NAVIGATING INTEREST RATE UNCERTAINTY

For fixed income investors, the need for attractive yields and positive returns is ever present. However, the landscape is more challenging now given uncertainty over the US Federal Reserve (Fed) rate rise cycle.

KEVIN ADAMS
Director of Fixed Income and member of the Henderson Fixed Income Investment Strategy Group (ISG).
Henderson Global Investors

Too much media attention has focused on the timing of the first rate hike, whereas the important questions for long-term investors are:

1. What is the "neutral" rate for interest rates in the US?
2. How quickly will we get there?

In the US, markets are pricing in higher short-term rates over the next five years, rising to around 2.5% – significantly less than the Fed's expected neutral rate of 3.5%. However, there is not much change expected in longer-term bond yields. This reflects the increased acceptance of 'secular stagnation' or a sustained period of low nominal growth.

HURDLE FOR NEGATIVE RETURNS HAS NEVER BEEN LOWER

Broad bond market yields are currently near all-time lows, but alongside it, the potential negative impact on prices from a given rise in yields (duration) has never been higher. As a result, there is little income buffer to offset even a relatively small rise in underlying rates markets (see Figure 1).

Our core assessment is that we have already seen the generational low in US and UK government bond yields and a turnaround could present a significant risk to total returns over the medium term, but the timeframe is very uncertain.

While higher interest rates, and correspondingly higher government bond yields, might be good news for pension funds, in terms of reducing the present value of liabilities, looking after the asset side of the balance sheet is equally important.

One way to achieve this is through multi-sector fixed income strategies.

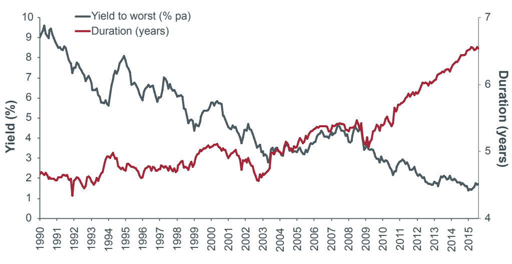
MULTI-SECTOR STRATEGIES EXPLAINED

The first thing to recognise is that moving to a non-traditional, multi-sector approach does not necessarily mean it is higher risk. In the same vein, investing in a global bond index does not mean you have diversified your risk, because the dominant driver of return for investment grade bonds is the change in the general level of yields in the economy.

The flexible, multi-sector approach means that managers are not forced to own sectors, countries or assets because they form part of a 'benchmark' in order to manage tracking error. That said, often these portfolios will invest more heavily in sub-investment grade securities. Thus, looking at who you lend to from a grass roots perspective, is crucial in protecting against credit losses over a medium term horizon.

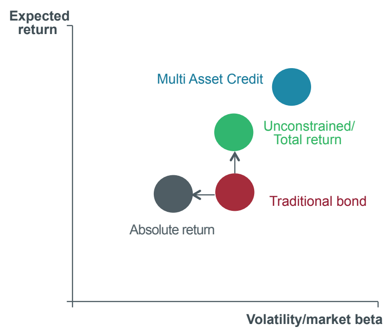
Figure 2 summarises how different multi-sector fixed income growth strategies seek to solve the problem. Here we focus attention on non-traditional 'liquid' strategies, which offer an alternative to core fixed income without the need to lock-up capital.

Figure 1: Worsening risk-reward trade-off in investment grade markets



Source: Barclays Global Aggregate Index, Henderson Global Investors, monthly data, January 1990 to August 2015.

Figure 2: Non-traditional liquid strategies as an alternative to core fixed income



Source: Henderson. Stylised example for illustrative purposes only.

ABSOLUTE RETURN

These strategies seek to outperform cash by generating uncorrelated returns through long/short ideas across market sectors, countries and companies. The primary focus is on capital preservation. Thus the return target is of similar magnitude to the yield on high quality bonds (Libor + 2-3%) but with lower volatility, particularly on the downside. A critical element here is experience in using derivatives to manage overall risk exposures, which enables the approach to deliver returns in a range of market conditions.

The lack of embedded market exposure tends to result in low correlation and strong diversification benefits, and may also be attractive for insurers under Solvency II, where long and short positions can be netted by rating for purposes of capital calculation.

UNCONSTRAINED/TOTAL RETURN

An increasingly popular approach is to widen managers' freedom over where to invest, moving away from an index-relative mindset. This flexible global bond approach invests across all sectors and regions on a benchmark-agnostic basis targeting positive total returns, and employing some absolute return style strategies/hedging techniques to manage downside risk.

The strategy has some correlation to traditional bond markets and similar volatility, but credit and duration exposure is actively managed. So unconstrained strategies can and will have duration exposure, but it will not be the dominant driver at all times as is the case for a traditional investment grade index. We characterise this strategy as a one-stop shop for bond exposure, often seen as a substitute for a broad global aggregate mandate.

MULTI ASSET CREDIT (MAC)

In an uncertain rates environment, higher yielding assets with low interest rate duration can help to drown out rates uncertainty. MAC strategies seek to minimise rates exposure and focus on the higher yielding areas of the credit markets. These can be high yield, emerging markets, bank loans, asset-backed securities, and can even include investment grade corporates, investing on a predominantly long-only basis seeking to clip coupons.

Given the higher sensitivity of these areas to the credit cycle and potential default risk, the ability to allocate up the ratings spectrum into cash and investment grade is a valuable tool, alongside bottom-up credit analysis of issuers, securities and structures.

Typically, MAC strategies have been used as a higher income strategy, to diversify existing investment grade corporate bond exposure or where a pension scheme is looking to reduce equity exposure, as a potential alternative.

Multi-sector fixed income strategies growing in popularity for good reason

The heightened degree of uncertainty in markets strengthens the case for a flexible investment strategy that focuses on investment outcomes. The challenge for investors is that no two funds are exactly the same, while some straddle the boundaries outlined above.

As a manager of these strategies we believe there are two critical areas to get right. The first is idea generation across multiple skillsets and asset classes: investors gain from dynamic asset allocation and improved governance, but success is more reliant on manager skill than market returns. The second is risk management and time horizon. Within absolute return, we are more conscious of managing short-term downside risks particularly when correlations converge, whereas MAC strategies can tolerate more volatility with a focus on mitigating against permanent credit losses.