Re-thinking fixed income.

Why it still has a crucial role to play in portfolios.

The 2007/08 global financial crisis marked the start of what has been, and still is, a very difficult period for investors.

In a bid to ignite growth and spur a recovery, major central banks have flooded the world with liquidity through unprecedented loose monetary policies. Although these actions have benefited economies, they have been at the expense of distorting global financial assets, arguably none more so than those within the fixed income universe.

One clear example of such distorting behaviour is the direct effect of the money-printing policy that is quantitative easing (QE) – which has suppressed core government bond yields to all-time lows. Now investors are worried what will happen when the taps are switched off. This has forced investors to face the ‘great rotation’ debate head on, considering whether to move out of fixed income and into equities in order to shield themselves against rising interest rates. None of this helps investor anxiety levels.

Concerns are understandable too. Signs that the US and UK economies are improving will no doubt have a bearing on the future direction of bond yields globally, and with interest rates at such low levels, bonds are somewhat vulnerable should central banks decide to change tactics and start unwinding their emergency measures.

Therefore, as the bond market evolves, so must investors. Those who do not adapt their portfolios are at significant risk. Advocates of the rotation from bonds into stocks would have you believe that the answer is to sell down your bond holdings in favour of equities. This approach is, in our view, far too simplistic for a number of reasons. Find out why on the following pages.
1. Demographics: the ageing populations of the developed world ensure a steady stream of fixed income buyers seeking to secure reliable retirement incomes.

This is true for private investors, whose defined contribution pension pots and additional savings are invested for income. Likewise, in the institutional world, defined benefit schemes view any rise in bond yields as an opportunity to help plug the hole in their funding deficits.

2. The rotation away from bonds is likely to be far more gradual than many experts and commentators acknowledge.

Global inflation is actually low by historical standards and therefore the upward pressure on official rates should not be as severe as many fear. And so while there may be a change to QE policy, we firmly believe interest rates will remain ‘lower-for-longer’ – until the recovery becomes evidently entrenched. That said, it should be recognised that UK inflation has been structurally higher and remains above target.

3. Diversification. The fact that bond returns are typically negatively correlated to equities means their inclusion within a portfolio can offer a useful balance.

What is more, due to the fixed level of income they pay, bonds are generally less volatile than equities and many other financial assets. Diversifying across a wide variety of bond classes can help to reduce the volatility of a total portfolio, while at the same time helping to enhance return opportunities.
4. Many investors still fundamentally need fixed income assets and much of the 'rotation' is going on within the bond universe.

The appetite for income is insatiable and investors are moving away from ‘traditional’ bonds – such as UK gilts – toward higher yielding areas of the bond market that offer the potential for enhanced returns in this complex and belligerent ‘lower-for-longer’ environment.

Potential options for investors:

• **Global corporate bonds**
  Many companies are actually in better shape than their respective economies due to conservative and supportive policies such as cash hoarding in order to strengthen balance sheets. Opportunities therefore exist within both investment-grade and high-yield markets. Investors can potentially thrive if they do the necessary groundwork to uncover those quality companies that can comfortably meet their debt obligations.

• **Asia and emerging markets**
  These regions have favourable long-term dynamics that make their bond markets very attractive, including healthy finances, strong economic growth rates, favourable demographics and strengthening political systems.

5. Standard risk-modelling tools recommend fixed income as part of a balanced client portfolio – and will continue to do so.

While this does imply an inherent demand for the asset class, it also challenges advisers and clients alike to think about the best way of achieving fixed income exposure now that supposed ‘easy money’ from bonds has been made.
Irrespective of the challenging backdrop, all segments of the bond market continue to have a role to play within client portfolios. It is the emphasis of each particular area that should now come under greater scrutiny and requires a re-think.

Applying a more flexible approach to fixed income investment does of course bring risks. Less well-known areas of the universe are likely to be less liquid in nature compared to more traditional instruments such as government bonds. Specific risks can also vary significantly between each fixed income asset class. Emerging market bonds for example involve higher levels of country-specific risk, while non-government bonds can be associated with company-specific risk. Again, the current environment lends itself to investors who are prepared to do their homework and thereby avoid companies likely to default.

Investors will naturally need different approaches to seeking out these more diverse, but potentially more rewarding, areas of the fixed income market. Some clients and advisers have the time and expertise to revise portfolios themselves, and to make allocations to fixed income assets such as emerging market, Asian and high-yield bonds. However, it may make sense for less confident investors to outsource such decisions by using a strategic fixed income solution.

Regardless of how it is achieved, the key point is that investors need to add a degree of flexibility into their fixed income portfolios. Further, they need to be bold enough to break away from conventional fixed income solutions, recognising that what worked in the past will not necessarily work in the future.

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