Is your Fixed Income manager providing the right defence?

April 22, 2020

"Only when the tide goes out do you see who is swimming naked."

Warren Buffet

Just like the tide going out in Warren Buffet's analogy, every crisis reveals some uncomfortable truths.

When the GFC tide went out, it revealed banking systems too fragile to weather their over-levered exposures. The COVID-19 tide is revealing excesses in business and corporate structures, but also weaknesses in investment strategies across Australian fixed income managers.

Whether it's composite bond managers who have taken too much credit risk, investment grade credit managers who have taken too much cross-over risk, or credit managers who have taken too much offshore and high-yield exposures, one factor binds these strategies and hinders their flexibility to position for what's to come.

They have all sacrificed liquidity in their search for yield and returns.

Liquidity, much like Buffet's tide, is one of those things that only really matters once it starts to dry up.

The Pendal Fixed Interest Fund prioritises both quality and liquidity, and has therefore provided investors with defensiveness when they've needed it most.

When the tide is high and markets are calm, the dispersion of performance among Australian fixed income strategies tends to be small. The extension of risk in the ways described above can remain largely hidden or ignored.

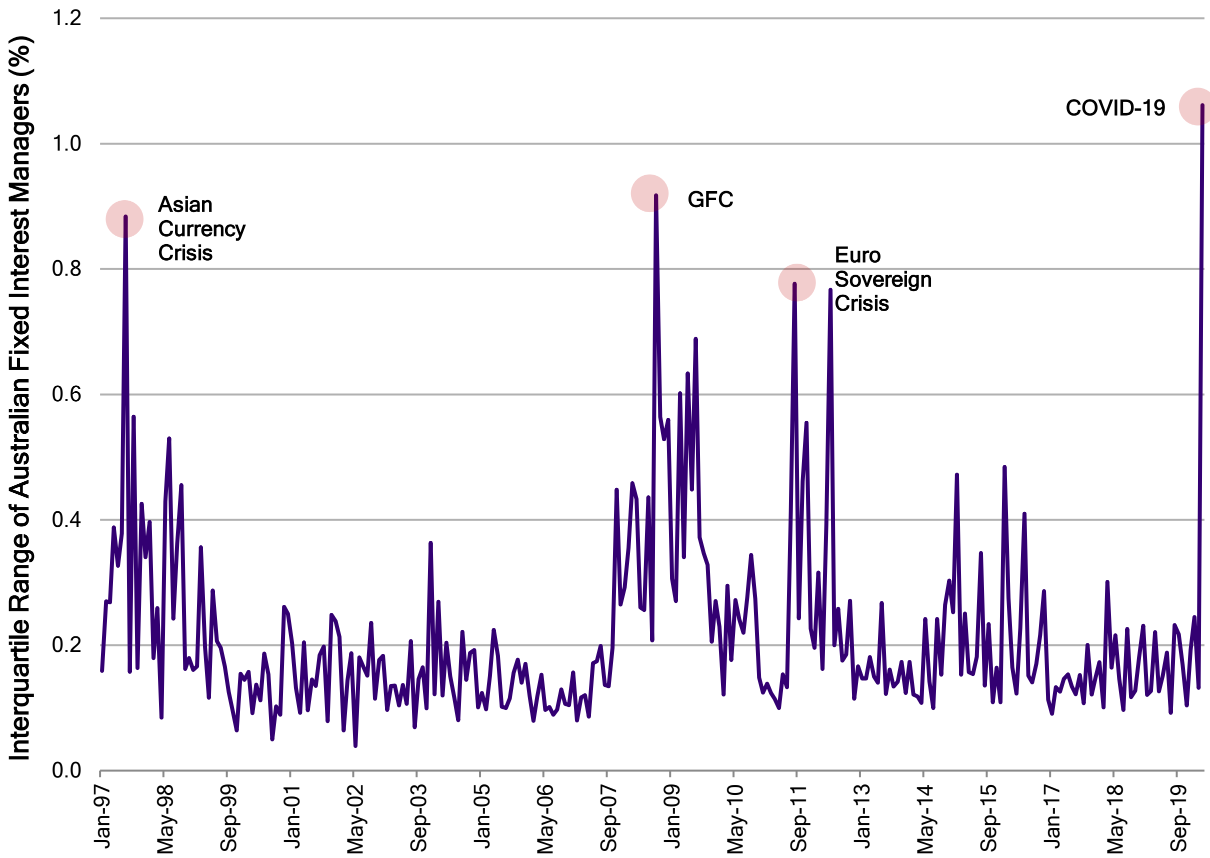
But market volatility over the last quarter has been off the charts. Price moves across asset classes have reached, or in some cases surpassed, GFC proportions. It's not surprising that we are now seeing the biggest dispersion in returns for more than 22 years. The dispersion in the way those returns have been chased reveals itself.

