June 2015

Seeking a 'GLASS half-full' approach to bond investing

There has been much attention in bond markets on whether, or when, the Federal Reserve will raise interest rates. The removal of the word 'patient' from the central bank's statement on its interest-rate intentions in the spring had apparently paved the way for a subsequent rate rise.

In our view, Fed policymakers would like to raise interest rates, not least to afford some flexibility to the money market system. However, given the relative softness of the global economy, recently disappointing indicators of the strength of the US economy, and persistent debt burdens in the aftermath of the global financial crisis, a significant rise in interest rates seems unlikely.

Below, **Paul Brain**, head of fixed income, explores a number of questions that appear to be troubling bond investors right now, and considers some potential solutions.

Would it be disastrous if the Federal Reserve were to raise interest rates?

Given how much effort Fed policymakers have put in to preparing investors for a rise in rates, it seems unlikely that they will catch market participants by surprise. So, if a move to increase rates does not shock, why should it be a disaster? One concern would be that financial markets have been shaped by suppressed interest rates for some time, and that valuations in all assets have become very distorted and detached from fundamental support.

Nonetheless, while this may be true in some markets, such as equities, a series of 'tantrums' (rapid rises in bond yields) has actually enabled the US Treasury market to reflect the likelihood of a rise in rates. Specifically, the gap between yields at the 'front' end of the curve, which are being kept low by the zero interest rate policy, and yields at the 'long' end does appear to provide some protection against a tightening of policy by the Fed.

Does this mean there won't be a rise in yields once the Federal Reserve starts to raise rates?

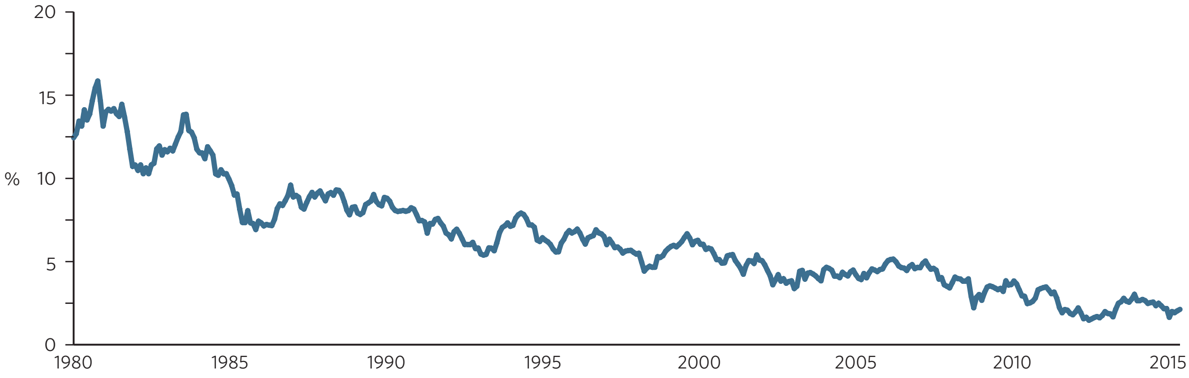
No. The first rate rise is likely to lead to speculation over the extent and timing of others, and we anticipate that the bond market will need to price this in by pushing yields higher, initially. Ultimately, we think this process will be overdone (i.e. yields will rise higher than is warranted) as the economy remains fragile and large government debt burdens continue to dampen growth and inflation expectations.

In the meantime, why is a modest rise in bond yields problematic?

There are a number of reasons to be concerned about this event. The first is that, if we enter this interest-rate 'bear' phase, we observe that we will do so with the greatest interest-rate risk in history. After 30 years of yield declines, as shown for example in Exhibit 1, duration (a measure of interest-rate sensitivity) is at its highest on record.

With many investors still using bond indices as benchmarks for their investments, falling yields have meant that they have been taking on greater and greater interest-rate exposure. The use of bond exchange-traded funds has accentuated this trend. As Exhibit 2 shows, the effect of even a modest rise in bond yields can be very damaging to capital values.

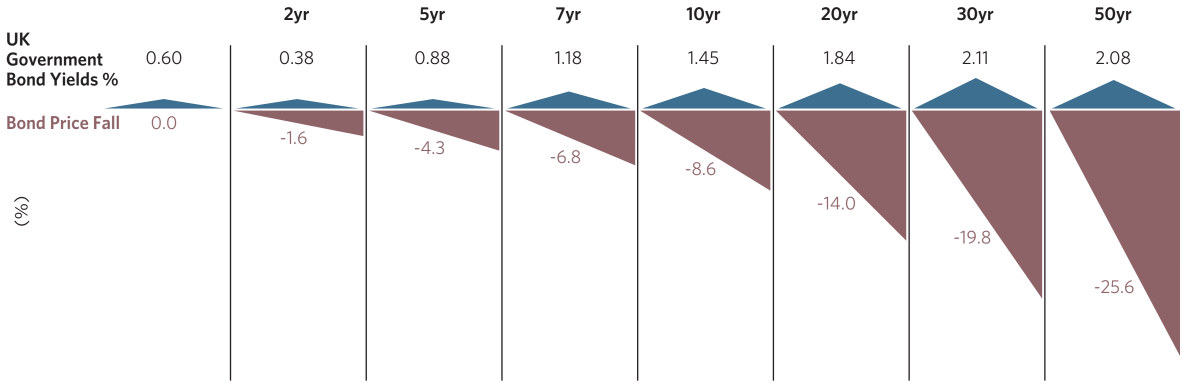
EXHIBIT 1: US 10-YEAR TREASURIES – REDEMPTION YIELD (%)



Source: Bloomberg Data, June 2015.

