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Investing in a low growth environment.

The Investment Report.



Global Unconstrained Fixed Income

A global unconstrained approach needed in the current environment

What you see is what you get

Global fixed income markets have been both a beneficiary and a victim of the low-inflation, low-growth environment seen since the Global Financial Crisis (GFC). Falling yields do indeed have their benefits, particularly for investors who already own high quality fixed income securities. Many investors simply do not care that 10-year Australian government bonds trade at a meagre 2% yield when total returns so far in 2016 have been in excess of 6%. Looking in the rear view mirror (Chart 1), government bond returns in developed markets look seductively good, at least relative to the anaemic cash rates on offer.

However, when asked to provide expectations of future bond returns, our best guess is always the same – it is the yield-to-maturity. In fixed income, what you see is what you get (assuming no defaults and holding to maturity). This means, right now we can expect investing for the next 10 years in high quality government bonds to generate 2.09% per annum in Australia, 1.41% in the US, 1.10% in the UK, -0.23% in Germany, and -0.02% in Japan. For those seeking return, it is a fairly dire state, even amidst a backdrop of relatively low growth and inflation.

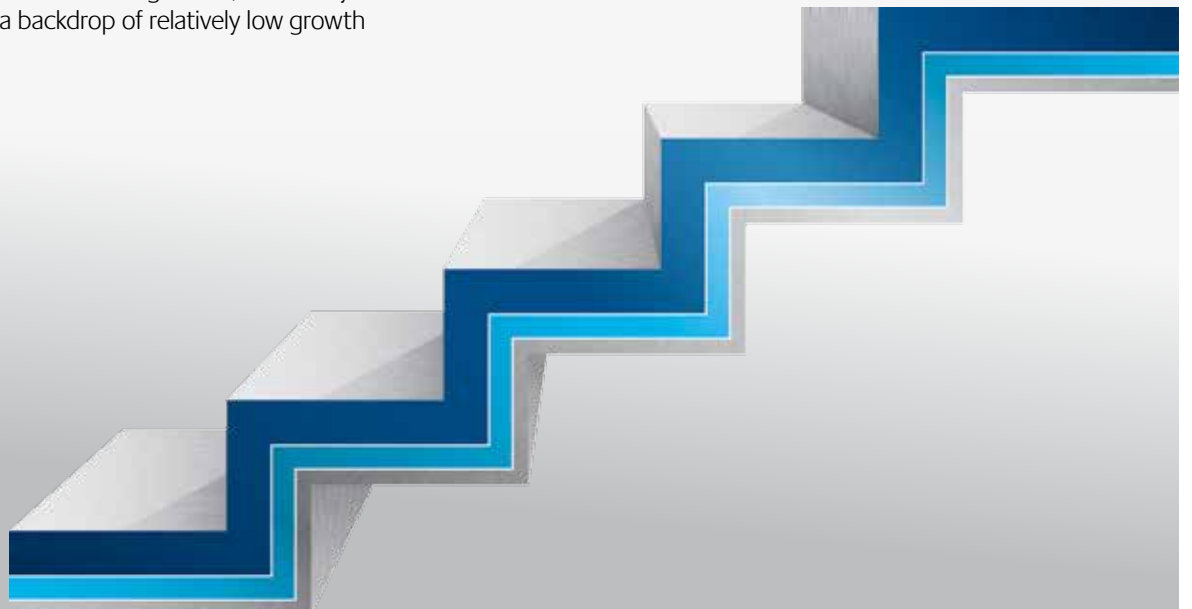
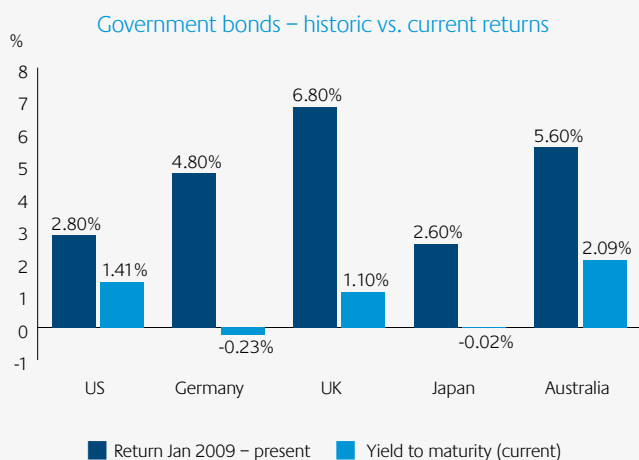
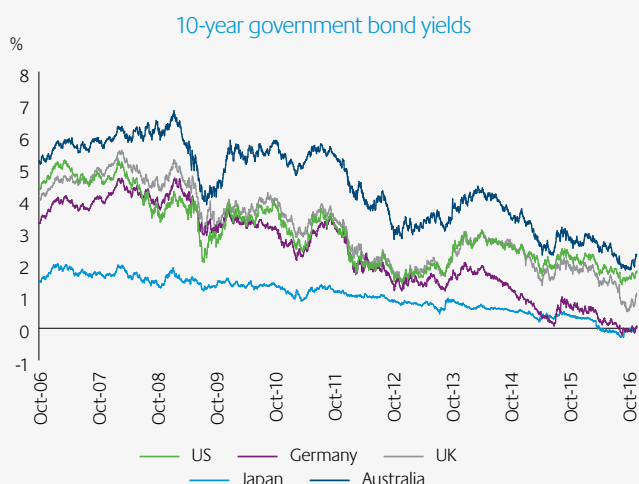


