We've got to get used to this idea that Japan is the blueprint for what we're experiencing in a number of western economies and will be for some time.

Martyn Simpson

It's perverse to me that anyone thinks they need daily liquidity, it's bonkers.

Martyn Simpson

How have investors shifted their view towards different forms of credit?

Parr: Many trustees are increasingly aware of these markets under the guidance of their advisers and I think there is a willingness to move small percentages in the direction of what might be newer markets for some pension schemes.

However, it is bound by practicalities such as liquidity, etc. as to what access can be achieved and generally that's a fairly slow process for pensions here. It's also much harder for DC than DB; there's still a shortage of funds of that type in the DC world.

Martin: But on the DB side you said they are perhaps more willing to take a bit more risk…

Parr: Well it's easier for them to do that through the ability to select funds that maybe mean you don't retain any liquidity. It is easier and it's more conventional to look at such asset classes. It's still a new world for DC though and it is still simple by comparison in terms of its investment options.

Simpson: There is so much evolution that needs to happen and there needs to be a mature view on daily liquidity. It's perverse to me that anyone thinks they need daily liquidity, it's bonkers. When we're able to take a more mature attitude to the realistic levels of liquidity we need, hopefully we can address the more sensible investment options in that space. And there's a difference between saying 'I don't need daily

liquidity' and taking a two-year lock up. There's an awful lot of space in between and if you're prepared to accept you might have to move the money out in blocks over a little bit of time then clearly that really breaks open the floodgates to a much wider range of investment opportunities.

Martin: Those people who missed out on the credit opportunities of 2008, they've taken a gilts bounce recently. Perhaps they can still say 'This time round we'll take advantage of that'.

But this is credit crisis number two potentially, so we could perhaps take account of that at this point in time. I've always been a bit dubious of the question of 'Is credit a growth asset class?' I'm keener on asking 'Does it give me a sufficient return?' For pension funds it's not necessarily about maximised return, it's about sufficient return and the return that they need.

If you're talking about growth I would think more about emerging market debt, those types of areas. Or if you want a higher return look at secured loans.

Simpson: Absolute yields are already very low on emerging market sovereign debt.

Martin: Yes. So we're talking about local currency actively managed.

Drewienkiewicz: The thing I like about credit is it does have that quality, as long as the default regime doesn't totally shift, when your credit suffers clearly your expected return in the future goes up. That's a nice attribute for pension funds to have in their portfolios. And if you think about what you're really expecting from equities then you may well discover that 6% to 8% from a fixed income part of the portfolio looks pretty good.

Brain: I think when you do the maths on high yield for better equity and risk-adjusted bases it actually wins hands down, but I'm encouraged to see people look at it that way rather than to treat it as an alternative to investment grade or gilts. It is a different type of asset class. The same with emerging market debt; I think hard currency emerging market debt has more similarities with investment grade/sovereign or western sovereign governments.

Drewienkiewicz: The investors' time horizon is really key as well. That's an area where there could still be better communication between managers and pension schemes and advisers. Most commonly you write a year-by-year mandate and you have a certain target to achieve each year. But very rarely do I see it laid out as 'This is our time horizon and we want to achieve a total net return of 'x' over this number of years', which really is a more sensible way to address the problem.

Martin: I wouldn't put credit into that growth asset class where I would high yield, but if we look at a global credit benchmark and we see 40% in financials, would I want to go above that? Yet we'll go and ask managers to manage against that and if financials have a rally over a quarter we'll be penalising them for not holding these financials which seemed such an obvious bet in hindsight.

So I think a kind of asset swap or buying old credit and trying to garner that kind of extra spread you get for holding credit over time seems a sensible way of doing it rather than being wedded to benchmarks.

Parr: I have to say unfortunately that's not really got through to trustees yet, it tends to be regarded as not much more than one asset class. The other questions one asks as a trustee are, 'How have those markets been fulfilled in the past? And why have we not been investing in that in the past? Are these new classes that didn't exist before?'

Drewienkiewicz: Most of the asset classes we've been talking about have been there for some time, it's just some of them are getting bigger than they were and more liquid. But as we've seen in 2008, 2010 and 2011, some of that liquidity is temporary, so in addition to taking on extra credit risk you're taking on extra liquidity risk in some instances.

Martin: Especially for defined benefit trustees whose historic focus was on growth and open schemes. As schemes have changed their profile, their characteristics, and de-risking planning, the focus is on return in a risk-adjusted environment.


