Kapstream
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Tubthumping (I Get Knocked Down)

More commonly remembered by its lyrics, the 1997 song 'Tubthumping' by British band Chumbawamba topped charts globally, becoming an international hit. The single was one of the best-selling of that year in the UK, US, Australia, Canada, Germany, New Zealand, Sweden, Belgium, and the Netherlands. In the US it remained one of the top-100 sellers again in 1998 too. It has been written that group guitarist Boff Whaley said the song was inspired by "the resilience of ordinary people".

'*I get knocked down, but I get up again, you are never gonna keep me down'*, were clearly lyrics that resonated strongly then, and today remain a fitting musical analogy that epitomises the way countries and communities have reacted to the impact of the pandemic. Their relevance is no less fitting a description of the behaviour of investors in the aftermath of the ensuing March sell-off.

For investors, it must be said that getting back up has been made relatively easy thanks to the widespread intervention of central banks, mostly all adopting a 'whatever it takes' attitude to their support of economic and financial market systems (notably with some variability in response speed and depth globally). Money has never been cheaper with interest rates held low and likely remaining there for the foreseeable future, and notably in fixed income markets bond repurchase programs, four months on, have returned most to almost normal liquidity and pricing conditions.

But, getting back up, and *staying* up are not the same. The latter requires resilience, adaptability, an openness to continue to learn from the unforeseeable nature of shock events, and by an understanding of what it was that laid you flat in the first instance. But before we draw groans for the writing of yet another look back analysis of the March crisis (and specifically the behaviour of global fixed income markets at the time), this piece is rather more focused on the road forward, of the lessons learned and with '20/20 hindsight', the careful evaluation of the things more obvious now that were perhaps not so obvious then.

Fundamentals vs technicals

At a broad level we have said before that none of the events of the past three or four months have caused us to change our views about the fundamental health of the issuers in which we invest (and more specifically their ability to service and repay their debt). That is not to say that lower rated issuers are not at risk of downgrade and default; risks there are heightened, but our general attitude to risk means we rarely if ever dabble in such areas, and in our opinion now is not the time to start.

The world remains in a precarious state. It's vital as investors we never lose sight of fundamentals, and especially at these times apply more focus to businesses or sectors we're exposed to that have been or are likely to be impacted more greatly by the continuing economic challenges caused by the not-yet-in-recession pandemic spread, for example REITS and airports, where we have adjusted allocations accordingly. However, "don't fight the Fed" has been said many times before, and we have learned to accept over time the strong tailwinds provided by the widespread monetary support of central banks. At least for the near-to-medium term, markets are likely to continue being driven by or at least highly supported by technicals.

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Home bias

Despite historic appeal from a relative yield perspective that has driven our long term bias to Australian credit versus comparable assets elsewhere, it's become obvious from the far weaker liquidity of Australian credit during the crisis depths that the relative yield/spread advantage was not enough to support the strong home bias going forward. We have always known that the Australian credit market was less-liquid, but even we were surprised by the relative lack of liquidity. This was due to a combination of a smaller overall market, fewer market-makers willing to put their balance sheets to work and some offshore players quickly retreating home.

A secondary driver was that the RBA did not act as quickly nor to the same extent as the Fed in supporting domestic credit markets. The risk of a repeat sell-off event comparable to March is not zero and therefore can't be ignored. As a result, we have determined to selectively reduce this bias going forward, as opportunities present themselves in either primary or secondary markets. This will likely see us move from the current allocation of ~67% Australia and 33% offshore, towards 60:40 and over time to a more even 50:50 split. We are particularly attracted to investment grade US issues with short-to-medium maturities, where liquidity is expected to remain far stronger.

More modest exposure to less liquid sectors (e.g. MBS/ABS)

While we continue to like the sector that pays the highest yield compared to similarly rated bonds from other corporate and financial issuers, and again we remain comfortable with fundamentals, domestically, despite well-directed support by the Australian Office of Financial Management (AOFM), the sector remained the most challenged from a price discovery and liquidity perspective. It has still not recovered fully at the time of writing. With hindsight, a more prudent exposure limit is felt more appropriate and the allocation to MBS/ABS in portfolios has typically been reduced by 3-5%.

Holding a higher minimum of cash/cash-like assets

Even sovereign bonds, which in the past have demonstrated robust liquidity, were not easy to trade for a short period of time at the peak of the crisis. Given our desire to retain a liquidity 'cushion' at all times, we have determined to maintain a true cash/cash-like exposure of at least ~5%, more in line with our long run average. We had allowed our portfolio to become more fully invested (through 2019 and early 2020) than in the past, which while positive from a headline return perspective meant that coming into a period like March we were more exposed to capital loss, given that it was close to impossible to liquidate anything without significantly elevated transaction costs.

Diversification of return sources

While we still believe in the benefits of investment grade credit's risk versus reward and indeed today the spread over the risk free rate for a highly rated portfolio of shorter dated bonds is almost as attractive as it's ever been, it has always been important to 'cast the net' as widely as possible in seeking other sources of return available to fixed income investors operating with a flexible mandate (such as Kapstream is fortunate to have), beyond the reward generated by purely physical assets. This includes an extension of more dynamic management of duration and currency (which has always been a hallmark of our approach), for example:

1) given depressed levels of interest rate volatility as a result of central bank policy, the use of options as a cheap hedge which can serve to protect the portfolio from unforeseen rate moves (in either direction);

2) more pointed curve positioning has recently led us to participate in opportunities in the interest rate swap market, where front end carry and rolldown trades look attractive on a risk/reward basis;
3) with developed market central banks at or near their effective lower bounds, cross-country interest rate relative value trades provide little scope for differentiation, hence currencies are an effective tool for expressing relative performance, for example the Euro's recent outperformance of the USD, as a result of the region's better handling of COVID-19 and of ongoing fiscal uncertainty in the US.

Particularly within the context of a monetary policy framework which is firmly 'on hold' and 'lower for longer', constructing a portfolio of uncorrelated positions will be a powerful diversifier of return sources through time.

Despite what Chumbawamba sang, we hopefully won't *'need a whiskey drink, a vodka drink, a lager drink, a cider drink'*, nor have to sing a song to remind us of the good times or the best times. But we'll certainly drink to the importance of perpetual learning and of building resilience into portfolios.

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