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Volatile markets require a balanced approach to risk and return

Author: Lyle Sankar, Head of Fixed Income, PSG Asset Management

2022 was an extremely tough year for global fixed income assets, with long bond yields rising sharply in developed markets resulting in one of the worst years for bond markets in almost a century. Emerging market bonds suffered both from a correlated move higher in yields in line with developed market bonds, but also from heightened volatility. With a positive view on South African government bonds being largely a consensus trade in early 2022 in the local fund management industry, most would have been disappointed with the outcome – an underperformance of cash markets and significant volatility. The graph below plots the yield on the South African 10-year bond over 2022, and a few key observations can be made:

- The bond yield started the year at 9.8% and ended close to 1% higher.
- The market experienced five painful sell-offs in yields of close to 1% on average, followed quickly by similar size rallies where yields rapidly reverted to lower levels. This level of volatility in a single calendar year is extremely unusual.
- These bouts of weakness can be tied directly back to the many themes or events that drove yields higher last year: geopolitical risk, developed market central banks raising rates significantly, political risk in SA, loadshedding and rising or more sustained higher inflation.

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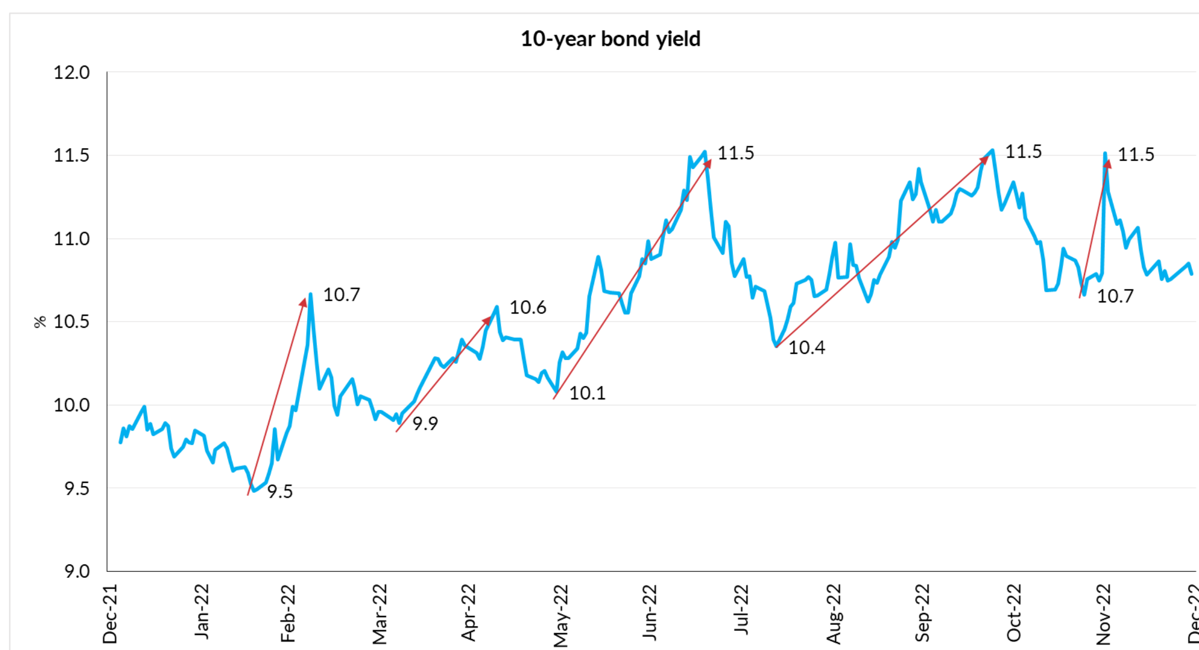


Source: Bloomberg

Considering the full range of outcomes

As seen in the graph above, navigating the bond market in 2022 required a balanced approach to risk and return. Volatility in yields presented short-term pain but significant opportunity to create value for clients. We believe our long-term, valuation-focused approach offers immense value in these types of markets, as we consider the full range of outcomes for any given security. This entails spending time thinking about where we can be wrong (managing risk and protecting client capital) as well as where we believe the market is being too pessimistic. Excess pessimism drives yields higher, and presents opportunities to exploit the gifts presented by the market by exposing clients to suppressed valuations and a favourable skew in outcomes. Combining a balanced approach to risk and return opportunities with smart portfolio construction increases the odds of success for clients over the long term.

Valuations: your primary defense against capital loss

Cheap valuations or high starting yields that reflect significant pessimism offer significant protection against capital losses. Considering fundamentals, nominal and inflation-linked bonds (ILBs) in SA have for some time offered significantly higher yields than our required risk-adjusted returns for emerging market peers with similar ratings, and a significant yield pick-up relative to developed market bonds. Despite yields rising by 1% over the year and five painful market selloffs, SA bonds returned 4.3% last year (FTSE/JSE All Bond Index TR), largely due to the protection a starting yield of 9.8% provided against capital loss. In contrast, low starting developed market bond yields provided very little protection against drawdowns in 2022, emphasising the importance of always buying with a margin of safety.

