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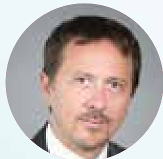

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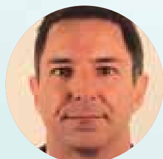

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HOW TO FIX FIXED INCOME

Low yields and fading central bank support have left investors scratching their heads about what to do with their bond allocations

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Worries surrounding the bond market have been growing since the beginning of the year, and as the months roll by investors are being forced to make a decision on what to do.

The combination of the withdrawal of quantitative easing and historically low interest rates has resulted in the sector becoming increasingly risky. In the US, the eurozone, Japan and the UK, central bank rates are close to zero and yields on long-term government bonds have plummeted.

The impressive performance delivered by equities in 2017 is another factor discouraging investors from investing in debt. Given that dividend yields still look better than bond yields from the same quality of company, investors may be more inclined to allocate their money to equities.

Investors have different views on the bond dilemma. While some try to reduce the risk factors, others have opted to exit the fixed income space altogether. Either way, fixed income just doesn't seem to appeal to investors as much as it used to.

Here, five independent asset managers reveal how they deal with these concerns and whether or not they have changed their exposure to the sector to maintain returns.

MARKUS BAMERT • Lenox Capital

Serve and protect with the safest of bond plays

As a discretionary asset manager for mainly Swiss private clients, we have a fiduciary duty to protect assets. Investing in investment grade fixed income with a negative nominal or real yield does not align with this, particularly when the securities are of long duration. Consequently, we exited most Swiss and eurozone fixed income funds some time ago.

As we have all learned from 2008 onwards, leaving large cash balances in bank accounts has its own problems. So we still hold three funds on the fixed income side to reduce our cash allocation. One is the **Kames Absolute Return Constrained** fund. The fund invests in short-term investment grade bonds and holds those until maturity. There is a conservative trading overlay too that aims to lift the fund's returns to above the small income derived from coupons.

Another holding is **Robus German Credit Opportunities**. The fund focuses on various debt instruments from small and mid-sized German companies. Liquidity is monthly, with a notice period. This is more congruent with the underlying holdings. We prefer to hold a dedicated position in a less liquid high yield fund than invest in funds with daily liquidity, which mix liquid and less liquid instruments. The recent issue at a Swiss money manager proves this point.

Lastly, we are invested in the **DoubleLine Short Duration Bond** fund. About half of the fund is invested in securitised issues. With US dollar/Swiss franc foreign exchange hedging costs nearing 3%, this position serves primarily to help us avoid holding excessive cash in the portfolios.

MICHAEL LIENHARD • Cape Capital

Playing policy tightening

Interest rates in most of the developed world continue to be close to historical lows, with credit spreads still at the tighter side of the range. We see increasing signs of a maturing credit cycle and less accommodative central bank policies.

In such an environment, we recommend reducing the number of risk factors and variables in global fixed income portfolios. This should increase the predictability and scalability of any bond allocations during times of market paradigm shifts.

With the end of free money fast approaching, liquidity risks might increase further from their current elevated levels, especially for longer-dated corporate bonds. We therefore suggest focusing on credit segments that are not directly subject to any quantitative easing, along with having a stable carry that is higher than the historical average loss realisation rates.

A short- to medium-term credit duration is beneficial too, as we believe that the cyclical tight spots are behind us. Regarding the maturing credit cycle, we advocate overweighting investment grade companies with strong balance sheets and free cash flow generation, and we favour capital structure risk over pure issuer default risk.

In summary, we currently prefer a portfolio with low interest rate duration, no FX risks and a clear focus on investment grade issuers, including subordinated bonds and synthetic credit risk to enhance the carry. Although the credit cycle is maturing, we are confident that the strong current credit matrix and the relatively benign leverage within most of the developed world's investment grade balance sheets will still provide a decent risk/reward profile. We therefore recommend a neutral allocation to credit as an asset class and decidedly underweight duration.

RETO JUNG • WMPartners Asset Management

Gauging the mood

The low interest rate environment, as well as the considerable rate differential to the US dollar, represents a formidable challenge, not least to investors thinking in Swiss francs.

In addition to the fact that a significant proportion of bonds regarded as risk-free are returning negative yields, risks as measured by duration are on the rise as well.

From a short-term point of view, we think improving returns are unlikely. Inflation gauges are hovering near the central bank target ranges.

What's more, political uncertainties – keywords include trade wars, Italy and Turkey – are hanging over financial markets like a sword of Damocles and are driving increased demand for safe-haven fixed income investments.

In the medium term, we expect yields to increase moderately. Given the generally high level of public indebtedness in major economies, we would suggest that both interest rates and yields will remain lower for longer globally.

Against this backdrop of rate-free risks, fixed income investors are desperately looking for alternatives. Likewise, we see little potential for conventional bonds at this time and retain a sizeable underweight to the asset class.

To obtain some yield mark-ups with manageable risks, we invest in the corporate bonds of investment grade issuers. Given their attractive yield-risk profile, we are using subordinated insurance bonds to complement our fixed income portfolios.

