The Fixed Income Conundrum

For nearly forty years both short term interest rates and bond yields have marched inexorably lower. During that time there have been many significant equity bear markets, but fixed income - and government bonds in particular - have typically been a provider of steady yield and, in the worst of times, comforting capital gains. Bonds have both enhanced portfolio yields and reduced risk.

However, the scale of the decline in bond yields over the past few years reduces the ability of fixed income to continue to perform this role, but that traditional benchmark-aware fixed income has now become just the opposite, a real return-free source of elevated portfolio risk. As the table below shows, bonds' ability to deliver capital gains has declined with time as yields have fallen.

	S&P 500	Global Bonds
2002 Recession	-28.36%	8.8%
Subprime Crisis	-13.83%	5.2%
GFC	-41.82%	4.8%
Flash Crash	-12.80%	2.1%
US credit downgrade	-16.26%	4.9%
2018 Trade War	-13.52%	1.6%
Covid-19	-19.60%	1.4%
Total	**-81.76%**	32.4%

Yields are now lower than those available from equities and in many cases are negative in real if not also nominal terms. The ability to generate capital gains is surely less than the potential for capital losses. Fixed income's vanishing yields have both lowered expected portfolio returns and increased the expected risk of balanced portfolios.

In that context we have a fiduciary responsibility to, at the very least, consider other assets and indeed we have already moved fixed income holdings away from being vanilla, benchmark exposures. We have utilised short duration to reduce risk and credit to enhance yields. Our current search for alternatives has taken us well beyond traditional fixed income and we have not found a single asset that can perform the role that fixed income has performed over the past forty years. Primarily those functions are two-fold:

1. To generate a steady yield.

2. To generate capital gains during economic or market crises.

In general, assets with higher yields also increase portfolio risk, especially in times of stress. Credit is a good example. It is riskier than investment grade debt and thus has a higher yield, but it is also vulnerable in periods of market stress, exactly when fixed income is expected to deliver gains. Equally, any asset capable of protecting from that stress generally lowers the portfolio's running yield. Options protection, for example, provides almost certain downside protection, but has a negative carry and, almost always a negative expected return across a cycle.

There is therefore no one solution to the fixed income conundrum, but there are a series of worthwhile trade-offs. Our goal in the recommendations that follow is to attempt to replicate, in sum, the role fixed income has traditionally provided by taking a series of risks that are, as much as possible, independent of those taken elsewhere in the portfolio, in order to enhance returns and reduce portfolio risk.

Allocating more to Growth Assets

One potential solution that many are advocating is to increase the allocation to risk assets at the expense of fixed interest. The logic of replacing bonds with more equity exposure is that dividend yields exceed fixed income yields, and portfolio upside is enhanced. The price that is paid to achieve these objectives is a significant increase in portfolio risk and reliance on a single asset class to generate performance. For those comfortable with this trade off increasing risk is a viable option even though it creates a much less balanced 'balanced fund'. Our search is for a solution for those who do not wish to take higher levels of risk.

Cash has an important role

Despite cash yields being at historical lows we favour cash over benchmark duration government bonds. That is a stronger statement about the unattractiveness of bonds than the appeal of cash. However cash does have two advantages – it is not vulnerable to rising bond yields and it is a beneficiary of higher short term interest rates. Thus, it reduces portfolio risk in the event of higher yields adversely impacting upon both bond and equity holdings.

Our preference is to hold a cash enhanced fund as opposed to cash itself. The fees of these funds are modest and are likely to be more than offset by the ability to harvest higher yields available on short term investment grade paper. These funds are likely to deliver yields very similar to that of investment grade bonds without the duration risk.

Fixed Income Alternatives

In all the options that follow we have been careful to ensure that there are efficient access points available to New Zealand investors. All are in unitised fund structures and are thus platform friendly.

In the absence of assets capable of performing both the yield enhancement and risk mitigation roles fixed income has performed historically we have identified two ways to enhance yields and two ways to mitigate risk.

1. Yield Enhancers

The trade-off associated with seeking higher returns is the assumption of higher risk. Fixed income's gift to balanced portfolios in recent decades has been that by enhancing returns by assuming greater duration risk, overall portfolio risk has been reduced. We believe that seeking higher returns from fixed income today means that risk is increased, not decreased. That may be via duration, where we believe downside risk exceeds upside risk, or credit, which is positively correlated with equities, thus increasing portfolio risk.

We cannot escape the reality of having to take risks to enhance yields, but we can look for opportunities where the risk assumed is different to that present in the wider portfolio. By diversifying risks, we can reduce, or at least not increase, portfolio risk whilst enhancing returns.

