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New Year – New Beginnings!

The beginning of a new year signals a fresh start – a review of what has come before and an opportune time to reflect on what has been working as well as the changes that may be necessary for us all to achieve our goals in the year ahead. In the context of investment strategy and asset allocation it is no different. It is a great time to review what themes are emerging - both fundamental and technical - in order to position portfolios to provide the best possible chance of meeting target investment returns.

At Kapstream, our clients have been challenging us to think of fresh ways to enhance the return of their fixed income allocation whilst not straying from the mantra of capital preservation - considered to be a fundamental backbone of our portfolios.

As a market backdrop, the bull market in global interest rates finally looks to be at turning point, led by a more robust US economy allowing the US Federal Reserve to finally 'lift off' it's extremely accommodative monetary policy with two rate hikes to date and the market pricing in at least two more in 2017. Moreover, President Trump's plans of tax cuts and expansionary fiscal policy is expected to further fuel US Gross Domestic Product (GDP) growth and inflation, providing further confidence in the path to normalization of interest rates. The only question now is whether President Trump's policies will be well executed and the US can reflate its way out of the US$19.9 trillion national debt (or 99.1% of external debt to GDP). With President Trump in the White House and able to sway financial markets with his active Twitter account, it's sure to be an exciting year in politics, and indeed markets.

In the UK there are growing levels of uncertainty on the final path to Brexit and the implications across the broader Eurozone, with Theresa May espousing a 'hard' Brexit vs a more compromised departure from the EU. It is doubtful that Prime Minister May will be able to conjure her wish of negotiating free flow of goods and services between the UK and EU, while at the same time restricting immigration into Britain (particularly within the two year timeframe of exit stipulated by invoking Article 50). Typically individual trade agreements between nations have taken up to seven years to negotiate. Importantly, it is not only the departure of Britain from the EU that will cause volatility in markets but the precedent of this occurring which may threaten the very foundation of the Single Market. Should Britain be able to successfully leave the EU without too much pain it will cause other countries to consider the same path.

Elsewhere in Europe, Chancellor Merkel will be facing a tough battle to retain power with the national election in Germany slated for September. Immigration will again be a hot topic for the election and across the region with the rise in popularity of right wing politics.

Given this backdrop, we have all the ingredients for a more volatile year ahead than previous years.

So, how should investors be positioning their fixed income portfolios in light of this more volatile backdrop? And what strategies are available to enhance yield in a low interest rate or progressively higher rate outlook?

One lever that can be utilized to provide clients with additional yield - whilst still maintaining the key important characteristics of fixed income - is liquidity. Conventional wisdom has to date dictated that fixed income be effectively at call and highly liquid, however increasingly clients are questioning the extent of ***how much*** liquidity is really required in their portfolio.

The real question being asked is "can I achieve an enhanced return from my defensive allocation by sacrificing some liquidity in favour of not taking on additional credit default risk or interest rate risk?" Put another way, can an investor allocate a core portion of their fixed income allocation to less liquid securities in order to increase risk adjusted return?

By having all of one's fixed income allocation in at call funds there is an acceptance and conscious decision of achieving a certain lower return – a liquidity discount.