We prefer senior loans in light of their more enticing yield opportunities and we are also engaged in private market bonds given their comparable risk/return characteristics. We favour both of those over emerging market and high yield bonds.

ROBERTO PISANI • Penta Asset Management

Reaching for yield

European tapering and yield normalisation will create one of the most challenging environments for euro-denominated fixed income investors for the years to come.

In the US, where yields should increase further, strategies such as corporate investment grade short-dated bonds should provide enough coupon to compensate for the expected price decline, resulting in a slightly positive performance.

However, the expected total return for a similar euro-denominated strategy is unlikely to be positive.

Bonds range from sovereign to Tier 1. Going down the ranks increases the risk and usually the expected return too. As direct investments imply too much specific risk, we prefer to rely on fund managers with proven skills and track records when we invest in the sub-investment grade category and/or in subordinated debts.

Take, for example, the **Lazard Capital Fi** fund, which invests in Tier 1. Its yield is 4.6% for a duration of 3.7 years. Senior high yield loan funds such as **Scor Euro Loans**, which offers a yield of 3.7% for a duration of 3.4 years, are also an attractive alternative.

Last but not least, minimising duration risk while benefiting from credit risk is possible with a fund such as the **UBAM Global High Yield Solution**, which currently delivers a yield of 7.6% for a five-year credit risk, but for a duration of only 1.4 years.

Yes, the volatility of such products is much higher than any conventional fixed income investment, but weighting the size of the positions accordingly keeps the risk of the overall portfolio within acceptable levels.

KONSTANTINOS TZAVRAS • Kendra Securities House

Get ready for a rate lift-off

As financial markets started to wake up to the normalisation of monetary policies by major central banks last year – with the Federal Reserve being the most advanced in this process and the Bank of Japan the least advanced – bond yields spiked at the beginning of 2018, but have remained stuck in very well-defined trading ranges since then.

At a time when the US economy is firing on all cylinders, Japan's data is rolling over and Europe is going through a six-month slowdown (albeit from high levels compared with its own medium-term history), we believe the highest risk to markets is not a trade war or Italian or British politics, but rather the Fed's policy in early 2019.

Inflation, as measured by the Fed's favourite metric, has already reached the target and there is no sign of hesitation when it comes to the Fed's willingness to raise rates further this year. Its actions and rhetoric will be the key to the price action across asset classes in early 2019, in our view.

Will the Fed stick to raising rates and force the yield inversion? Will their policy to keep raising rates make the 10-year US Treasury spike beyond 3.2%, sending shock waves across asset classes? Will they pause, sending the message to markets that enough is enough for now?

The US yield curve is only 20 basis points away from inverting and it is remarkable how sticky the 10-year yield has been for six months now. But perhaps we should listen to what the market is telling us. With speculative short positions on the 10 year Treasury at record highs and the yield curve so flat, we find value again in the US dollar fixed income market.

At current levels, we are buyers of US Treasurys and very high-quality US dollar bonds (AA+) with a maturity of three to five years, and we are very sceptical about bond funds that are short Treasurys, which is one of the most crowded trades currently.

At the same time, we are sellers of US dollar high yield bonds, as this is the next accident waiting to happen, especially if one notes that the leverage of US small caps is at record highs, far exceeding the leverage of the era before the financial crisis.

Emerging market debt is becoming increasingly attractive, and local currency will offer an attractive buying opportunity in the coming weeks, especially if we see the US dollar peaking close to current levels. We would be buyers of both hard currency and local currency bonds.

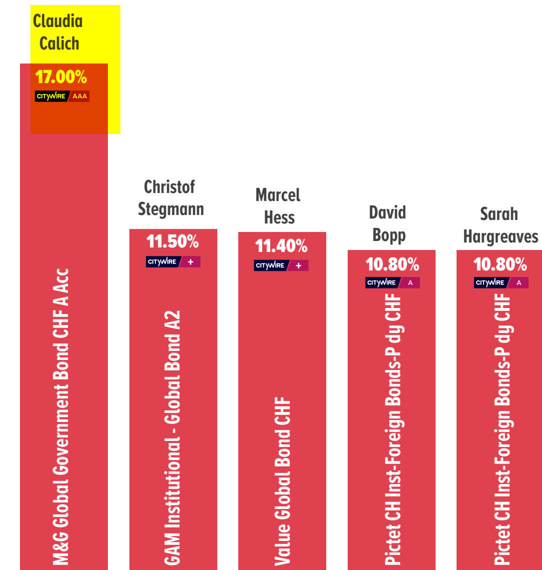
YIELDS ON MAJOR 10-YEAR BONDS

Bond	10-year yield (06/09/18)
German Bund	0.372%
US Treasury	2.895%
Japanese Government Bond	0.099%

SOURCE: LIPPER

TOP FIVE GLOBAL BOND MANAGERS BY TOTAL RETURNS OVER THE PAST THREE YEARS

(results from 31 July 2015 to 31 July 2018)



SOURCE: CITYWIRE DISCOVERY