Making the most of fixed income in a low-yield world

INFLATION IS EXPECTED TO INCREASE AND BOND YIELDS STAND AT RECORD LOWS, PRESENTING A CHALLENGE FOR FIXED INCOME INVESTMENT. SHERILEE MACE AT INSIGHT INVESTMENT CONSIDERS AN ALTERNATIVE APPROACH FOR FIXED INCOME ALLOCATIONS.

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Asset allocation used to be relatively straightforward for pension funds. Historically, the challenge was how to maximise long-term returns. This evolved into striking the appropriate balance between assets more focused on stabilising the funding level, and allocations to growth assets designed to help close funding gaps and reduce costs.

These questions remain relevant today, but with gilt yields at historic lows and the long-term impact of unconventional policies such as quantitative easing (QE) unknown, the traditional trade-off between bonds and growth assets looks unhelpfully simplistic.

This is clear when considering the investment needs of a typical UK defined-benefit pension scheme in today's market environment. Funding levels are still uncomfortably low in many cases meaning the need for attractive returns has never been greater. At the same time, most pension funds are fearful that an extended period of ultra-low interest rates and QE will lead to long-term inflation, which in turn would have an impact on their liabilities. A pension scheme would typically invest in index-linked gilts to protect against the impact of higher inflation in the future, but index-linked gilts also provide substantial interest rate exposure. They could suffer material price falls if interest rates rise. The problem is that an increase in interest rates is the typical policy response to higher inflation.

This poses an interesting investment challenge regarding how a pension scheme can simultaneously achieve the following three objectives:

- Generate attractive returns
- Protect against the threat of higher inflation in the future
- Avoid exposure to assets which will fall in value if interest rates rise

Traditional approaches to fixed income investment cannot satisfy all three requirements at the same time, and for investors considering how to make the most of their allocation to the asset class, new thinking is necessary. It is possible to make use of new investment techniques to manage the risks you are worried about, such as inflation, and generate attractive returns without exposure to interest rate risk.

A growing number of pension funds in both the public and private sectors are making use of modern investment techniques to target attractive returns independent of market direction, while hedging inflation risk without exposure to the impact of rising interest rates. Such an approach aims to both reduce inflation risk and generate returns without the added risk of capital loss that might be unavoidable through a traditional approach, as outlined above.

With regard to hedging inflation risk, pension schemes can invest in instruments or specialist funds designed to protect against the impact of higher inflation expectations in the future. For example, by investing in vehicles that hold inflation swaps, a pension scheme can ensure that the value of its assets will rise and fall with the present value of its liabilities when inflation expectations change. They provide inflation protection similar to a portfolio of index-linked gilts, but without the potentially undesirable exposure to rising interest rates that such a portfolio of bonds would also introduce.

Pension schemes can make full use of such instruments through pooled funds, making governance and implementation straightforward. Such funds are typically partially funded, which enables a high level of hedging without a need for substantial investment, thereby freeing up capital to invest for return. By way of example, protecting against future changes in inflation on £100 million of liabilities might only require about £30 million of capital. By contrast, under a traditional approach, to protect against future changes in inflation on £100 million of liabilities would require a fund to buy £100 million of index-linked gilts, leaving much less capital to invest for growth. It would also expose the capital to any subsequent changes in interest rates.

With regard to generating an attractive return from the remaining fixed income capital, an absolute return bond strategy can provide a source of growth in all market conditions. Unlike traditional fixed income investments, such a strategy is capable of delivering attractive, positive performance even if yields rise from their current near-zero levels.

Traditional funds that aim to outperform a particular benchmark will usually be restricted in terms of where they can invest, with the majority of capital held in assets and proportions that are similar to the benchmark. By contrast, absolute return funds have broader, more diverse investment guidelines in order to be able to invest in whichever areas of the market they feel the best opportunities currently lie. This will typically include the option of having zero or even negative (short) allocations to asset classes or sectors which are unattractive, unlike traditional funds which may be forced to maintain an allocation to such holdings, even if on an underweight basis.

The Insight Bonds Plus Fund is such a strategy, designed to deliver attractive, positive returns throughout the economic cycle, targeting 2% in excess of cash per annum, over rolling three-year periods. It is a global "best ideas" portfolio focused on generating absolute returns. It is free to invest globally across the full spectrum of potential fixed income investments, calling on the experience and expertise of Insight's large, well-resourced fixed income team. The Bonds Plus 400 strategy follows a similar investment process but with a higher return target, at cash plus 4%, with a higher tolerance for risk.

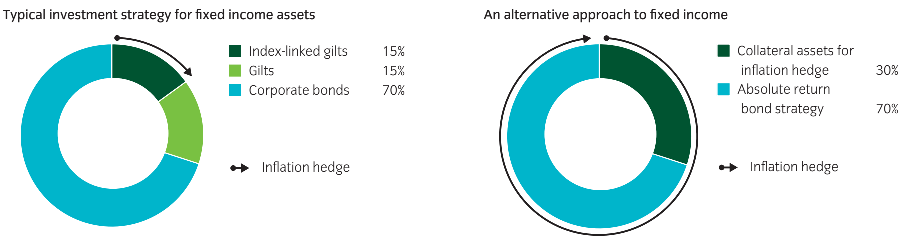
The two funds are able to take long and short positions in government and corporate debt and can invest across the credit rating spectrum, including both investment grade and sub-investment grade debt. They can allocate to sterling-denominated securities, as well as international bonds and can also take foreign currency risk. This flexibility allows the Fund's managers to allocate assets across a wide range of fixed income investments, taking advantage of opportunities as and when they arise.

Why Insight Investment for absolute return?

Insight Investment has a strong track record in managing absolute return funds. We were among the first to take advantage of the increased flexibility of the UCITS regulations to bring a full range of regulated absolute return funds to investors. Launched in 2002, Insight is responsible for assets under management of £228.7 billion[1], across absolute return, multi-asset, fixed income, liability driven investment, cash management and specialist investment strategies.

1. All data at 31 December 2012. Insight's assets under management are represented by the value of cash securities and other economic exposure managed for clients.

A new approach to fixed income can hedge inflation risk without exposure to interest rate risk



What happens if both inflation and interest rates/yields rise?

• Limited protection against higher inflation • Likely capital loss due to higher yield	• Full protection against higher inflation • Positive returns despite rising yields

Source: Insight Investment, for illustrative purposes only