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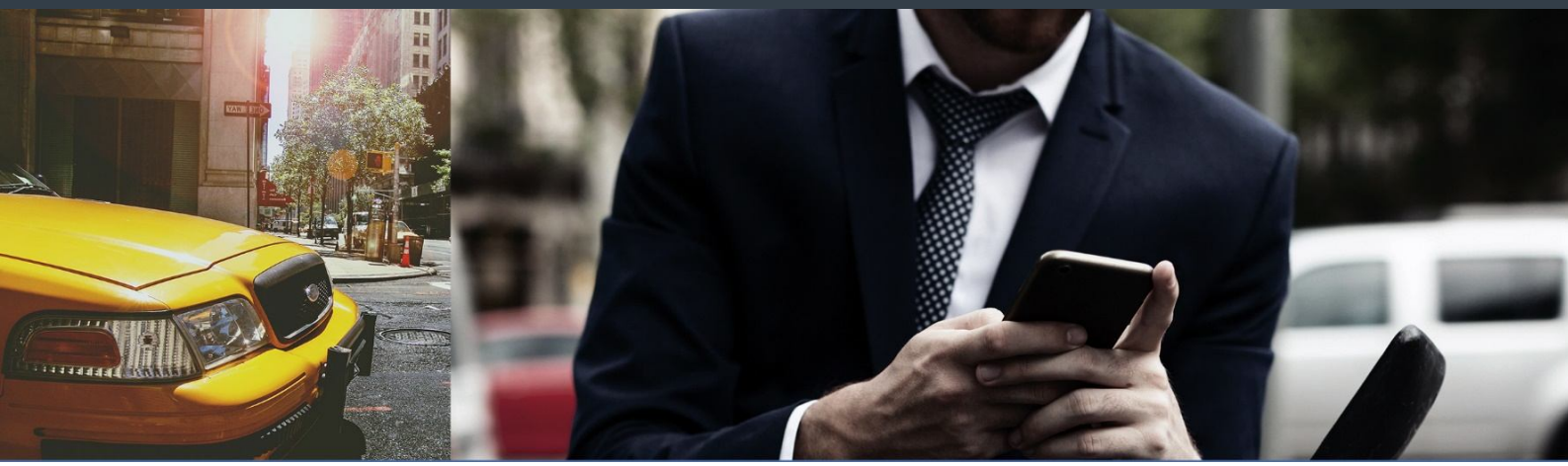

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Has income disappeared?

No, but it has become harder to find

Written by: Bronwyn Blood, Portfolio Manager of the Granate SCI Multi Income Fund

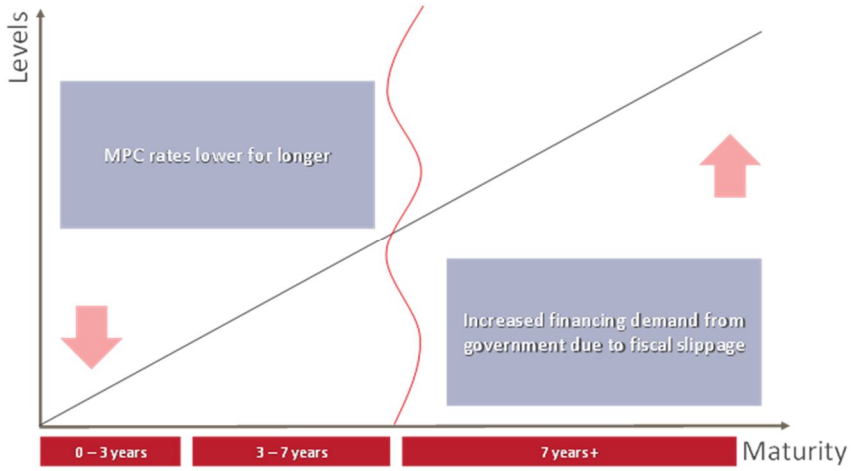
Conditions in fixed income markets are very different to what they were before the COVID pandemic. Historically, a good credit mix, which included corporate bonds and debt instruments issued by banks and state-owned entities, would comfortably have provided inflation-beating returns. However, as investor appetite for these instruments has grown while companies have cut back on raising capital, the rates on offer have fallen and opportunities have become scarce. This has been compounded by lower interest (and therefore reference) rates. Heightened demand coupled with constrained supply means that you could be earning as little as 150 basis points above Jibar on a three-year corporate bond: a total return of just over 5%. With the SARB anchoring inflation expectations at around 4.5%, you'd come out with a barely positive real yield.

So, what to do?

If the staple diet supplies are thin, you need to forage more widely – but without taking undue risk. Income fund managers who were willing and able to do this have bucked the trend. In this article, we discuss how we have managed to find and harvest new income opportunities, without taking undue risk. Our broad toolkit, flexibility and slight bravery were important companions on our foraging journey.

Capitalising on the 'Great Steepening'

One of the most significant changes – and opportunities – resulting from the COVID crisis has been the steepening of the yield curve. With a cumulative cut of over 300 basis points in the repo rate, short-end rates (one to three years) are at unprecedented lows. In contrast, longer-end government bond yields (seven years and up) are at extremely attractive levels due to concerns about fiscal deterioration and rising government debt levels.



