September 2020

From winter springs summer

With the backdrop of March and the trailing 'winter of discontent', the stark reality is that a number of converging factors will drive investors to rethink defensive allocations:

- bank deposit and cash/cash-like rates have tumbled to historic lows with little to no opportunity for improvement on the horizon;
- a 'lower-for-*even*-longer' outlook on rates, constraining return opportunities for conventional fixed income strategies;
- developed-world sovereign bond yields at or close to zero;
- heightened caution around fundamentals in riskier fixed income categories (like high yield and emerging market debt).

All of this amidst continuing global economic uncertainty. Earning an attractive absolute return without incurring unintended risk or with poor risk/return asymmetry has undoubtedly become harder for all. This is, however, an environment well suited to absolute return fixed income styles, and notably those focused on high grade assets and with a flexible mandate.

Who would have thought at the start of the year that a forecast return in the 'mid-to-high 2s' would be sufficiently conducive? But with bank bills at only 10-11bps and global investment grade spreads at higher levels today than for some time we are reminded it's always a relative game!

Let's break things down and consider the headline risk and return components of *all* fixed income strategies.

Fixed income portfolio management demystified

On the dashboard of any fixed income portfolio managers' process there are essentially just three main risk/return 'dials' to manipulate; **credit risk** (or risk of default), **liquidity risk** (how frequently or how long you have to wait to dependably monetise investments for fair value), and **duration risk** (sensitivity to interest rate movements).

The extent to which they are dialled up or down is naturally dependent on the skillset of the manager and their particular edge, the size of their intended risk budget in any one area, and of course, the external environment. You could argue leverage and currency should also appear in the list. Both can add return (and risk), but for now let's assume that the majority of fixed income investors using their allocations for *defensive* purposes a) prefer to avoid the complexity of 'magnifying' underlying exposures through leverage (unless deliberately wanting to shift more into hedge fund territory), and b) also prefer to limit their exposure to non-AUD currencies.

Fixed income risks in the current climate

1. Credit risk

At a broad level the risk-off events that dominated the first half of 2020 have not caused us to change our views about the fundamental health of the issuers in which *we* invest, and more specifically the ability of those issuers to service and repay their debt. That is not to say that lower rated issuers (for example in the high yield and emerging markets sectors) are not at higher 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. As COVID-19 restrictions continue to impact a range of industries over a more prolonged period than originally anticipated, we can only assume an upward trend in payment delinquencies and insolvencies. In our view, it will remain vitally important for defensively-tilted fixed income portfolios to avoid lower grade issuers, and higher beta sectors that will be more heavily impacted by continuing COVID-19 constraints.

2. Liquidity risk

Taking onboard our preference to maintain the bias towards higher quality credits, hence the avoidance of higher default probability candidates and problematic sectors outlined in the prior paragraph, if you're able to forego accessibility, this remains a sensible and valid option to pick up yield for those operating to longer time horizons with their investments.

Private credit in particular has proven a reliable source of added alpha and in the current prolonged environment of low rates, the attraction is clear. Even in the OTC bond world, less liquid sectors such as mortgage- and asset-backed securities remain appealing, offering coupon rates considerably higher than comparably rated but more 'vanilla' corporate or financial sector bonds.

But caution is warranted; market participants were caught off guard by the severity of the illiquidity created by the COVID-19 driven risk asset sell-off in March. While still a valid and rewarding lever to manipulate, it must be used within a carefully diversified portfolio with sufficient liquidity maintained elsewhere. We are mindful that such assets may not be anywhere near as liquid as you want when you most need them to be.

3. Duration risk

Today, investors need to be acutely conscious of duration exposure, which we believe is very much the 'elephant in the room'. With very little room for material/further downward movement in rates, anyone owning more conventional funds pegged to a traditional long duration benchmark will at best see no further rates 'tailwind' from a return perspective.

For the better part of three decades we have been in a perpetually falling rate environment, meaning anyone owning bonds (or bond funds) with conventional index levels of duration (which can be anywhere between 4-6 years depending on which index you pick) has enjoyed a consistent tailwind to returns. Gains have been made as rates fell and investors favoured (and valued more highly) 'older' bonds yielding more than new issuance coming at lower yields.

While it may be argued that today there is low (or even no) probability that rates rise in the short-term, with most central banks at or near zero, scope for further falls is limited to say the least. The risk/reward attraction of a 'lazy long' duration exposure no longer stacks up. At worst, investors in such funds could very easily see their (paltry) annual coupon income completely wiped out with even a modest technical rate spike. The yield 'cushion' that may in the past have been relied upon to absorb the impact of an adverse move in rates (i.e. an increase) is simply not sufficient to avoid the very real likelihood of an outright negative return. On that basis alone, it's very hard to see how traditional fixed income strategies will fulfil their claims of defensiveness in this environment!

We make no apology that this is an argument supportive of defensive, absolute return, global 'go anywhere' strategies over more traditional long-only, benchmark constrained approaches that have (in a post-GFC falling rate and accommodative environment) enjoyed strong tailwinds. But the sands have shifted and those investors that continue to bury their heads in it run a very great risk of low or no return, and just as likely loss going forward.

If ever there was a time to rethink your defensive fixed income exposures…