The chart below shows this return dispersion among active managers in the Australian Fixed Income universe with the difference between the first quartile and fourth quartiles over a one-month period.

This can be even larger over a year. The rolling year-to-March is showing a gap of more than 4% between top and bottom-ranked managers. That's incredible for a defensive asset class like Australian Fixed income.

See chart below:

Chart One: **Inter-quartile Monthly return difference (%)**



Source: Morningstar

Pendal's Fixed Interest Fund has had a very strong March quarter. The consistency of the fund's performance can also be seen over the past 12 months and three years. It's delivered top quartile performance vs peers and importantly strong active returns when needed.

Returns	3M	6M	1Y	2Y	3Y	5Y	10Y
Bloomberg AusBond Composite 0+ Yr Index	2.99	1.63	6.80	7.00	5.74	4.24	5.92
Pendal Fixed Interest Fund	3.75	2.25	7.95	6.85	5.52	3.46	5.59
Quartile	**1**	**1**	**1**	**1**	**1**	**2**	**2**

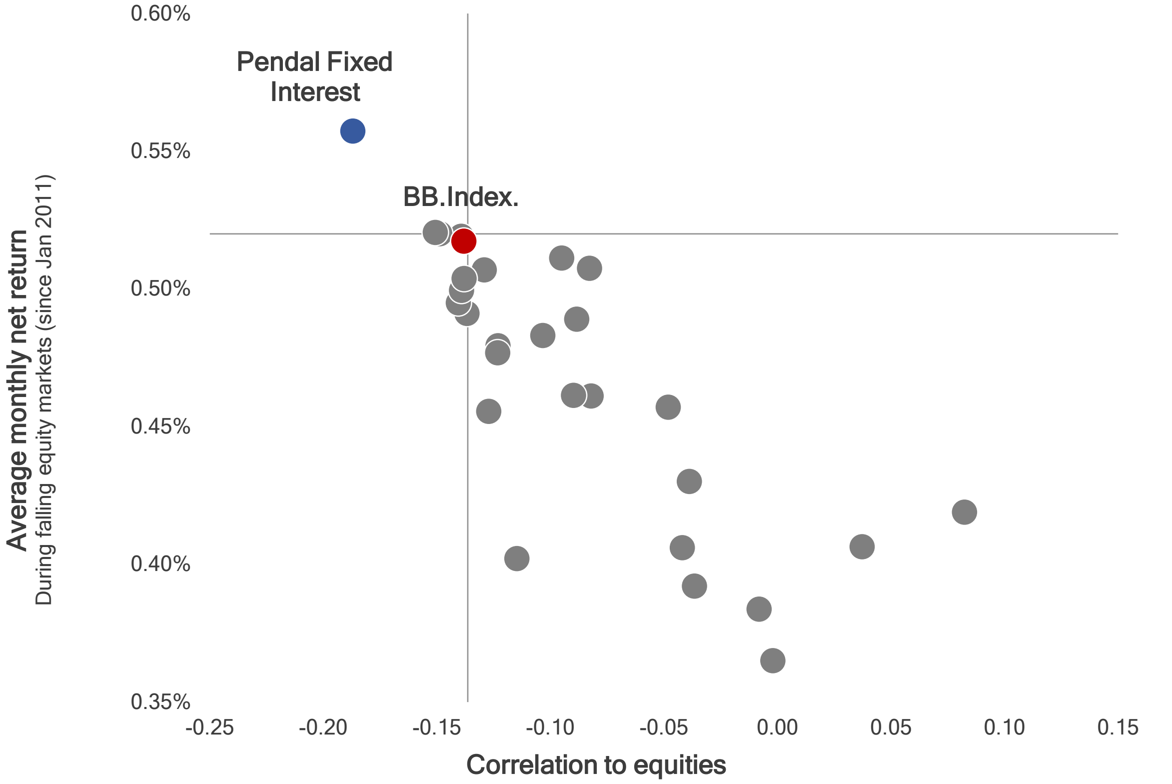
Source: Pendal
*After fees % as at March 2020