Smart portfolio construction provides the second layer of defense

Understanding correlations and utilising the entire yield curve can add significant value to portfolios. As noted in last week's article by PSG Asset Management's Anet Ahern, understanding correlations is critical when managing portfolio risk. Inflation-linked bonds (ILBs) and nominal bonds offered limited diversification benefits to each other pre-COVID, with inflation being largely contained in SA. More recently, with inflation rising and becoming less predictable, ILBs and nominal bonds have behaved differently. In particular, ILBs have protected capital during

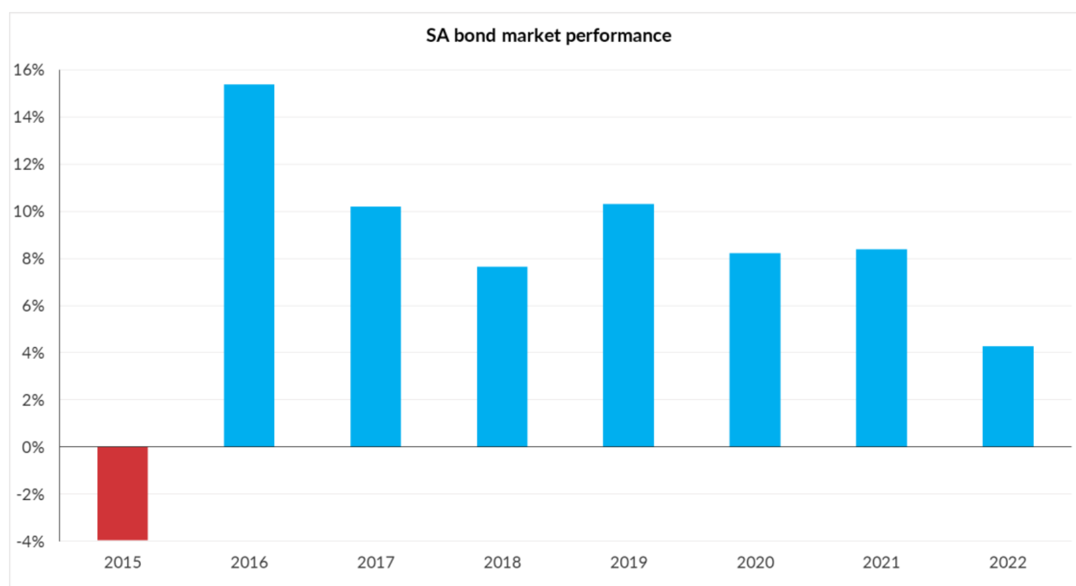
periods of nominal bond market weakness. The increased diversification benefits between ILBs and nominal bonds in 2022 allowed proactive local fixed income portfolios to exploit the valuation differentials to the benefit of clients. Being alive to these changes is a hallmark of our process, allowing us to both reduce risk and exploit cheap valuations for clients.

Using the full yield curve to your advantage can also be immensely additive given that different parts of the bond curve respond differently in various market environments. During 2020, it was best (after the COVID selloff) to be positioned on the very short end of the curve to benefit from what is referred to as the roll-down trade. In 2021, it paid to be positioned on the longer end of the yield curve as short-term rates adjusted higher to rising inflation, and long bonds responded well to improved fiscal metrics. In 2022, the biggest return differentiator was to be found in exploiting shorter duration ILBs which performed very well from both a capital preservation and return perspective. We were successful in positioning our portfolios to take advantage of these opportunities in all three cases.

Opportunities and risks deserve equal attention in our thinking

The SA risks are very visible, especially in terms of Eskom and loadshedding and the impact this is having on sentiment and growth. The bond market, being extremely liquid, already prices in these visible risks as reflected in the current high yields. Given the current bad news is already reflected in the price, it is useful to consider the potential surprises to the upside that the market may not fully appreciate:

- inflation in SA is rolling sharply lower in 2023 and is likely to remain contained within the target band
- the SARB appears to be close to the top end of its current rate hiking cycle
- SA has a much lower debt to GDP ratio than what was expected following on the COVID-19 pandemic
- China's reopening provides an underpin for our bond yields
- We see significant evidence that we are in the early stages of an inflecting market, and commodity exporting emerging markets like SA can be major beneficiaries



Source: RMB

After a tough year for the bond market in 2015, the market produced six subsequent years of returns above 8% p.a. We believe that, when considering the full range of outcomes for bonds and when also taking into account the high bond yields that reflect known risks, they look set for a multi-year opportunity to generate equity-like returns at bond levels of risk.

Glacier Research would like to thank Lyle Sankar for his contribution to this week's *Funds on Friday*

Lyle Sankar

Head of Fixed Income

PSG Asset Management

Lyle was appointed as head of Fixed Income in April 2022. He joined PSG Asset Management in 2014 as a credit analyst and trader. He currently co-manages the PSG Money Market Fund and is fund manager of the PSG Diversified Income and PSG Income Funds. Prior to PSG, he completed his articles with Deloitte Cape Town before joining Coronation briefly in business development.

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