Chart 1: Risk-free return or return-free risk?



Source: Bloomberg Barclays Global Treasury Index as at 14 Oct 2016.

Chart 2: Race to the bottom



Source: Bloomberg as at 14 Oct 2016.

This means other reasons are now given for holding high quality fixed income securities in a portfolio, including:

- Diversification against equities or growth assets.
- Anticipation of even lower yields and continued capital gains.
- Expectations of lower or negative growth/inflation, making ‘real’ yields look OK by comparison.
- Liquidity provision.
- Income generation.

While we will not debate the relative strength or merits of these rationalisations here, one thing is for sure: if return is what you seek, then beta alone will not get you there.

Higher, faster, longer, stronger

There are two tried and tested ways of increasing the return on a fixed income portfolio: increasing duration and increasing credit exposure. For those looking to squeeze a bit more out of their portfolio, both of these involve taking substantially more risk.

As it relates to credit, we would warn that there are no free lunches here. Although generally a sensible option, investors should invest in a diversified manner, preferably actively to ensure credit losses are kept at a minimum. But for a high quality core fixed income allocation, credit on its own is not overly defensive given the relatively high correlation to equities and other risky assets. To the extent that increased credit is desirable, we would recommend picking a dedicated and specialist global credit or high yield manager to navigate turbulent waters.

On the other hand, apart from hedging a specific long-dated liability, we would not recommend increasing duration since yield curves are relatively flat, and the increased yield generated by shifting out the maturity spectrum would not be sufficient for the increased level of risk. Additionally, as shown in Chart 3, duration across developed government bond markets has extended considerably in the past 10 years and before the GFC. Debt issuers are behaving rationally in that they are borrowing money when coupon payments are at or near all-time lows. Is it a surprise that the average duration of market capitalisation indices continues to go up? Unfortunately for the lender, this has both increased volatility expectations given the higher risk profile and dramatically increased capital loss expectations should interest rates rise sharply. So, what is left?

Chart 3: Extending yourself?



Source: Bloomberg Barclays Global Treasury Index as at 14 Oct 2016.

