A reality check for income seekers

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Gilts are no longer delivering

In the past, UK local authorities had little need to look beyond our shores for their fixed income allocations. A portfolio of Gilts provided them with sufficient income to meet their liabilities. Today, this is no longer the case. At around 2%, Gilt yields are meaningfully lower than inflation, meaning investors are getting a negative yield in real terms. And not only are yields low, but the creditworthiness of a Gilt is not what it was. For much of the past decade, the UK's debt-to-GDP ratio stood at around 40%; now, following the deterioration in government finances after the financial crisis, it is closer to 90%. So not only are investors not getting the income they need, they are not being compensated for the additional risk they are taking on, in comparison with history.

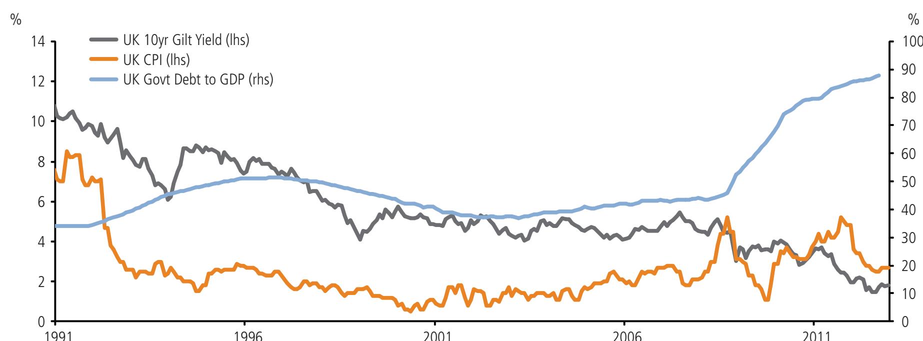
In the broader UK market, represented by the UK Aggregate index, the yield of around 4% is also low in relation to the risks. With duration currently around 8 years, investors could be exposed to sizeable capital losses if yields rise. The sterling corporate bond market is also heavily concentrated in financials, often of poor quality, providing little sector diversification.

A broader approach yields benefits

In this environment, it makes sense to take a broader approach. With households, companies and governments only part way through a multi-year deleveraging process, the low rate environment is here to stay, and local authorities that have not yet done so will need to adapt their approaches accordingly. The old way of investing – single country, single sector – is no longer effective. Instead, local authorities can benefit from taking a global approach and expanding the universe of instruments available to them. This is consistent with one of the fundamental rules of investing: diversification. By spreading their assets more widely, local authorities can theoretically achieve stronger rewards for a lower level of overall risk.

Global corporate bonds provide one way for local authorities to broaden their fixed

Figure 1: Gilts: A risk/reward mismatch



Source: J.P. Morgan Asset Management, Bloomberg, IMF as at Dec 2012

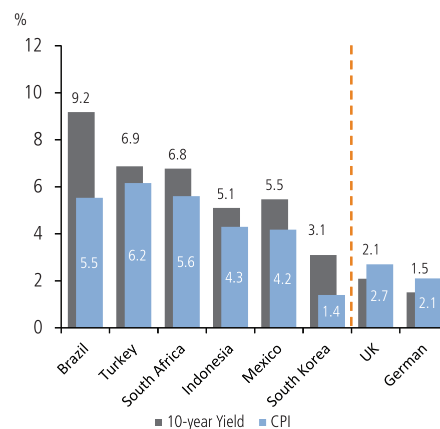
income horizons. By investing beyond the UK, investors have greater scope to pick and choose – either to avoid the higher risk areas of the market or, depending on their objectives, to allocate selectively to riskier areas where the risk/reward trade off appears favourable. Outside the UK, many instruments also trade with better liquidity than is typical in the sterling corporate bond market.

Within a corporate bond portfolio, local authorities can potentially achieve a more attractive yield by moving out on the credit spectrum and adding an allocation to high yield. High yield does not exist as a developed asset class in the sterling market, but in the dollar and euro markets it is a large, liquid asset class offering attractive opportunities for investors.

In the current environment, the key question for high yield is whether it is really still high yield, given the extent of the yield compression in recent years. It is certainly true that the spread relative to government bonds is high, and that this spread looks attractive in comparison to default rates. High yield companies also appear well positioned financially, benefiting from positive operating environments, robust balance sheets and good liquidity management. However, given the absolute level that yields have reached, the scope for capital appreciation from high yield overall may be limited in 2013. Nonetheless, investors do gain access to a yield of between 5.5% and 6% from an asset class with strong fundamentals.

Another option local authorities can consider as a way of accessing a more attractive income is emerging market debt. As part of a global corporate bond allocation or a go-anywhere strategic bond portfolio, emerging market bonds can play a valuable role. Not only are yields more attractive, but many emerging market issuers benefit from much more attractive credit fundamentals than their peers in the developed world, particularly in terms of debt profiles and economic growth. This is reflected in credit rating actions: in contrast with the widespread downgrade trend across developed nations in recent years, many emerging market issuers are seeing rating upgrades.

Figure 2: Emerging market local currency debt: Strong real yields for selective investors



Source: Bloomberg

Today, local currency emerging market debt looks particularly attractive, for two reasons. First, yields are high in both nominal and real terms. Second, exposure to emerging market currencies may help investors to preserve their global purchasing power. Currency movements are driven by capital flows, and capital goes to where it will get the best return. At the moment, that's likely to be emerging rather than developed markets, so emerging market currencies have the potential to appreciate.

Rethinking income

Whichever approach they choose – a global corporate bond portfolio, or a more diversified strategic bond portfolio – local authorities may need to consider moving away from traditional bond benchmarks. In the global fixed income universe, opportunities abound, but investors need to have an increased focus on where they find their opportunities. It won't be fixed income generically that delivers in the coming years, but sub-sectors within fixed income, and individual securities within those sub-sectors. An approach that is tightly benchmark constrained does not allow investors to capitalise on these idiosyncratic opportunities.

Local authorities may also benefit from changing the way they think about income. Investment income can come in the form of coupon or interest payments, but capital gains can also be converted into income – income does not have to come only from what are seen as traditional income approaches. The further that investors move from traditional fixed income asset classes and benchmarks, the more the focus becomes on the total return, rather than on the yield alone.

This is clearly a challenging time for fixed income investors. Nevertheless, even in today's low yield world there are plenty of opportunities to achieve an attractive income. However, if they are to meet their income needs, local authorities may need to make significant changes to their investment approaches, looking beyond the UK market to a broad investment universe encompassing a wider range of markets and sectors. A more flexible, globally diversified approach, driven by research into individual securities, can help local authorities to maximise the income they achieve for their desired level of risk. Rather than being restricted to traditional asset classes and constrained by benchmarks, local authorities need a modern approach that responds to the realities of the new investment landscape.