Releasing the pressure

Utilising unconstrained fixed income strategies within a retiree’s portfolio

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Introduction

Years of quantitative easing combined with the continuing threat of deflation in the developed world have seen bonds yields fall to historic lows. Notwithstanding the chances of official interest rates in the United States rising, in many parts of the globe record low yields are likely to abide.

Chart 1: Bond yields in most of the world remain at record lows

Australia has not been immune to the QE/slack economic growth one-two either – the cash rate, the Australian government bond rate and now the 1 year term deposit rate moving close to 2% over the past 12 months.

Chart 2: Rolling 12 month returns
This reduction in yields is presenting a significant impediment to retirees’ quest to maintain their income levels. In response, many investors think that to increase their yield they have no choice but to take a step into the unknown, investing in examples of what were previously seen as more exotic options such as unconstrained bond strategies and long short credit.

The emergence of absolute return fixed income strategies
Many of these strategies have not been tested through different market cycles, making it crucial investors understand what is driving their returns and their suitability for current market conditions. For example, the plethora of total return/absolute return strategies and unconstrained bond strategies that have launched on the back of the fear of interest rates rising and the subsequent capital losses that may be suffered by traditional bond funds benchmarked to a duration benchmark. But how can the average investor tell? For many of these strategies the benchmark is the same as their vanilla fixed interest cousins – the Bloomberg Bank Bill Index – even though the alpha strategies and risk profiles are completely different. It is just as difficult for the professional investment community – traditionally advisers have relied upon the benchmark to gauge the investment risk of the strategy and where to place it in a portfolio. But with a cash benchmark this becomes a lot harder to judge.

The majority of the more exotic fixed income strategies utilise credit beta, asset allocation within credit sectors or carry strategies to generate returns. This reduces their traditional usefulness as a diversifier against falls in the equity space. Indeed, some of these absolute return fixed income strategies have high correlations to equities or carry additional risks, e.g. liquidity risk. This is not easily measurable nor represented in the benchmark bank bill index, which has limited credit risk and is very liquid.

Chart 3: Correlations of credit indices to S&P/ASX 200

As in the chart above, correlations to equities change over time. New strategies should be thoroughly analysed by assessing the correlations of the underlying exposure during times of stress. During the GFC most fixed income strategies transformed, all of a sudden generating a more positive correlation to equities. The chart also shows that the only true diversifying strategy is the interest rate risk of government debt, which is ironically what a lot of these strategies are trying to avoid.
Liquidity is key
The other big issue is liquidity. With yields being driven so low the demand for higher yielding credit has been significant, and, with demand creating its own supply, issuances have risen accordingly. What was once a niche area in many investors’ portfolios is now heavily skewed towards credit; and lower-rated credit at that. Of course, Australia is not alone in this – investor allocations to credit or high yield strategies have been rising around the globe.

Chart 4: % of Fixed Income Assets in non-traditional bond funds

The concern now is that investors have become complacent about the ability to divest those investments when needed. Or they haven’t thought about it much at all. Much of the liquidity in markets over recent years has been provided by large banks making markets and holding risk inventory. But new prudential requirements for banks have seen reduced capacity for taking on risk and many cases of trading desks being shut down altogether.

Fundamentally, liquidity has become scarcer in secondary fixed income markets. The ability of dealers to hold risk inventory has declined by 70% since the GFC while the stock of fixed income assets has doubled. Further, liquidating a position now takes on average seven times as long as it did in 2008.

With the growth in ETFs and high yield funds, almost half of the US$70tn in managed assets globally is in funds that offer their investors redemption at short notice. At the same time, funds are investing increasingly in higher-yielding, less liquid assets. You can spot the imbalance there. The traditional buyers are in less liquid markets; desperate sellers (if there is a significant credit or economic event) are in quick-fire sale mode. Result? The sellers toss the buyers off the mismatched see-saw.

“Fundamentally, liquidity has become scarcer in secondary fixed income markets. .”
“The compression of liquidity risk premia suggests that investors are assuming any future withdrawals from funds will be conducted in an environment of continuous market liquidity.”

**Chart 5: Primary Dealer Positioning v Corporate Market Cap**

How mis-matched? The chart above illustrates the liquidity gap between the level of primary dealer positioning and the capitalisation level of US investment grade corporate securities. Currently the gap stands at approximately US$1.5tn, or 8% of the market cap.

