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Fixed income: investing in the new age

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Investing in fixed income markets has been extremely challenging ever since the GFC which has unveiled profound structural changes to the fixed income investment landscape. The recent outbreak of COVID-19 has wreaked havoc on global economies and exacerbated these structural changes which, we believe, has introduced new trends that fixed income investors have to factor into their investment decisions. At Sentio, we believe that investment philosophy and process are sacrosanct and should never change, but investment methodologies should be flexible and should always adapt to varying market conditions. This allows our team of portfolio managers the ability to apply their philosophy and process consistently irrespective of the environment. We discuss three key trends fixed income managers must consider when making decisions in their client portfolios.

Lower developed market yields

The major macro-economic change that has become relevant since the GFC is low global inflation. We believe that this is due to three structural forces, referred to as the "3 D's": Technological **Disruption**, Aging **Demographics** and **Debt** deleveraging. All three are powerful factors that have, post GFC, driven inflation down in the developed world with persistent threats of deflation when growth slows. Furthermore, monetary policy seems to have run its course as the zero-lower bound amongst developed nations is reached and fiscal stimulus, or QE as it's popularly known, begins to do the heavy lifting.

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Central bank intervention will place further pressure on developed market yields while numerous market commentators argue that the Phillips Curve[1] is broken, but we believe the relationship is relevant but blunted. This is because business costs have become more transparent, divisible and flexible (e.g. UBER drivers being hourly price-takers). Outsourcing and technological efficiencies mean that companies can absorb and offset costs much quicker without impacting overall labour costs.

As a result, we believe that inflation and bond yields will remain lower for longer in the developed world.

Higher developing market yields

The impact of this low growth, low inflation phenomenon is that highly indebted nations (generally emerging markets), will find it difficult to service their debt and run the risk of entering a debt spiral if fiscal austerity is not addressed (this is exactly the predicament of Brazil, Turkey and South Africa). The recent COVID-19 epidemic has meant that global economic growth will be further hampered resulting in increased pressure on highly indebted nations that have to fund at more expensive levels given the recent sell-off in EM bond yields. Stimulus measures announced by major central banks will provide much-needed liquidity to financial markets, calm investor fears and increase risk appetite. This action will hopefully provide reprieve to emerging markets and allow them time to implement structural growth initiatives.

However, we believe that there is a high risk that emerging bond yields could remain higher for longer.

Need to invest in “credit” to achieve investment objectives

In the low developed market yield environment, investing in government bonds is not about yield but rather capital gains which goes against traditional fixed income investing. In order to generate yield in their portfolios, investors must delve down the credit spectrum into the sub-investment grade territory.

High yield bonds are generally leveraged companies with debt-to-equity ratios greater than equivalent investment grade companies. As long as consumer, business confidence and economic growth are robust, these high-yield counters should be able to meet their debt obligations. If economic growth slows, these high yield companies will see a decrease in their revenue streams and find it difficult to service their debt thereby increasing the probability of default on their outstanding loans and debt (similar to highly indebted sovereigns). As such, high yield credit is far more sensitive to economic and confidence swings relative to investment grade and government bonds.

We think that fixed income investors will be forced into high yield bonds to generate fixed income returns or run the risk of underperforming their objectives by investing in relatively safer low-yielding, government bonds. Therefore, fixed income investment processes need extra levels of sophistication in order to appropriately select the correct ‘credits’ on an optimal risk-reward basis.

1 The Phillips Curve graphs the inverse relationship between unemployment and wage inflation – the theory states that increased economic growth will lead to increased inflation and employment.

Investment implications

Dynamic valuation models

Ultra-low developed market yields due to low inflation and QE, combined with higher developing market yields due to high budget deficits and lower growth, provides a challenge to any fundamental investor that uses valuation as a key metric to invest in the fixed income markets. Dynamic valuation techniques, which consider current market conditions in the valuation of assets, are thus required which, we believe, will outperform static long-run valuation models. Machine learning will also play a crucial role in assisting fundamental investors make better decisions in these volatile and dynamic environments.

Derivatives for asymmetry

Uncertain macro environments and uncharted fiscal and monetary policy will undoubtedly lead to volatility in fixed income markets going forward. Derivatives will play a key role in managing downside risk during sell-offs and providing upside participation in rallies. This asymmetric pay-off will result in superior risk-adjusted returns. Thus, expertise in the use of derivatives and alternative strategies will be key to differentiate in the fixed income space going forward.

Deeper focus on credit

The new age of fixed income investing will require a deeper focus on credit. Understanding the drivers or risk factors of credit issuers and sectors will be key. A deeper integration of fixed income analysis with traditional bottom-up equity analysis will be required in order to make optimal credit decisions in fixed income portfolios. Integration will allow backward-looking fixed income analysis to be complemented by forward-looking equity analysis and therefore make for more informed decision-making.

In recent times, factor investing or smart-beta investing, has become prevalent in the equity arena. Now, investors are using these same quantitative principles in the fixed income credit space. The usual equity style factors such as quality, value, momentum, volatility, carry and others are being adapted and applied in fixed income. Analysing credit[2] in this way opens up the risk spectrum in understanding risk exposures thereby allowing for better risk management and portfolio construction.

Liquidity management

With low expected returns in the developed markets, investors have increased allocations towards illiquid and exotic[3] assets in order to earn an illiquidity premium. The illiquidity premium can be substantial at times but during a risk-off event such as the current pandemic, liquidating such assets would be near impossible or could lead to large losses. South Africa is currently experiencing a similar scenario as liquidity in the local credit market is non-existent. Maintaining effective liquidity in fixed income portfolios is crucial during market crises in order to take advantage of the inevitable selloffs in risk assets as well as to meet investor demands for cash which is typical of these high-risk periods.

2 It must be noted that factor investing in fixed income credit is predominantly applied when there is a relatively liquid credit market as in developing markets. South Africa unfortunately has an illiquid credit market so factor investing in fixed income would not be applicable

3 Structured products with embedded options and risk enhancements to create unique payoff profiles.

Summary

We are convinced that several structural changes to the macro-economic landscape in the areas of valuation of fixed income markets, credit, volatility management and liquidity management has permanently altered the environment for fixed income investing. We believe that the following elements are crucial and that fixed income managers need to consider them to successfully manage fixed income portfolios in the new age:

- dynamic valuation models integrated with machine learning to value assets effectively;
- the use of derivatives for asymmetry;
- the effective integration of fixed income analysis and equity analysis to value credit instruments; and
- effective portfolio construction to manage volatility and liquidity.

Investment managers who have sound and adaptable investment methodologies and risk management techniques will be able to successfully incorporate these additional elements into their existing investment philosophies and processes.

Glacier Research would like to thank Sanveer Hariparsad and Rayhaan Joosub for their contribution to this week's Funds on Friday.

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Sanveer has 14 years of investment experience with a focused background in Actuarial Science and Financial Engineering. He spent the first five years of his career as a fixed income quantitative analyst at Old Mutual Investment Group and then at Futuregrowth when the fixed income teams merged. Thereafter, he joined Prescient Investment Management as a fixed income portfolio manager where he was responsible for managing specialised bond funds for a period of six years. Sanveer has since been with Sentio Capital Management for three years where he is head of Fixed Income and co-manages the multi-asset funds.

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Rayhaan is deputy CEO and co-founder of Sentio whose industry experience spans more than 20 years. Prior to founding Sentio, Ray spent 8 years at RMB Asset Management heading up the Alternative Investments and Quants teams. Ray holds a BCom and a BSc in Chemical Engineering.