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Global Investor: ‘Bond ladder’ a sound bet as numbers swirl

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As incipient as it may appear to many, now is the moment astute global investors begin to think ahead as to how and where they wish to trade and spread their investment allocations next year.

For those who did not make pre-emptive portfolio adjustments in February for the events about to unfold in Britain with the upcoming June 23 Brexit vote, scrambling to reposition at this point is indeed far too late.

After all, market cycles don’t die because of old age, they die because of macro imbalances or systemic geopolitical shocks — as would a Brexit “Leave” decision possibly trigger.

All being considered, after foreign exchange — the trading of any two currency pairings — equities are the second most unpredictable asset class to predicate with precision, at least when forecasting two quarters out. But, for Australian ultra-high-net-worth global investors, the more important portfolio consideration to tactically rebalance today is found within fixed income sub-allocations.

As capital preservation remains almost universally the number one priority for Australian UHNWs — with numerous holdings of$500 millionin fixed income instruments— what is thought to be the best way to approach US, eurozone, emerging market and Australian domestic fixed income becomes a hot topic of conversation with their advisers around this time of year.

And beyond a linear prediction about the trajectory of US or domestic Australian interest rate policies, far more is reviewed and considered when balancing fixed income portfolios larger than “seven figures”.

Remembering that almost all global fixed income is benchmarked against US interest rate policy, it is important to know that the following is currently being discussed within sophisticated investor circles:

• US interest rate duration exposure, typically, one, three, five or 10 years, is at an highest high.

• This is due to a rapid expansion in the amount of debt outstanding post-GFC combined with a significant extension of maturities for US Treasuries and

corporate bond debt, combined with a reduction in bond coupons.

• It is estimated that if a 1 per cent upward shock to interest rates surprised markets, that would translate into over $US1 trillion in capital losses to bond holders.

• If this did happen, this loss estimate would be large relative to the $US600bn in credit losses realised to date from non-agency mortgage-backed securities since 2006 and over twice the inflation-adjusted losses experienced in the tumultuous 1994 bond market sell-off.

So the logical question remains, approaching such tumultuous and volatile months ahead and then going further to think forward towards next year, why would UHNW, or any Australian investment community for that matter, continue to allocate so significantly towards fixed income markets and do so in effective ways?

The answer may be found in the fact that the hunt for income has been intensifying, globally, as the pool of international government bonds yielding below zero has reached a record high this month, driven in some large part by negative interest rate policies in Japan and Europe.

Global investors have been forced to pile into long-term debt in order to receive positive incomes while remaining mindful of a broader volatile conditions. In response to these concerns, one strategic approach being considered by many heading towards 2017 is referred to as a "Bond Ladder".

Laddering refers to a portfolio of bonds whose maturities are spread out over a certain period of time, such that a portion of the portfolio will mature each year.

The ladder structure remains in place over time by reinvesting proceeds from maturing bonds into new bonds with maturities at the longer end of the specified range, which preserves the average duration and income stream of the portfolio.

Ladders can be implemented as a pure "buy and hold" but in practical terms, continue to require constant adviser supervision and should, in reality, only be implemented by those seeking fixed income consistency over the medium to longer term — not simply as a kneejerk response to the current suboptimal conditions.

However, even with the predictable cash flows, semi-annual coupon payments and transparent maturity schedules that laddering provides, global investors must

remain vigilant to surprise hikes by US Federal Reserve chair Janet Yellen or indeed the inverse with unexpected cuts to Australia rates by our Reserve Bank.

One thing has become clear, though — during this period of unconventional global monetary policies, “buy and hold” may be one thing, but “set and forgetting” is absolutely not an option in this post-GFC epoch.

The good news for the Australian economy is that the national income shock that has plagued the nominal growth data is now tapering as commodity prices appear to have stabilised, and with this our RBA may well remain wedded to interest rates closer to current levels.

The savviest global investors are not only planning ahead for 2017, they are factoring in scenarios that will unfold closer to 2027 and one of the most practical ways to implement these views is to construct and commit to a bond ladder today.

Larkin Group is an ultra high net worth wealth team focusing on high yielding global investments.

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