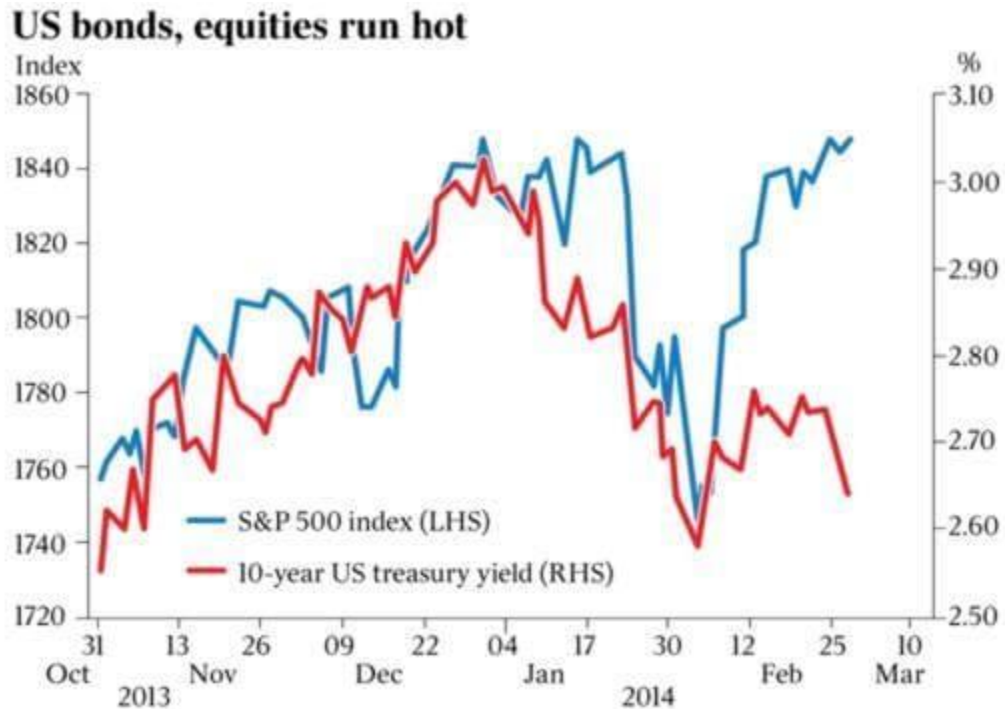
Savvy players take flexibility to fixed-income investment



Savvy players on fixed-income

By **Stirling Larkin**

INVESTORS are now dealing with the unusual phenomenon of high equity prices and high bond prices at the same time.

The world used to be a far simpler place. If the economy was stagnant and inflation was low, the smart money would look to buy fixed income assets such as government bonds.

If the economy was growing, equities were the place to be. Commodities and precious metals, most notably gold, had a role to play as a hedge against inflation in the event that the economy grew a little too fast.

In our post-GFC world, however, there seems to be a new set of rules applying, with both bonds and equities running high despite continuing reports of a weak global economy. High bond prices mean low yields.

At the moment there are two substantial trends emerging and now is the time to decide which one to support.

Most Australian Ultra High Net Worth investors realise that the good times will not roll on forever and are looking to position themselves to take advantage of the next act of this drama.

They have also found ways to arbitrage the dislocations between the two and there is no reason why others can’t as well.

As discussed in recent weeks, one trend is a continuation in the strong performances of global equity markets which have been “stoked” by unconventional monetary policies in America, Japan and Europe.

This has also been complemented by relatively low volatility levels during this time.

The other, conflicting trend is that we are seeing multi-month lows in US Treasury bond yields which fly in the face of what we should be seeing when asset classes such as equities also perform well.

Some UHNW investors have taken the view that the equity market is set to go higher, while others believe that the bond market is the place to be.

This disconnect between the two has rarely been so large. Neither camp may be right, but time will tell which one is most definitely wrong.

The answer to which of these two trends will continue will most likely be determined by what happens to inflation during 2014, 2015 and beyond.

We can't wait till then however, to make any decisions, as successful investing relies on being ahead of the curve today.

In making our decision we need to appreciate that the most likely scenario is that as the current unconventional conditions revert back to normal, as evidenced by the US Fed QE tapering, what is likely to happen is that volatility will also return to long-term averages.

This does not mean that volatility will be high but it does mean that compared with recent times it will feel much higher than it's been.

Therefore bond investors remain confused about the mixed messages higher volatility and moderate inflation send.

A practical way the global investor has addressed this is by better understanding the important factors that will shape the future direction of the bond market and how these will have an impact on the ways investors should approach fixed income investments this year.

According to Rick Rieder, chief investment officer of Fundamental Fixed Income at BlackRock, there are two important factors all investors should pay attention to.

Firstly, interest rates should move higher in the next 24 months.

Rieder believes a combination of better-than-expected economic growth and US Fed QE tapering will push rates modestly higher. This will mean that investing in fixed income assets in a rising-rates environment will be challenging.

Secondly, BlackRock believes that rates at the "belly" of the bond market yield curve will rise more dramatically than long-term rates.

Even though this might seem counter-intuitive since shorter-term rates are generally less sensitive to rising rates (lower duration equals lower rate sensitivity), they expect the yield curve to flatten and for rates at the belly of the curve (three to seven year segment) to rise more dramatically and remain more volatile, than long-term rates.

This would then be bad news for shorter-duration assets but an argument for maintaining flexibility in bond duration positioning. The bottom line is that they think a traditional approach to fixed income investing will struggle in this environment and these won't have sufficient flexibility to adapt as market conditions change.

Australian UHNW investors who are already well aware of this have been looking at more flexible approaches to fixed income investing.

Specifically, they are investing in more adaptable, go-anywhere funds that seek to capitalise on evolving market trends. They also allow themselves to have some latitude to be wrong.

Savvy fixed income investors respect the relationship between a bond's price, its coupon rate, the yield, maturity and how it factors in risks. Understanding these direct and indirect influences can help investors balance their portfolios and support strategies that succeed in all market conditions.

These sophisticated investors have also found ways to arbitrage the dislocations between asset classes and this was evident in late 2010 when listed hybrid securities received heightened popularity. This year the smart money has been exploring greater opportunities in the global dividends and distributions swap and futures markets.

These, for example, allow investors to trade dividends paid in a particular year in the more liquid dividend markets such as the EURO STOXX 50 and Nikkei 225.

A practical way, however, for those investors who have limited access to such opportunities may be to look into the popular alternatives such as the listed Pimco Total Return Exchange Traded Fund or the SPDR S&P/ASX Australian Bond Fund ETF which are structured to deliver lower portfolio turnover, more accurate tracking and lower costs than off-market participation.

Whichever trend we support, ascertaining the size and pace of inflation this year and next is the important part of the puzzle.

If we believe that stockmarket trading conditions have found a base, even with incremental improvements in conditions, a case for further momentum is difficult without signs of more inflation.

Coupled with this, the key to maintaining this momentum will be private capital expenditure as chief executives start investing the cash accumulated on their balance sheets from recent years.

If not, the trend towards higher US Treasury bond prices may be justified.

As Ayn Rand said: “Money is only a tool. It will take you wherever you wish, but it will not replace you as the driver.”

As we drive forward and come to the fork in the road, we need to decide now which way we turn.

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