Pete Drewienkiewicz

Greece will ultimately default and there's a possibility other periphery nations will go through pretty severe credit restructuring.

Pete Drewienkiewicz

Parr: But emerging market/local currency is a market that is relatively new. Certainly the market that exists today is not the same that existed 10 years ago and won't be the same in 20 years' time because we're seeing this global realignment of economies so you'll see global realignment of capital markets as well.

Brain: I think it's fair to say that absolute return bonds and 'go anywhere' credit portfolios, which have quite a wide ranging mandate to be able to shift their investment across various parts of the entire credit spectrum at various times, are probably two products that are getting a lot more press now and a lot more people are coming out with their own offerings.

Martin: I'd still be very careful how they're packaged because there are two camps. There's one absolute return that's in all market conditions at all points in time; they're rarer. The absolute returns over an economic cycle of seven, eight or 10 years are more common.

Simpson: If we were to be brutally honest, in the past equities nearly always did the job for you. It's only as equities have disappointed and the times are maybe that bit tougher that you've had to look in different areas. When you're looking more at risk and return, fixed income has a good chance of doing that because if high yield falls 20%, mathematically you have a goal where it might get back to. If equities fall 20% then realistically you still don't know where they're going to.

Brain: The problem with fixed income markets is bond indices are counter-intuitive. With equity indices, the company does well and its weight in the index goes up. With bond indices if a country or a company is doing poorly its weight goes up so you get this deteriorating credit quality. And if you are managing money against the bond index you're almost a forced buyer of something that is deteriorating in credit quality.

For bond investing more than any other asset class it's more of an absolute return or return seeking objective rather than following an index.

Do you think pension funds and other institutional investors make the most of their trump card as long-term investors able to ride out some of this volatility?

Martin: Probably the answer is no. Could they make more of it? Yes. But it's always this dichotomy between pension funds and long-term investors. But the regulatory environment and accounting assumptions still lend themselves to too much short termism.

Can pension funds be a source of liquidity? Yes. Will we see more of that? Probably.

Drewienkiewicz: A flight plan consistent asset is cheap, long-dated and pays predictable cash flows. The Government has got excited about bringing an infrastructure upgrade together with the pensions investment community. Clearly infrastructure has the possibility to fit that model in that it's going to throw off predictable long-dated cash flows of a high grade credit quality.

Peter Martin

The large Canadian and Californian pension funds have been investing in infrastructure directly for some time. Do you think that could work over here?

Parr: I strongly believe in investment opportunities in infrastructure, also private equity and venture capital. There's quite good evidence, particularly from the US, that a longer term horizon with venture capital type investment can give a good return.

How do investors feel about emerging market debt and what opportunities lie out there?

Brain: The development of different capital markets around the world is going to be a significant diversifier of interest risk for investors for some time to come. I think part of the market is still stuck in the past in terms of it is a risk asset class therefore when risk is off, for whatever reason, it tends to underperform regardless of the underlying fundamentals for the country you invest in.

Drewienkiewicz: There are a lot of interesting statistics thrown around and one of them is that if you're buying EM debt at the same rating as its developed market counterpart you're typically getting a 20% less-levered company.

Brain: The deficit numbers historically for sovereign emerging market debt have been much better in terms of total debt. Unfortunately, historically emerging market countries have tended to borrow from overseas investors a little bit. The foreign ownership of debt is usually quite high which is obviously a problem the eurozone is experiencing now. When your debt is owned by someone else who is outside your country and your monetary policy control then you're likely to run into a flight of capital fairly quickly.

Simpson: If we look at search activity, emerging market debt is one of the biggest areas at the moment but each allocation is quite small, just a couple of a percent. I think people are getting used to it, but I know over time people will be increasing that allocation. I think chances are it's the local markets where the biggest allocations are going to go because you've got your two returns of yield in the local market and the currency appreciation over time.

Martin: Emerging market debt, especially in local currency, is a good story. Plans should look at this more and make meaningful allocations so it makes a difference to outcomes. EMD is potentially a better way to access the emerging markets story compared to equities. There's lots of chat about GDP growth in emerging markets, but there's never that linkage to why it should translate to equity returns.

Drewienkiewicz: In many cases over the last few years our clients have been stepping up allocations from 2% to 3% to 8% to 10%, but there's further to go. Some people ultimately would like around 15% allocated to emerging markets with maybe 5% in equities, 5% in sovereign debt and 5% in corporate debt.

So what do you see as a healthy allocation?