EXHIBIT 2: INTEREST-RATE RISK – THE BOND ICEBERG

The impact a 1% rise in yields could have on UK government bonds of various maturities



Source: Newton, Bloomberg, January 2015; for illustrative purposes only.

Should we be seriously concerned about diminished liquidity?

The zero interest-rate policy ("ZIRP") followed in the US has driven investors out of cash and into bond funds – which equates to trading liquidity for returns, at the cost of greater volatility. A move into bear market territory could cause a flight out of these funds – a phenomenon that we believe bond markets are not equipped to cope with. The well-publicised decline in the balance sheets of market-makers may exacerbate the problem.

So, who will buy the bonds? In our opinion, there will be long-term investors looking to pick up bargains along the way, but initial panic may cause the kind of indigestion we saw in 2008.

In short, while there may not be a disaster in the long run, potential damage to capital as a result of near-term volatility is a genuine concern.

What steps can an investor take to avoid being damaged by short-term volatility?

We would suggest investors adopt a **'GLASS'** approach.

Global. It is intuitive to us that the more assets you own in markets where rates are on hold or declining the better. If the US is the only economy that can raise rates, why have US dollar bonds and be exposed to the rise in yields? As bond investors become increasingly sceptical about the stability of their own domestic markets, we see a global approach to bond investing (and indeed to currency exposure) as increasingly pertinent as a means both to diversify risks, and to generate positive returns in a rising interest-rate environment.

Liquidity. It is clearly advisable not to be caught out by holding assets that are likely to trade less frequently (loans, structured products and complicated derivative structures). Also, we think it is appropriate not to invest in an investment vehicle that is so big it can't adjust its strategy quickly enough to protect capital when yields start to rise (see below).

Anticipate and act. In addition to avoiding those markets that are less liquid, it seems a prudent idea to us to have a process that seeks to identify changing trends in markets (in terms of fundamentals, valuations, liquidity and volatility) and which may enable investors to avoid being caught out by falling prices and a deterioration in liquidity conditions. We see adjusting portfolio positioning ahead of these inflection points as key.

Shorts. Having the flexibility to use exchange-traded (and therefore liquid) futures and options to create short interest-rate positions may protect capital during periods of rising yields.

Seek alternatives. Investing in floating-rate and index-linked securities during a bear market may provide positive coupon flows and less capital volatility.

All of the above tools can be used by an absolute return bond strategy to try to protect the investor from the implications of a rise in interest rates by the Federal Reserve. One important consideration is portfolio size, and we regard this as a key factor in being able to follow the 'GLASS' approach.

So what is the right size for an absolute return bond fund?

Too big, and you may not be able to invest to make a difference, or change positions quickly; too small and minimum lot sizes for bonds may become a barrier to diversification, and investors may be deterred.

In relation to the strategy we manage, which invests in four liquid markets (developed governments, emerging-market sovereigns, and investment-grade and high-yield corporates), we believe a figure around $9 billion is about the maximum to be able to preserve the attributes of the 'GLASS' approach. As a minimum, we suggest not going below $25m.

There are many variables used in this calculation, but some things can be fixed. If one takes the least liquid market (high yield) and the smallest issue size in which we invest (US$400m), one can identify the maximum amount per issue (subject to holding no more than 10% of issue) and work back from there.

In our opinion, one of the other defining limits is the size of the team and the number of issuers you want each analyst to cover. If you want to keep the number of analysts relatively tight (in order to maintain the agility of the investment process), we think you have to accept there is a limit to the optimal size of the fund.

It is our contention that, when we invest in a bond and get it 'right', the decision should make a difference on behalf of our clients. Some of the 'mega funds' in the market may have to buy almost all of the issues as they launch, which would result in tiny positions per issuer and, to our mind, undermine the purpose of analysis. For example, if Morocco were to be the best performing emerging market, the mega fund's performance would not benefit meaningfully, given that nation's relatively small number of traded issues.

With all these moving parts, how can you manage risk?

Rather than use backward-looking value-at-risk (VaR) analysis and risk capital calculations, our view is that it is better to manage risk with an eye on the future. There are four stages to this kind of risk management process.

The **first** step, we suggest, is to design a strategy that has some volatility-dampening characteristics. We favour a multi-asset fixed income approach, which seeks to combine the 'risk-on' characteristics of high-yield and emerging-market debt with the 'safe-haven' nature of government bonds and investment-grade credit. Having the flexibility to adjust this mix to suit the economic cycle may also reduce risk.

The **second** step, as we see it, is to ensure one has a repeatable process which seeks to anticipate the changing features of the economic cycle. Our global thematic approach to investing has provided us with a 'roadmap' for over three decades.

The **third** step, we would argue, is to ensure there are some in-built constraints that prompt diversification and limit losses. We recommend avoiding over-concentration within the portfolio, particularly in riskier assets, and seeking to use the diversification benefits of different markets.

Finally, we think it is important to use forward-looking scenario analysis and to monitor positions on a daily basis. The output allows for a re-evaluation of positions if one is uncomfortable with the current allocation. Monitoring of the strategy using live pricing can also highlight where the current allocation is seen to be appropriate, and also where it may be vulnerable to a change in direction.

Using this approach, you might be able to conclude that the GLASS is half full, not half empty.

Further information

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