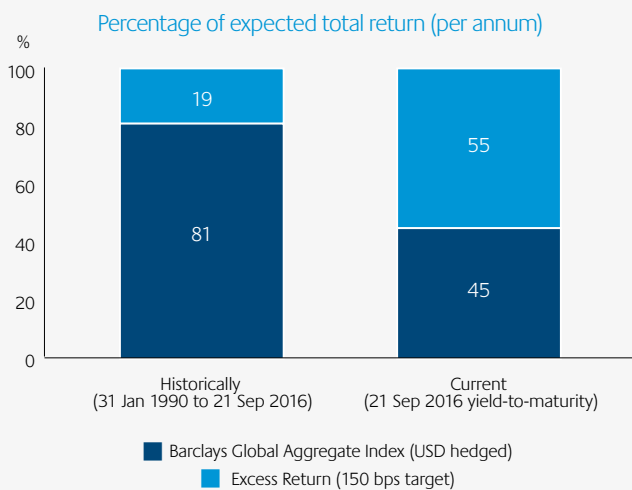


The alpha course

Conventional wisdom dictates that the vast majority of returns come from asset allocation decisions. Academic literature and research¹ seems to have settled on at least 80% being the amount of long-term return that can be explained through strategic asset allocations decisions. Therefore, developing an appropriate asset allocation and picking one's benchmark historically was of far more consequence than selecting an active manager. However, the low-yielding environment means that there is an increased likelihood that in fixed income, excess returns will exceed market returns in the period ahead.

For example (demonstrated in Chart 4), historically the global investment grade fixed income market (Barclays Global Aggregate Index – USD Hedged) has generated an annualised return of around 6.33% (since inception of the index in 1990). For an alpha target of say 150 basis points, this equates to around 19% of the total expected return per year. Indeed, conventional wisdom has been right. But currently, the average yield-to-maturity on the Barclays Global Aggregate Index is a mere 1.25%. Given that the yield is our best expectation of future market returns, this means that now – assuming a manager delivers on objectives – you can expect around 55% of total returns to be generated through excess returns. The choice of an active manager within fixed income is more important than ever.

Chart 4: Alpha now more important than Beta



Source: Bloomberg Barclays Global Aggregate Index (USD hedged) as at 14 Oct 2016.

To consistently deliver high quality alpha within portfolios, we have invested heavily to develop a network of investment capabilities worldwide to enable the creation of a global platform, which ensures that we are able to offer clients access to our best investment thinking, regardless of where it occurs. Along with assembling a collection of world-class investment teams who are specialists in their relevant fields, we have fostered a transparent, research-based investment culture underpinned by our proprietary, technology-based platform – the Investment Opinion Network. (‘ION’). This platform allow us to deliver a ‘Global Unconstrained’ approach, which is necessary in the current environment.

What does ‘unconstrained’ mean to us?

The term ‘unconstrained’ has picked up in popularity in recent years within the fixed income world. But this term means different things to different people. In some cases, it is shorthand for a hedge fund. For others it means moving away from traditional fixed income benchmarks. Cynically speaking, unconstrained may be nothing more than a marketing buzzword used to repackage old ideas. We have a straightforward view of what ‘unconstrained’ means.

Simply put, we believe idea generation that develops free from traditional parameters such as region, sector, rating, and benchmark constituents generates the richest possible variety of global investment views. Hence, ‘Global Unconstrained’.

The label ‘unconstrained’ is intended to convey that investment ideas are expressed regardless of any top-down imposed world view. As a global platform, we take great care to ensure alpha sources are uncorrelated to markets and each other. This is why idea generation is developed independent of an overarching ‘house view’. Further, by intentionally decoupling idea generation and associated research from portfolio construction, we can combine alpha sources in many different ways so long as risk is balanced.

As we have established, in the period ahead, alpha will likely play a more important role than beta in a diversified fixed income portfolio. And we think we have built the ideal alpha platform to deliver an all-weather, balanced return stream that can squeeze a bit more out of a fixed income portfolio during this unusual environment and beyond.

¹ Brinson, Gary P., L. Randolph Hood, and Gilbert L. Beebower. “Determinants of Portfolio Performance” *Financial Analysts Journal* 42, no. 4 (1986): 39–44.

Ibbotson, Roger G., and Paul D. Kaplan. “Does Asset Allocation Policy Explain 40, 90, or 100 Percent of Performance”, *Financial Analysts Journal* 56, no. 1 (2000): 26–33.



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