Simpson: It completely depends on a scheme's governance budget, required return and flight plan. If you're investing for a 30-40 year horizon then an allocation of 15% – 20% would not be outlandish.

Parr: You can see a pattern with EMD: trustees are dipping their toes in the water for a longish period

Paul Brain

before increasing the percentage. It's a natural course for trustees.

Simpson: Like most things, if you're introducing something new, people will be quite cautious and build over time. If you're looking where the growth is going to be, it looks like emerging markets over the next 10 years and probably longer. It's just how you actually access that. A lot of our clients were more comfortable with equities initially, but chances are it's riskier than debt. If Brazil defaulted, Brazilian equities might not be doing very well either.

Is it right that we still consider emerging market debt separate to any other sovereign debt? Are these markets as decoupled as people like to think?

Drewienkiewicz: We were getting quite excited in August because emerging markets were doing very well. Unfortunately in September it all reverted to type: risk was off and emerging markets came off as well so I'm not convinced yet we've made that jump. I think you still need to consider it a risky asset class.

Simpson: Decoupling hasn't worked yet because most East Asian countries want to keep exporting to the US. They're going to have to develop domestic demand, start trading between themselves, which is starting to happen, but to say they're completely decoupled is fanciful. Pricing is influenced most by the marginal buyer, which tends to be EMD or western buyers who can go in and out. If they suddenly have a risk off period they pull out and there isn't a massive wall of money in Brazil that's going to suddenly replace that. So for the moment I think it's clear they're not detached.

Drewienkiewicz: That is one of the really big frustrations for pension funds over the crisis because all these products were supposed to be de-correlated.

Brain: It was really the Chinese slowdown that permeated from the summer through to the end of 2011. That's the thing that is most upsetting for emerging markets and therefore it's impossible for them to decouple. As soon as China slows down at the same time as the West, we're all stuck in the same mess.

What are the key risks in Europe and what is the likelihood of default in the next year or so?

Drewienkiewicz: Greece will ultimately default and there's a possibility other periphery nations will go through pretty severe credit restructuring. That's been on the table for at least 12 months.

The political leadership's obsession with trying to avoid triggering credit default swaps has been infantile and extremely ill-judged. The interminable process of kicking the can another few feet down the road, but not getting the political will together to kick it far enough, continues. They still seem to treat markets like a sub-servient child that can be hit with a big stick and it's completely misguided.

Martin: Given the number of elections coming up in the next year, kick-the-can will muddle through. At some point there will be the realisation you can't kick the can too much further and something will have to be done and the pain will have to be incurred at that point.

Brain: I think we're going to see some countries default on debt, but also on promises, by increasing the retirement age and so on. In countries that don't have a solvency problem defaulting on promises works, but for other countries like Greece, Portugal and possibly Ireland, defaulting on debt is probably the only way. The real issue is if they keep piling on fiscal austerity the whole thing will fall apart because

these are democracies and they won't take it for too long.

To take the markets out of the equation effectively means the ECB printing money to fund governments via the banking system which is what the LTRO (long-term repo operation) three year deal is all about. They believe that is the big kick of the can down the long road. The trouble is, without growth the deficit numbers just get worse and worse. You get into this deficit debt spiral and because they're focused on fiscal austerity the currency isn't devaluing enough, I can't see where the growth comes from. So ultimately some countries will try to leave and it may happen as soon as 2012.

France's downgrade presumably causes further problems.

Simpson: The Germans will realise at some point they're going to have to do something they don't want to do, which is probably a combination of allowing the ECB to print money and coming up with some kind of fiscal redistribution. It's a difficult position and the key thing is if we don't get any growth everybody's in trouble. At that point it doesn't matter what plan you come up with, so getting the economy back on its feet is probably the main thing. When I took on my first mortgage I looked at it and thought 'This is a lot of money', but thankfully after that I got some pay rises and it didn't seem so bad anymore. I think the whole of Europe's in quite a bad situation and they need some serious pay rises in the big scheme of things to get going

How does a fixed income fund manager operate in the confines of Europe?

Drewienkiewicz: There are countries round the edge of Europe that still have monetary policy flexibility such as Norway and Sweden, but ultimately we've been looking forward to the ECB effectively printing money to save the banking system because it is mandated to do that. Three year LTROs are part of that process.

Our exposure to eurozone bond markets is actually very low at the moment. We've been moving out of the core into other markets like Australia, Sweden, Norway, Canada, the US and UK. The UK market still does quite well because, perversely, it's a printer of money and can therefore maintain economic growth.