Differentiated philosophy

The chart below shows the key reason for this dispersion in returns over volatile periods.

While everything from safe haven government bonds to bank hybrids all technically fall under the umbrella of fixed income securities, many of these assets exhibit equity-like behaviour at the most inconvenient time for investors: when equity markets are falling.

Chart Two: **Average Monthly Return when equities are negative**



Source: Morningstar

Pendal's fixed income philosophy is purist in nature. We believe fixed income portfolios should provide investors with income and act as a safe harbour in times of equity market stress.

The performance of fixed income allocation should be the last thing investors worry about when their equities allocations are suffering drawdowns. As a result, and as the above chart shows, the Pendal Fixed Interest Fund sets itself apart from the crowd and delivers strong returns when the market environment grows more hostile.

The Pendal Fixed Interest Fund exhibits this defensive philosophy through a long duration bias.

Despite the very low starting point in yields going into the current crisis, government bonds – and in particular the power of duration – has continued to provide defensiveness when equity markets have suffered sharp drawdowns.

This primary tool of defensiveness is further supplemented with our focus on the quality and liquidity of investments we make for the portfolio.

Maintaining a high-quality and highly liquid portfolio allows truly active management that delivers true-to-label results. Our investment process blends quantitative rigour with qualitative insights, targeting a unique set of return opportunities consistent with our investment philosophy.

Outlook for Australian Fixed Interest

Everybody is doing Quantitative Easing (QE). Australia benefits from being a later mover, with the choice of many different QE templates used in around the world.

However, QE is not a tool that can work infinitely. The capacity of different central banks to continue QE also varies greatly.

We know from prior rounds of QE across the world that the first stage of QE is a broadly happy phase. Markets lift because the crisis has triggered a stimulus response.

However, later stages of QE will play out unevenly, depending on the reasons why it has continued. For Europe and Japan, the continuation of QE has been a symptom of very little firepower and alternatives left in the policy tool belt.

For the other economies, it may be a mask for insufficient fiscal stimulus or the previous loss of fiscal discipline. The US may well fall into this latter category in months to come.

Australia now finds itself in a sweet spot at the start of its QE experiment, and with far greater fiscal runway. This is one of the reasons we favour long-duration positions in the well-anchored front ends of yield curves in the ANZ region.

Australia has done a great job bending the COVID-19 curve, but the economy and markets are likely not out of the woods just yet.

Two major tailwinds have supported equity markets in recent years: buybacks and dividends. These are now turning into headwinds as corporates focus on balance sheet repair. Bonds continue to be a legitimate diversifier in this environment. But with yields at very low levels, fixed income portfolios need to be managed proactively.

Duration remains a buy-on-dips asset class until we have better visibility on economic and earnings trajectories. Policy makers will not be shooting themselves in the foot by allowing any significant bond sell-offs until that clarity is found.

Australian Investment Grade (IG) credit is a legitimate source of income and alpha for portfolios. The Pendal Fixed Interest Fund has purposefully stuck to index weight in its corporate credit exposures in recent years as macro risks have mounted, but were failing to be reflected in ever tightening credit spreads.

This discipline now affords us a golden opportunity to take advantage of market dislocations and put money to work on quality assets at mark-down prices. By not following the herd in chasing spreads lower in recent years, the challenging liquidity conditions in secondary markets now act in the Fund's advantage in looking for resilient IG credit.

For any medium-term investor looking for opportunities to boost returns in their income portfolios, Australian IG credit is a buy.