Where to Best Capitalise on Illiquidity

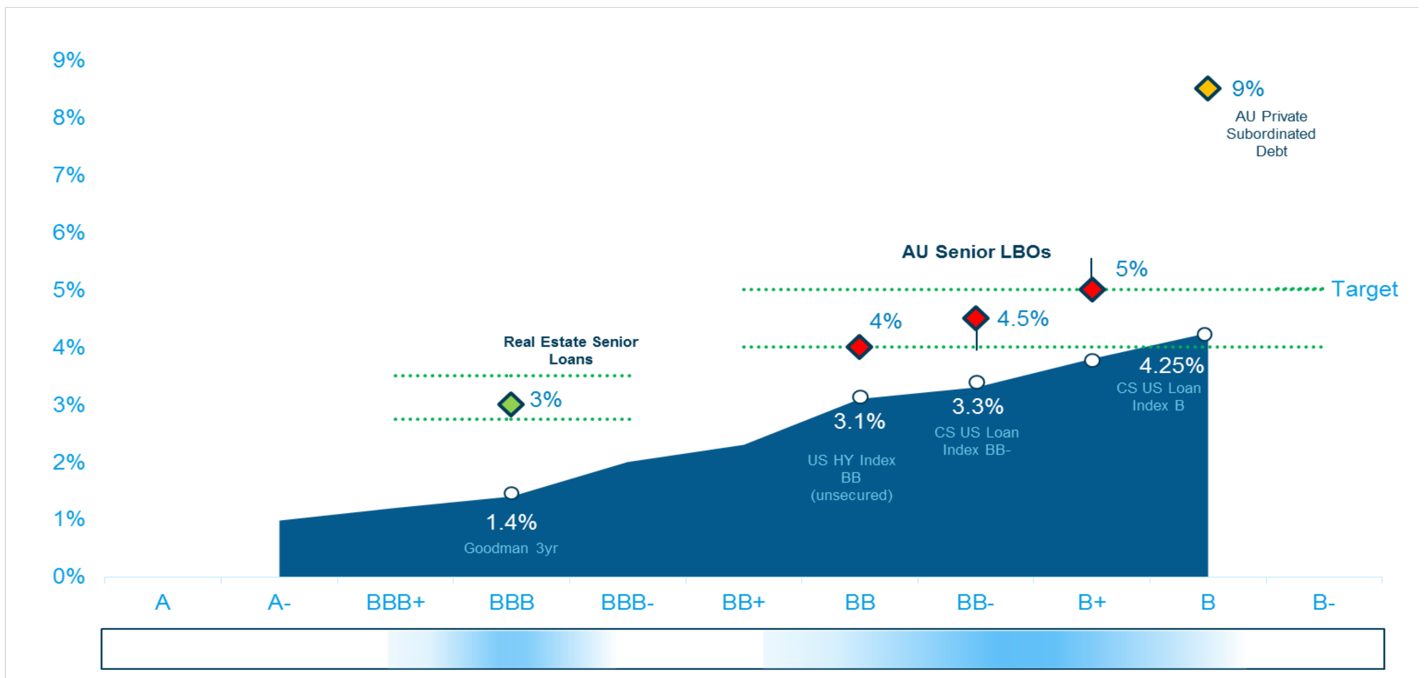
An illiquid credit asset class that has grown significantly since the Global Financial Crisis (GFC) is private debt – i.e. direct lending via loans by funds. Traditionally loans were largely the domain of banks that have been the largest participants in the sector. Post-GFC, however, banks in developed countries have been forced to substantially reduce their lending activities in areas that have attracted higher capital charges and Basel III risk weights, including sub-investment grade, leveraged buy-out debt (LBO), commercial real estate lending and middle market corporates. This is not due to these sectors being less credit-worthy after the GFC, but merely a result of regulators imposing higher capital charges that make these loans less attractive going forward.

Moreover, regulations such as Dodd-Frank and specifically the Volcker Rule have limited the amount that banks are able to engage in utilising their balance sheets for proprietary and secondary market trading. The effect being: dramatically reducing underwriting, primary issuance, liquidity and secondary market trading in credit.

This has paved the way for institutional funds meeting this shortfall in demand for lending via direct lending funds, as well as facilitating banks in selling existing loan exposures to funds in an effort to reduce high capital risk-weighted assets. In fact, circa US$270bn has been raised by private debt funds globally since the first quarter of 2013 *(source: Prequin Private Debt Online)* in various private debt strategies.

In Australia the most appealing sectors of private debt are real estate loans and leveraged buy-out debt. The chart below shows margins available for these sectors by credit rating plotted against like-rated liquid investments. As can be observed, the premium for illiquidity is 1.75%-2.00% over the liquid similarly rated market.

In short, private debt pays an attractive premium versus more broadly syndicated credit and provides investors with tangible ways to enhance yield in a low interest rate and more volatile market.



Source: Bloomberg

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