KAPSTREAM CAPITAL

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Fixed income at crossroads?

Historically low yields, tight spreads, and something of a benign near term outlook across much of the fixed income landscape has stimulated many investors to reset expectations and revisit strategy in the asset class. Investors face several key decisions as they navigate through the current environment.

Duration. Route to salvation? Or damnation…?

Consensus is clear that we are at (or somewhere very near to) the end of the bond bull market. Duration-laden strategies have enjoyed the powerful tailwind of declining interest rates over the past seven years, and the 'lazy long' approaches followed by conventional fixed income managers have generated solid returns for investors. But, as we stare upwards from the bottom of the valley it's hard to envisage when the same conditions will be repeated. Yes, the asymmetric risk/reward profile of duration remains, but arguably now in complete opposition to its more rewarding nature of the past. Bond bear markets can be devastating and as shown below, it can take an extraordinary amount of time to recoup an investment after recording a substantial negative return (which given the expected direction of interest rates in the medium term, is almost a certainty for duration-laden strategies).

Magnitude of loss on investment					
		-5%	-10%	-25%	-50%
Return on investment	2%	2.50yrs	5.25yrs	14.50yrs	35.00yrs
	4%	1.25yrs	2.75yrs	7.25yrs	17.75yrs
	6%	1.00yrs	1.75yrs	5.00yrs	12.00yrs
	8%	0.75yrs	1.25yrs	3.75yrs	9.00yrs
	10%	0.50yrs	1.00yrs	3.00yrs	7.25yrs

Source: Kapstream; Assumes monthly compounding. Recovery periods rounded to nearest quarter of a year.

With rates near all-time lows, equity markets near all-time highs, and credit fairly priced, where can investors find returns?

Investment grade credit remains an attractive place
Investment grade spreads remain tight, however we feel it is foolish to apply a blunt, benchmark-led approach to the asset class. Corporate profitability remains strong, Central banks are likely on hold for longer than anticipated which gives us comfort that investors still get well rewarded for the risk of investing in investment grade bonds.

However, it is imperative to use greater flexibility in seeking out the very best investment opportunities, often missed by those shackled to a more conventional approach.

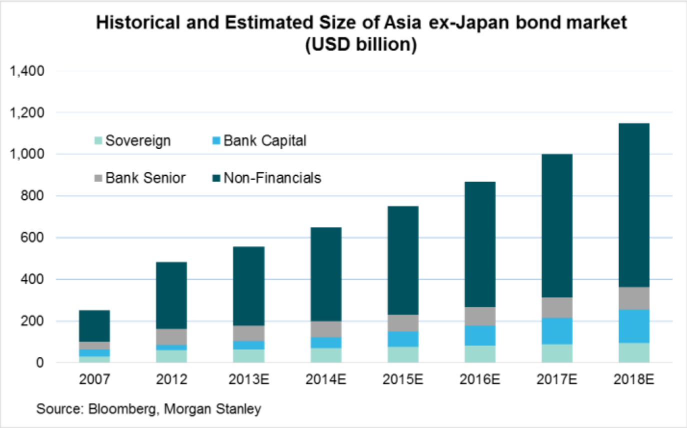
Furthermore, we question the sense of breaking down assets into 'sovereign' or 'credit'. Everything is credit. Is Portugal a sovereign or does it have credit/default risk? Are CBA bonds credit or do they have an implicit sovereign guarantee if one day they find themselves in trouble? The fine line between what is sovereign risk and what is credit risk is highly blurred!

Pragmatic diversification across a fully global opportunity set may have the potential to decrease risk, improve liquidity, and enhance returns.

Case study – Asia ex-Japan[1]

Any investor planning their debt allocation in the coming years may need to ponder a strategic involvement in the Asia ex-Japan credit market. While their debt markets are small relative to the developed world, the growth prospects in Asia are tremendous (see chart on the following page). Since the Global Financial Crisis, Asia ex-Japan's credit market has increased by nearly 250% in size to approximately $500 billion. It is expected to reach US$1 trillion by 2017 with gross annual issuance of over $150 billion per year. More importantly, non-financial corporate issuance is projected to dominate that growth. Unfortunately, larger investment managers do not access this region given the benchmark constraints and size of the market. Less than 5% of the Barclays Global Aggregate Bond Index is in Asia ex-Japan, eliminating unique investment opportunities beyond the reach of benchmark constrained approaches. Not only does the debt in Asia ex-Japan offer potential diversification benefits, but also it trades considerably wider than similarly-rated bonds from US issuers and typically comes with some sovereign backing.