Martin: It's a question of going back to creditability – when do I believe the story that these things will be paid and they are safe? I think we are an awful long way off getting to that, especially in Europe.

Simpson: Looking back the Germans must be kicking themselves for not saying on day one: 'Whatever happens we'll bail Greece out'. That would probably have saved them a lot of money in the long term.

Europe is not like an emerging market country going bust where there genuinely isn't enough money in the country to bail themselves out. There's enough money in the euro area to solve this problem, it's more a question of how to distribute those resources and whether there's the political will to do that.

Martin: A bailout in time saves nine.

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A new world order – implications for bond investors

Paul Brain, Newton Investment Management, January 2012

Bond-investing pension funds are contending with a number of significant concerns. Among these are worries about the escalating sovereign debt crisis in Europe (and the associated risk of defaults), the debasement of currencies, the potential inflationary effects of quantitative easing, and the credit quality of bond markets supposed previously to have been 'risk-free'.

Fixed-income investors are asking how best to deal with such concerns. We believe that interest rates in the majority of debt-laden Western economies will not rise in the immediate future, that in relative terms the currencies of debt-laden countries are similarly challenged and, furthermore, that there is still sufficient time to address and resolve concerns over sovereign debt. We recognise, however, that financial market conditions are subject to dramatic upheaval, and we believe that bond investors with long-term objectives should benefit by:

1. 'Going global' in a deleveraging world
2. Adopting an absolute-return approach
3. Diversifying exposure using dynamic asset allocation

Going global in a deleveraging world

In the aftermath of the global credit crisis, the 'stable' environment which investors had enjoyed in the two decades before the crisis has changed radically. Whether the trough in bond yields in 2008 heralded a structural reversal in bond investors' fortunes cannot be deduced with any certainty. However, we believe it is clearer than ever in the post-credit-crisis world that economic activity, as well as the demand for, and the supply of, bonds, are driven by global trends. In evaluating opportunities and risks in bond markets, it is appropriate, therefore, to use a process that is global in orientation, and which harnesses those trends.

After years of coordinated monetary and fiscal policies around the world, different countries are now adopting different approaches to tackling the government debt crisis. There is a clear divergence, for example, between approaches in several of the indebted western economies and those in the 'east' (excluding Japan) and emerging markets. A period of divergence in relation to monetary and fiscal policy, inflation and credit conditions between economies seems almost certain to lie ahead.

There are a number of developed (and developing) markets (such as Australia, Sweden, Norway, Canada and Denmark) which have improving credit stories (in relation to the G4 countries), and which present the opportunity to generate positive returns in a global growth context, particularly given the scope, in many cases, for further currency appreciation versus the 'big three' currencies (the US dollar, euro and Japanese yen).

We believe that diversified exposure to these different themes is an attractive way to reduce domestic risk, and provides investors with a range of solutions.

Adopting an absolute-return approach

As well as advocating global bond investing, we believe that investors should consider adopting an absolute-return approach, which does not mirror or track any bond index, and which has the flexibility to move between regions and asset classes, as appropriate to an investor's objectives.

The global credit crisis changed the background for fixed-income investors radically: short-term interest rates were cut to unprecedented lows and government debt levels rose to historic highs. In the aftermath of the economic downturn, a rise in interest rates (which may be required as part of an effort to combat inflation) could eventually create a 'bear' market in bonds.

As most investors hold bonds for their scope to protect capital and income, bear markets in bonds can be especially painful (and usually unexpected). There are two ways in which bond investors may lose capital: through default, and via rising interest rates. During the global credit crisis, investors experienced some of the former; they may now be vulnerable to the latter.

There are several ways in which investors may limit capital losses in an environment of rising interest rates. For example, if interest-rate expectations are mounting, use of derivatives to offset the risk of higher rates should be beneficial. Such a strategy need not be complicated and need not cover an entire investment portfolio; buying put options on government bonds, for instance, can be an effective way to generate positive returns from falling bond prices. Alternatively, adding holdings of high-yield corporate bonds may allow investors to benefit from an asset class that tends to do well during times of strong economic growth. Whichever approach investors take in seeking to limit capital losses, we believe their priority should be to keep their strategy simple and liquid in order to provide adequate protection of capital in the event that markets become unstable.