Private Credit

The main risk we assume with this asset is illiquidity. Within private credit there is a wide range of risk levels available, from senior secured at the more sober end, to property development loans, distressed loans and venture debt for those seeking excitement. Our focus is very much at the low-risk end of the spectrum. These loans have more risk than investment grade debt, but much less than publicly traded instruments with similar yields. The excess return available is more due to the assets being private, than their underlying credit risk.

The reason that these elevated returns are available is primarily regulatory pressure on the banking sector to hold more balance sheet strength to support of their loans than they would ordinarily. Thus, the banks are motivated to offload certain assets to enhance their return on equity. This process is mature in the US, maturing in Europe, developing in Australia and nascent in New Zealand.

There is no secondary market for these loans and so the liquidity provided to investors reflects this. Small flows can be accommodated via coupon payments, loan maturities and potential fund flows, but full liquidity cannot be guaranteed until the loans mature which is typically 2-5 years.

Insurance-linked Securities (ILS)

ILS offers returns in excess of those available from investment grade fixed income and similar to those from credit exposures. The appeal is that the risk that is assumed in ILS is totally independent of the risks affecting other fixed income securities, and the wider portfolio. That risk is natural disaster risk and rising rates or falling equity markets don't cause earthquakes or hurricanes.

ILS funds are relatively liquid reflecting the underlying assets which, for the funds we are concerned with, are the wonderfully frankly named 'catastrophe bonds' (not surprisingly more frequently referred to as 'cat bonds'). Cat bonds are 3-5 year duration securities usually issued by reinsurers to transfer certain very large risks off their books. These tend to be very large natural catastrophes such as earthquakes and hurricanes, the largest of which by some distance is US hurricane risk. The bonds generally have a gross yield of 5-8%, depending on market appetite at the time, and an expected annual loss of 2%, leaving an expected return to the investor of 3-6%. The expected loss doesn't occur each and every year. Indeed, most years it is zero, but occasionally, when a major event occurs, it can be significantly higher. The 1-in-100-year loss for a diversified ILS fund is in the order of 30%, which is probably similar to that of investment grade fixed income and better than that of equities.

Risk Mitigators

The primary utility we are seeking from these assets is a high probability of generating capital gains in times of economic and market stress. The two options below have different characteristics and there are environments in which only one of the two may deliver as hoped. Where possible therefore we favour an allocation to both assets.

Gold

Gold has acted as a store of value, or hedge against all forms of disaster, man-made and natural, since almost the dawn of civilisation. As such there is powerful empirical evidence of its enduring value despite a seemingly never-ending battle as to its merits amongst theoreticians.

Gold is not a certainty to benefit from economic crisis, but it is well placed to protect against inflation, to which the balanced fund is particularly vulnerable. The supply of gold is constrained, and this is certainly not the case for other stores of value such as the world's major currencies. There are obvious parallels here to bitcoin and other cryptocurrencies but we much prefer gold's pedigree and tangibility.

Gold is very liquid (we favour owning gold directly via an ETF rather than gold miners) and the fees are cheap. The downside is that it has no yield and as such the only return is via change in its capital value and that may be positive or negative over any given timeframe. It is worth noting though that since the gold standard was suspended in 1971 gold has appreciated by around 8% per annum.

When fixed income offers a meaningful yield gold's lack of a positive expected return is a significant impediment to owning it. However, at current yields the opportunity cost of owning gold is much less and it can contribute significantly to portfolio risk reduction in certain scenarios.

Trend-following

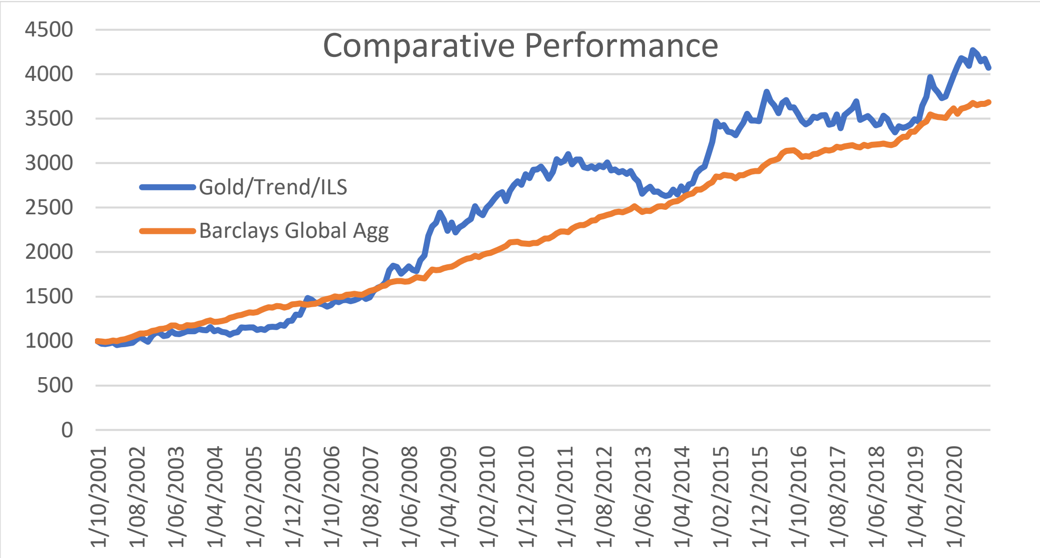
The concept underlying these funds is very simple. Trend-followers trade across several hundred markets globally, identifying, and seeking to profit from, trends in those markets. A key point is that the trends can be either up or down, the strategy is ambivalent. The instruments traded include equity indices (not individual stocks), bonds (futures/swaps not individual bonds), interest rates, currencies, energies, metals and agricultural commodities. The strategy is 100% quantitative, meaning that although it was designed by humans it is completely rules based and is executed mechanically via computers.