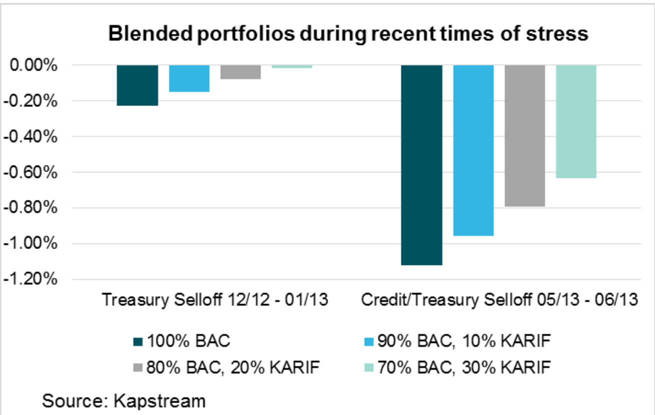
[1] Asia ex Japan (according to the Barclays Global Aggregate Index) includes Australia, South Korea, Taiwan, Malaysia, Singapore, China, New Zealand, Hong Kong, Thailand, Philippines, and India.



Handcuffs? For law enforcement only please…

With traditional bond fund management, managers are constrained to invest in the sectors and securities of a particular index. The bias lies with the issuers because typically the larger the borrower, the greater component of the index it becomes. Going forward the majority of new issuance will come from entities that are increasing leverage by issuing longer dated paper. This has effectively turned traditional core portfolios into bets on interest rates. In fact, government and government related debt now comprises approximately 65% of the Bloomberg AusBond Composite Index and 85% of the Barclays Global Aggregate Index.

Using the Bloomberg AusBond Composite Index (BAC) as a proxy for a core fixed income portfolio, modelling suggests that allocating a modest percentage to an unconstrained strategy, such as the Kapstream Absolute Return Income Fund (KARIF), may reduce risk (see below).



In stressed market conditions, the stabilizing effects of unconstrained portfolios reduces the volatility of returns and the negative effects of rising rates.

Lack of liquidity results in increased volatility

True liquidity is something we have been expressing concern about for several months now. Higher cost of capital and heightened regulatory risks have pushed banks who historically held material inventory into a far simpler 'broker' role. As a result, the traditional liquidity providers no longer have the same appetite as they once did. This makes it increasingly difficult for traditional index-constrained managers to construct and actively manage a diversified, risk-controlled portfolio.

Absolute return. Fence-sitters need not apply…

Occasionally we glance at our relative return peers with some envy. When seas are rough, they are able to return to the relative calm of the harbor and hug the benchmark until the storm passes (and we observe that rarely does such behaviour result in 'abandon ship'…).

An absolute return approach that seeks to deliver a consistent positive return at all times enjoys no such lifeline. While arguably tougher, we have sought to make that 'all-weather' approach an advantage for our clients with results to match. We aim to:

- Seek out the most attractive opportunities
- Reduce the risk of being exposed to bond bear markets
- Separate the duration component to limit risk in the event of a sell off
- Focus on protecting capital
- Provide a suitable return in the low yielding world

Conclusion

A combination of the factors discussed above suggest that it is highly unlikely that traditional benchmark focused approaches that aided investors for the past 30 years will continue to achieve the investment and diversification goals in the years to come. While we remain in the 'lower for longer' camp expecting interest rates to remain on hold for some time, we do not kid ourselves that the journey from a falling rates environment, through the 'flatlands' and towards ascent, is without risk. Equally the same environment throws up opportunities too.

The unhindered nature of Kapstream's unconstrained approach allows us to maintain something of a barbell shape in our portfolio; at one end maintaining a stable, liquid base, and at the other staying agile and dynamic in seeking out the risk-adjusted returns through ever changing market conditions.