Re-writing the rules on bond investing

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"Today's bond markets look very different – the fallout from the credit crunch, shifting dynamics across the global economy and unprecedented central bank intervention have seen a re-drawing of the landscape."

Until the financial crisis of 2008, bond markets generally offered investors relatively low volatility, a high degree of transparency, high correlations across global markets and the re-assurance of AAA-rated sovereign issuance in times of uncertainty. As well as helping to manage portfolio volatility, investing in bonds tended to generate predictable cash flow and provide a degree of protection against inflation.

Today's bond markets look very different – the fallout from the credit crunch, shifting dynamics across the global economy and unprecedented central bank intervention have seen a re-drawing of the landscape:

- In many major markets, zero to negative real yields are a reality as record low interest rates can no longer compensate investors for the impact of growing inflationary pressures. Bond yields have been driven down by the uncertainty over the health of the global economy in the wake of the financial crisis and concerted bond-buying programmes from the major central banks.

- The pool of AAA-rated sovereign debt has also shrunk as developed market governments struggle to balance the dual pressures of burgeoning fiscal deficits and ailing economies. Some estimates suggest that the pool of "nine-A-rated" sovereign debt (that is, rated AAA by Fitch, Moody's and Standard & Poor's) is now less than half what it was pre-crisis, having fallen from US$10.9 trillion at the start of 2007 to around US$4 trillion now.[1] With the US, France and the UK all having suffered downgrades, the very concept of "risk-free" assets is being called into question.

- Furthermore, investors have had to accept greater levels of both sector rotation and volatility as financial markets continue to take their cue from politicians and policymakers rather than fundamentals. Wrangling over the fiscal cliff in Washington, crisis after crisis unfolding in the Eurozone, and central banks striving to restore order have all played their part in driving markets over the last few quarters.

So what are the prospects for bond investors?

We expect that, at some point, developed market interest rates will rise from their current, very low levels. Once the likes of the Federal Reserve and the Bank of England feel that their economies are turning a corner and pull back from quantitative easing, the artificially-low yields on government bonds are likely to rebound.

Many investors, already facing the challenges around yield generation and inflation risks, are now being forced to focus their attention on managing duration in portfolios. The marked fall in yields over recent years has left many bond holdings highly sensitive to even the smallest rise in interest rates. Historically, this might have signalled a wholesale switch out of bonds, but this no longer needs to be the case.

Investors could be forgiven for looking at bond markets today and seeing only the risks associated with interest rates rising, but what we see are opportunities for taking advantage of the market dislocation.

Searching out global opportunities

Importantly, as well as becoming more volatile, returns from global bond markets have also diverged over the recent past. Before 2007, global bond market movements tended to be highly correlated,

1. Source: FT.com "Dearth of triple A alters investment map" March 26, 2013

particularly during times of market uncertainty. Even the growing emerging debt markets tended to take the lead from US Treasuries – unless they were hit by external shocks – in which case they still tended to move as a bloc. This no longer holds true.

In part, this can be attributed to the shift in the balance of power in the global economy that was already taking hold prior to the financial crisis. No longer driven solely by US demand, the new "multi-speed" global economy is more complex. Taking manufacturing industrial production as a proxy for economic activity, the range of growth rates across economies has widened considerably and this trend is expected to persist. These differentials are creating new opportunities and greater scope to add value for those investors who can harness them.

How this is reflected in bond yields across markets can be seen very clearly from the table and charts below. At the end of last year, the yield on the Barclays Global Aggregate Index excluding European periphery countries was only around 1.7% with 6 years of duration risk.[2] From these levels, there is very little upside and significant downside potential.

This contrasts sharply with the potential on offer in other sectors that would traditionally have been seen as "off-benchmark" bets by investors. The basket of high yield credit, emerging market debt, peripheral Europe and high yield loans represented by the chart on the left offers significantly more potential to investors with an average yield closer to 5% and with a lower duration on average. It is precisely these sorts of opportunities that investors need to capture if they are to realise the potential in bond markets going forward.

A generation of more nimble, multi-dimensional approaches to bond investing are helping to re-write the rules and offer investors a route to capture opportunities outside mainstream fixed income investing. Unconstrained fixed income strategies can offer investors greater potential returns with less focus on duration and a low correlation to any one sector or fixed income risk.

Standish and unconstrained fixed income

Standish has a history of managing these types of fixed income strategies and we have over US$3.5 billion under management in unconstrained mandates.[3] The aim of our Opportunistic Fixed Income strategy is to offer investors the ability to diversify away from the main risk in most fixed income portfolios – rising interest rates.

Manufacturing industrial production indexed to December 2005

Source: Standish, Datastream as at 31 December 2012

Barclays Global Aggregate ex-European Periphery

– USD Market Value	$40.2 trillion
– Average Duration	6.0 years
– Average Yield	1.70%

European Periphery & Other Indices

– USD Market Value	$6.4 trillion
– Average Duration	4.3 years
– Average Yield	4.90%

Source: Standish, Barclays, JP Morgan as of December 31, 2012. Note: "Core" Europe = Austria, Finland, France, Germany, Netherlands; European Periphery = Greece, Ireland, Italy, Portugal, Spain. Past performance is not a guide to future performance.

2. Source: Barclays as at 31 December 2012

3. Source: Standish; assets under management as of December 31,2012. Includes assets managed by Standish personnel acting as dual officers of the Dreyfus Corporate of the Bank of New York Mellon, wholly owned subsidiaries of The Bank of New York Mellon Corporation.

A global, diversified, multi-sector opportunity set offers greater opportunities to generate alpha. We have access to in-depth global research across countries, sectors and securities giving us access to a very broad opportunity set. We feel this gives us significant advantages relative to our competitors given how pivotal active allocation is to driving returns. That is not to say that the importance of individual security selection should be understated – we believe that it will play an increasingly important role in generating returns, and it has been a critical source of alpha for us across fixed income portfolios. Sometimes the best opportunity is at the security level and sometimes it can be a country or sector play.

At Standish, we adopt what we would term a “benchmark-agnostic approach”, targeting an absolute return of 3% to 5% over domestic LIBOR through an investment cycle, with a tracking error range of 3% to 7%. We also consider it of paramount importance in these uncertain times to maintain liquidity and deliver returns with less volatility than equities. The broad spread of strategies employed in managing portfolios and resultant diverse sources of return has helped us historically to generate strong risk-adjusted performance. Our approach is about more than rotation between sectors, however. It is a more complicated process that includes sector rotation, of course, but also draws on security selection, our exposure to credit, country choice, positive and negative views on interest rates and currency exposure.

In addition to the blend of top-down and bottom-up investment idea generation and our go-anywhere mindset, we are also able to target duration neutral or net short positions in countries, sectors and specific corporate issuers. This is particularly useful when the risks in the bond market appear asymmetric, as they do now. This approach generates low correlations of returns relative to other asset classes, including stocks and US Treasuries.

Unconstrained does not mean there is a lack of control, however. We do not employ leverage and we pay very close attention to all aspects of risk. Risk management and understanding sources of volatility are vital tools in managing the strategy – for example, we know the tracking error for each sector, bond by bond, expressed as basis points at risk on the upside and downside.

Overall, the strategy aims to manage duration in a way that protects investors from extreme market moves. The best investment ideas come in all shapes and sizes. Some strategies may have a horizon of six to 24 months. Others may be as short as one to two days. Because our strategy uses such a broad global opportunity set – everything from Treasuries and other government instruments to emerging market and securitised debt – we are able to take advantage of the positive pockets of return that can be found no matter where we are in the economic cycle.

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