Trend-following works best in markets where consistent trends exist across many different markets, whereas it dislikes erratic choppy price action. its appeal in a portfolio context is two-fold. Firstly, sustained trends are frequently most pronounced in times of market stress and secondly, the strategy has a positive expected return across a cycle. It is a strategy that performs well as a risk mitigator but will also contribute to returns over time.

Trend-following, like ILS, is expensive to implement and the fees are high. It is also reasonably volatile and will have periods of negative returns. Liquidity is typically monthly.

Summary

We have no reliable historical data for private credit, but we can examine how an equally weighted combination of ILS, gold and trend-following would have performed relative to the Bloomberg Barclays Global Bond Index since 2001. For this analysis we use our intended exposures; Fermat as our ILS exposure, unhedged gold bullion and ISAM as our trend-follower.



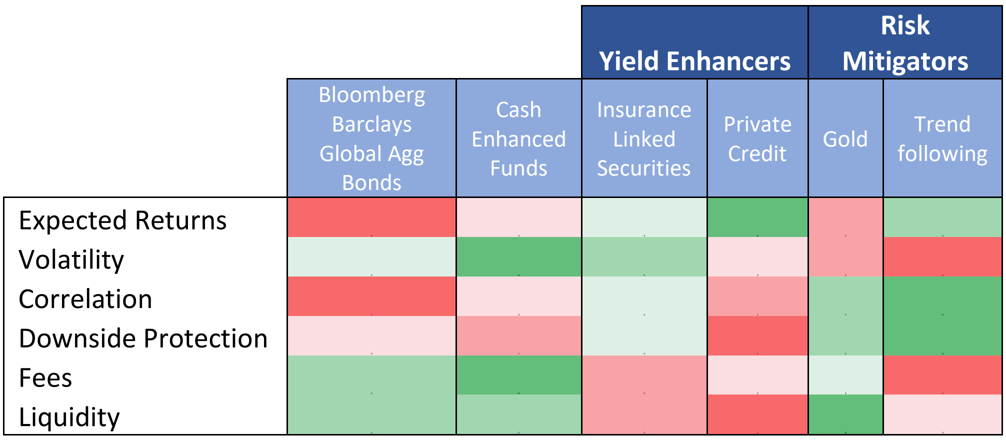
This reveals that through the last half of the bond bull market a combination of 3 of our 4 suggested alternative exposures generated slightly better returns than bonds, albeit with more volatility. Fixed income will not replicate these returns going forward and we expect our alternatives to remain robust.

The table below shows that in previous stressed environments the alternatives performed particularly well, although not consistently across each crisis.

	S&P 500	Global Bonds	Combined Gold/trend/ILS
2002 Recession	-28.36%	8.8%	10.1%
Subprime Crisis	-13.83%	5.2%	14.6%
GFC	-41.82%	4.8%	36.9%
Flash Crash	-12.80%	2.1%	2.9%
US credit downgrade	-16.26%	4.9%	1.3%
2018 Trade War	-13.52%	1.6%	-2.4%
Covid-19	-19.60%	1.4%	9.1%
Total	**-81.76%**	32.4%	91.8%

We can also evaluate these strategies across a range of metrics. Note that these are our expected future outcomes. Some factors such as fees and liquidity are relatively easy to forecast, others much less so. In the table below green is 'good' and red is 'bad'. Note that every asset class has its share of red which reinforces our message that every potential solution is a trade-off. Understanding those trade-offs is key.

Expected Asset Class Performance



It's also worth considering that the same exercise looking backwards would show bonds as all green. That is the point of these recommendations. Despite fantastic historical performance fixed income simply cannot repeat this in future.

Conclusion

There is no silver bullet for the fixed income conundrum. However, we recommend replacing some of portfolios' benchmark aware investment grade fixed income with cash enhanced funds to reduce exposure to rising bond yields. To further bolster portfolios, applying a combination of our yield enhancement and risk mitigation strategies is likely to both increase returns and reduce risk.

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