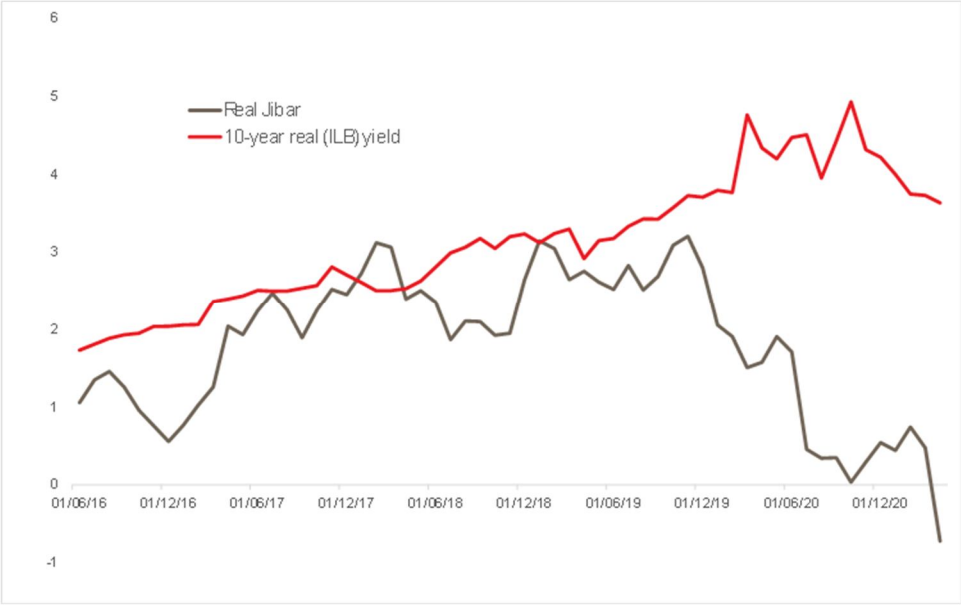
Sources: Bloomberg, Granate Asset Management

Historically, the short end of the curve provided real (above-inflation) yields, making it an obvious area for income funds to focus on. However, the very low short-end rates we've recently seen have meant that funds have had to move up the government bond curve to provide more adequate returns for their investors.

Of course, there are associated risks, which must be accounted for. The biggest is interest rate risk (duration). However, sovereign default risk has moved to the forefront of investors' minds due to government's deteriorating fiscal position, which has been further exacerbated by the crisis. Although the odds of a sovereign default have increased with rising debt-to-GDP levels and the slow implementation of structural reforms, we believe that the risk is not as high as government bond yields have been pricing in. In our view, these assets have therefore presented the biggest opportunity in fixed income over the past year. While taking a slightly longer duration position has meant increasing interest rate risk, we believe it's been a risk worth taking for the very high real yields that have been harvested at the longer end of the curve. Importantly, the move from bank and corporate credit to government bonds also reduced credit risk. The government remains the lowest-risk issuer of rand debt.

Inflation-linked bonds are finally back in season

Inflation linkers have also felt the negative effects of government's deteriorating fiscal position and have been trading at real yields not seen since 2014. As with their fixed-rate counterparts, we feel that this risk is slightly overdone, especially in certain parts of the curve. Given that the nature of this asset class is that it provides inflation protection and is more stable over time, we believe it is very well suited to an income fund. These instruments can therefore add an additional source of diversified return. This is illustrated by the graph below, which shows the dislocation between short-dated real yields (measured by Jibar) and long-dated real (inflation-linked bond) yields that have been offering in excess of 4%!



Sources: Bloomberg, Granate Asset Management

Secondary credit markets offer opportunities

While the credit market is generally expensive, smaller funds can access cheaper sources of credit in the secondary market. (Although these are available to all funds, smaller sizes mean that they may not be meaningful for bigger portfolios.) The secondary market is often overlooked but can present many opportunities due to its decentralised nature. This can create inefficiencies, which in turn can result in additional sources of yield pick-up, mainly due to mispricing. This has been the case since the COVID crisis, currently making the secondary market a fertile feeding ground for alternative sources of credit and yield enhancement.

The search is on for structured opportunities

These are products normally structured by banks that offer tailored terms for product features such as interest rates, interest types and maximum rates payable. These products generally have embedded derivatives in the form of swaps or options, which allow investors to express a particular view or implement a particular interest rate profile in a fund. For us, structured products have been an important enhancer, as they have enabled us to take advantage of very high bond yields but to choose a particular return or interest rate profile to limit volatility.

We believe size matters

While the fixed income universe is diverse, conditions as they've recently played out have reaffirmed our desire to remain a small to medium-sized fund in this space. To us, this means access to a broader opportunity set and the ability to be more selective about the opportunities presented. Despite what may be deemed a 'credit drought' and the difficult market conditions that persist, we still see exciting prospects for funds that can be nimble – and that are willing to take the opportunities that present themselves.

Glacier Research would like to thank Bronwyn Blood for her contribution to this week's Funds on Friday.

Bronwyn Blood

Granate Asset Management

Bronwyn is an Investment Analyst and Portfolio Manager at Granate Asset Management. Prior to joining Granate in December 2015, Bronwyn was the Portfolio Manager of the Flexible Fixed Interest funds and the flagship Absolute Yield Fund at Cadiz Asset Management. She took over the management of the Flexible Fixed Interest funds when Cadiz bought African Harvest in 2006 and managed the Absolute Yield Fund from 2007.