Our particular rationale for an absolute-return approach is grounded in a fundamental characteristic of bond index composition: bond indices are based on market capitalisation, so the greater the volume of issuance, the heavier the index weighting. The bond index investor is forced, therefore, to buy increasing amounts of the bonds of those countries that are issuing large volumes of debt, and is thereby locked into these countries' declining credit story.

As governments face financial difficulties, they will often have to issue more debt, thus becoming a larger constituent of a bond index. A benchmark, or index-orientated, approach will entail an investor holding more of the debt of such issuers, in circumstances when they should not necessarily do so. We believe that indices should be used as a reference tool to help define the range of an investor's opportunities, not slavishly as a means to establish the parameters of portfolio construction.
The traditional global government bond indices are overwhelmingly dominated by 'the good, the bad and the ugly' markets: the US dollar, euro and yen make up just under 90%.

Diversifying exposure and using dynamic asset allocation

Uncertainty in economies and financial markets should bring with it opportunities, particularly because, during economic cycles, different fixed-interest asset classes enjoy success at different times. In order to take advantage of the changing fortunes of these different asset classes, a dynamic approach to asset allocation is critical.
Returns from different fixed income markets diverge over time. If fixed income is broken down into its four main components: 1) traditional global government 2) emerging market sovereign 3) global investment-grade corporate and 4) global high yield corporate, the divergence is stark. For example, according to

Bloomberg index data hedged back into sterling, global high yield corporate bonds returned nearly 60% in 2009, but lost 27% in 2008; and were top performers in 2010 (14.8%) and worst in 2011 (2.9%). Global government bonds were the top performer in 2008 (11.6%) and worst in 2009 (1.18%)

This divergence provides plentiful opportunities for the active bond investor who has the flexibility to invest around the world to generate attractive returns, rather than simply harnessing bonds in pursuit of liability-matching (the purpose for which bonds have frequently been used in the past).

Government bond markets

The eurozone's challenges continue to undermine investment strategies; however, European duration, heavily biased towards the 'core' markets (Germany, the Netherlands and Finland), appears to offer relative value, especially given possible signs of a slowdown in the rate of economic growth in Northern Europe. The UK economy reveals some vulnerability, and intermittent 'safe-haven' support from European investors suggests a positive relative duration exposure.

In terms of hold-to-maturity bonds, some overseas markets have already priced in higher short-term interest rates. Their short-dated bonds offer, therefore, higher yields than those in the US, and should, we believe, produce a positive return over the coming months.

Emerging market government bonds

Many emerging-market countries have enjoyed the benefit of strong economic growth and, as a result, their debt levels are generally in decline. We believe US-dollar debt issued by emerging market countries is still attractive, especially if associated interest-rate risk is hedged accordingly, where appropriate to protect investors' interests.

Corporate bonds

Corporate bond markets have continued to make headway since their nadir in 2009, despite underperforming sovereign markets during 2011 as a whole. It is still possible to identify credits whose issuers have sound balance sheets, good business models and, therefore, the ability to pay back their bondholders. The occasional credit upgrade is also beneficial. Here, as with other bond asset classes, hedging of interest-rate risk may be required to protect investors' interests.

High-yield corporate bonds

High-yield corporate bonds remain at historically elevated spread levels, which, to some degree, cushion investors from a decline in the value of government bond markets. Thus, high-yield bonds continue to hold appeal under a central scenario of sluggish (but still positive) economic growth of around 1-2%, in combination with 'lower-for-longer' interest rates.