The compression of liquidity risk premia suggests that investors are assuming any future withdrawals from funds will be conducted in an environment of continuous market liquidity and that the value of their fund holdings will not fall substantially when they exit. The risks to that assumption are in only one direction – on the downside – if a significant event (like perhaps a rise in US rates) occurs.

**Releasing the pressure**

With these issues in mind how do you ensure that your defensive absolute return strategies don’t suddenly have a positive correlation to equities especially in times of equity market stress, or become illiquid forcing you to sell shares instead? How do they diversify within an absolute return/unconstrained fixed interest allocation? And how does it fit in with the broader portfolio, especially for a retiree who has the dual objectives of capital preservation with income generation?

One important thing to consider here is the purpose of this allocation. Is it to diversify away from growth assets? To generate income for the portfolio? Or is it to generate low risk absolute returns?

**Diversifying away from growth assets**

So what fixed income strategies provide correlation benefits?

That is dependent on the alpha drivers and typically they fall into the following buckets:

- Traditional fixed interest strategies: duration/yield curve/currency
- Credit related strategies
- Asset allocation
- Distressed debt
- Illiquidity

Source: Bloomberg
You can still maintain an absolute return or low capital risk allocation within defensive strategies but still look to have some level of diversification benefit for the overall portfolio. Looking to blend active strategies where the manager focusses on more traditional fixed income risks, and also look for strategies that perform well in rising or high volatility environments where credit and equities struggle, will help diversify risks.

Generating income
The other important consideration is the income component. Bond funds have different tax outcomes relative to equity managed funds. Certain strategies can wipe out distributions. For example, as you move into more absolute return strategies, many managers look to utilise derivatives to help either hedge out risk of physical credits or look to generate additional returns. Any loss on these instruments or on physical credit is automatically on the income account and these can wipe out any distributions in a low yield environment. For income producing absolute return funds, an investor should look carefully at the structure and ask the manager to explain how they protect income from trading gains and losses.

How to consider fixed interest in this environment
In terms of asset allocation we have considered some key aspects of portfolio construction to utilise when considering defensive alternative fixed income strategies. The increasing number and range of strategies means investors are now required to develop a new asset allocation framework in order to achieve the same outcomes they were before with more traditional fixed interest funds.

When you are considering your fixed interest allocations, utilise a bucket approach as highlighted in the above diagram and look for diversification of style within the buckets. Look to active managers that clearly have the runs on the board in a difficult to navigate interest rate environment.

Reconsider the traditional asset allocation approach and look to use a more objectives based approach that align with what you are looking to achieve. This allows you to better set your expectations around risk and return, while also giving the fund manager more flexibility in the methods used to achieve the targets in the areas of income generation and capital stability.

The current level of rates internationally continues to scare investors off fixed income, although it should be indelible in any well-diversified portfolio. The benefits of ‘go anywhere’ fixed income strategies have been proven, but put in the spadework before putting in your deposit.

“The increasing number and range of strategies means investors are now required to develop a new asset allocation framework.”
Meet the author

Vimal Gor joined BT Investment Management in November 2009 and was appointed Head of Income & Fixed Interest in June 2010. He is responsible for leading the team, process and strategy for all of BT Investment Management Sovereign and Credit Funds. Prior to working with BT Investment Management, Vimal was at Aviva Investors in London for over 10 years where he was responsible for the management of the global bond portfolios within the sovereign team. He was also the lead fund manager globally for all of Aviva Investor’s Global Aggregate Bond Funds and worked on the G7 and Fixed Income Macro hedge funds. He was co-chair of the Global Aggregate Asset Allocation process. Prior to Aviva, Vimal was a Fund Manager at Murray Johnstone in 1994 before moving to Scottish Mutual in 1996 where he was a Fund Manager for three years. Vimal holds a First Class BSc (Hons) Degree in Economics and Computer Science from Salford University.

We offer an experienced team, a transparent investment process and a proven track record.

For Vimal Gor’s seven reasons for fixed interest now, visit here or search for BTIM – seven reasons for fixed interest.

Performance of flagship Fixed Interest Funds to 31 October 2015

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<th>Fund</th>
<th>3 months (%)</th>
<th>6 months (%)</th>
<th>1 year (%)</th>
<th>2 years (%)</th>
<th>3 years (%)</th>
<th>5 years (%)</th>
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For more information

Please call 1800 813 886, contact your financial adviser or email enquiries@btim.com.au

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