However, the ability to assess fundamental corporate resilience and value here will be key. This will set apart the alpha from the beta.

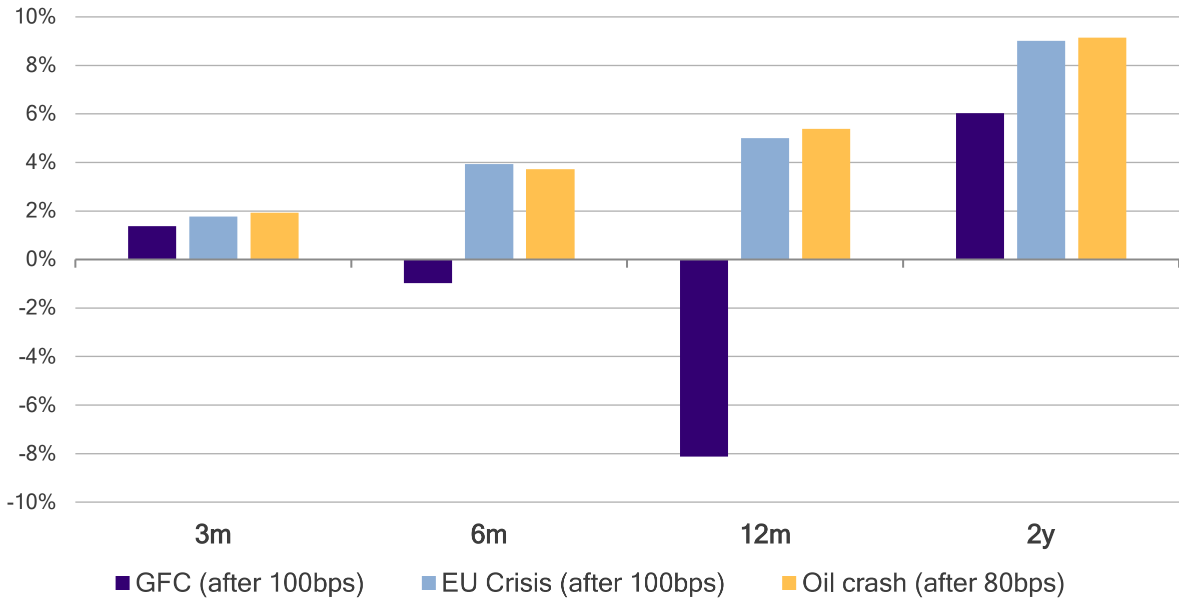
The Pendal Fixed Interest Fund has started to increase its allocation to credit from the benchmark weight in recent weeks, while many of our peers will still be looking for opportunities to liquidate holdings from their portfolios.

When in need of liquidity in any crisis, investors are forced to sell what they can – not what they want to. This is the primary reason for market dislocation and the attractive levels of Australian IG credit. It is an opportunity for investors who maintained their quality and value discipline as the markets became frothy.

The chart below highlights the medium-term opportunity in Australian IG credit, showing returns after episodes of significant spread widening.

Outside the GFC, medium-term investors have been rewarded for any holding period longer than three months. Unlike the GFC which resulted in continuous quarters of disorderly de-leveraging within the entire financial system, this crisis is largely the result of policy-induced economic shutdowns. The economy does not have to bounce back in a V for many of Australians IG credits to remain money-good.

Chart Three: **Returns from Australian IG credit spreads after significant sell-offs**



Source: Pendal/Bloomberg

Conclusion

After every crisis comes a period of healing – and we expect no different this time. As we saw after the GFC, we expect savings rates to rise rather than fall as we emerge on the other side of this health crisis. This will add to the pre-existing global savings glut chasing yield and returns.

However, soon after crisis investors also choose safety over return potential when picking their asset allocation.

Australian portfolios are notorious for under-allocation to fixed income and it is time to rethink this template. Despite yields at all-time lows, the power of duration kicks in when it really matters, as the Pendal Fixed Interest Fund has demonstrated over this period.

Fixed income allocations should be given to active managers who focus on alpha and deliver resilience and defensiveness when it is most needed.

For more information contact your
key account manager or visit **pendalgroup.com**

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