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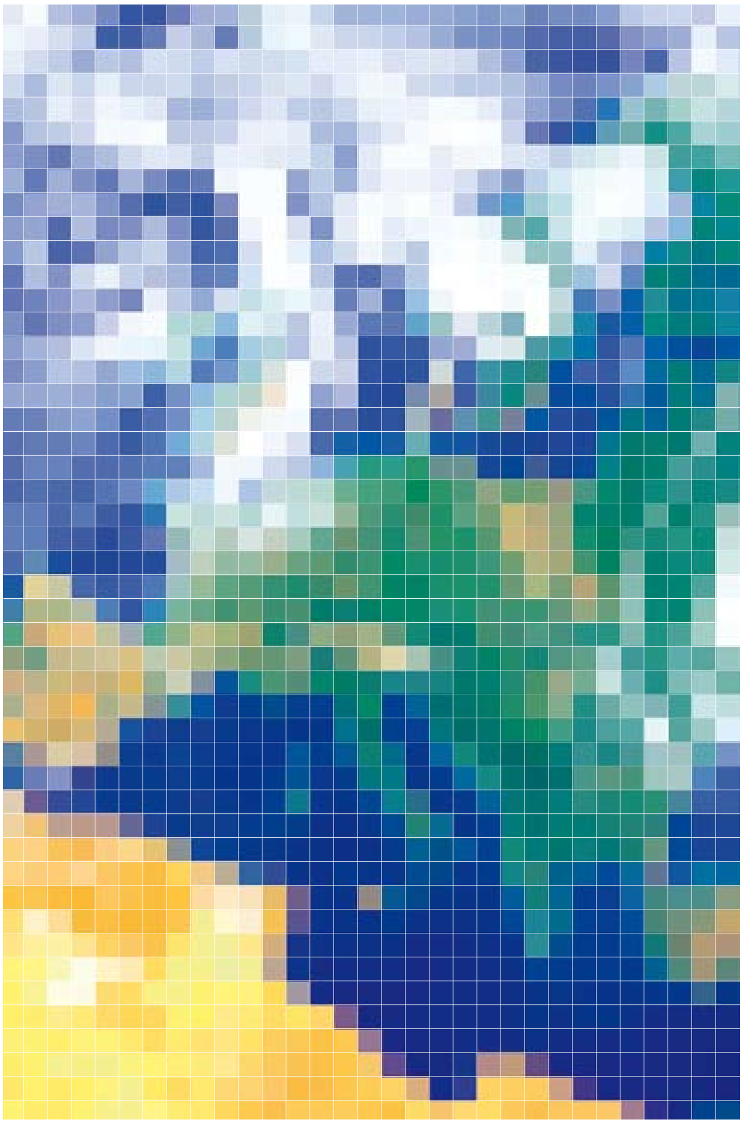

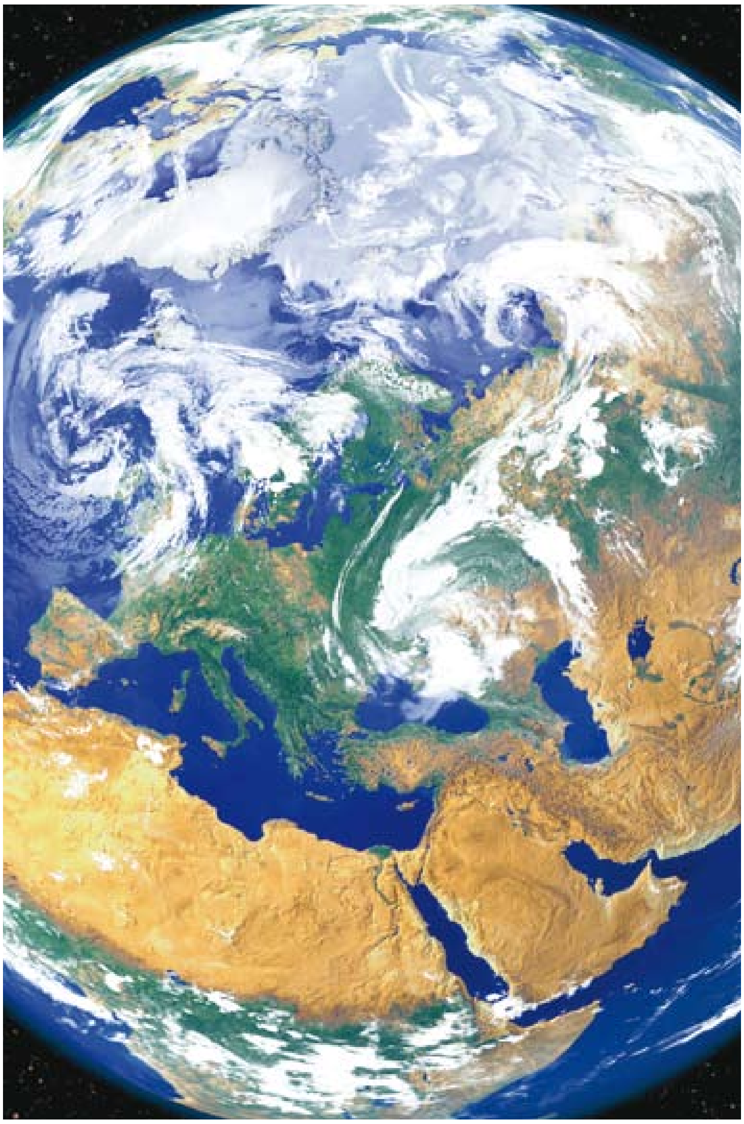

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