Take a flexible approach into a new era of fixed income

Arno Kitts of BlackRock believes fixed income investors can successfully adapt in the face of wholesale change, but they must be willing to embrace new approaches

The bond market is in the midst of dramatic changes and institutional investors must adapt if they are to achieve their investment goals. Investors have traditionally looked to their core fixed income allocation as a source of consistent, positive returns with low levels of volatility. To achieve these goals today in a fundamentally different capital market environment, investors will need to invest more pro-actively and with greater flexibility.

Bond yields have risen significantly and remain volatile, central bank policy is shifting and investors have experienced losses from traditional core bond holdings. With interest rates rising and volatility high, investors face the risk of not meeting their income and capital preservation needs, and they may even be losing money. Indeed, in May alone, investors lost a year's worth of income[1]. To enhance opportunities for income and total return, investors need to consider moving away from traditional core bond strategies in favour of an alternative approach that is flexible and can adapt to the rapidly changing realities of the bond market.

All change for bond markets

Bond markets are shifting from assuming the Fed would keep long-term interest rates low through its bond buying programme for the foreseeable future to a growing realisation that there is an end to Fed accommodative policy. It only took a single comment by former Chairman Bernanke that the end could be sooner than expected to put the bond market in crisis mode, sending prices down and yields spiking higher. Investors of all kinds have felt the effects, which led to losses in most traditional strategies that for many years had offered attractive income and returns.

In fact, over 50% of the global sovereign bond market has suffered losses this year as the yield on the benchmark ten-year US Treasury spiked.

Many bond funds have experienced additional losses since then as bond yields continued to move higher, reaching as high as 2.99% for ten-year Treasuries in May this year[2]. As yields moved higher, expected bond volatility also rose sharply. Chart 1 demonstrates the resulting losses for traditional bond strategies, with the Barclays Global Aggregate Bond Index losing over 3.1% in the May-June yield spike and smaller losses in earlier spikes.

CHART 1:
Rising volatility and yields cause losses in traditional strategies

Source: Merrill Lynch, Morningstar, Bloomberg as at 5 September 2013

Why did traditional core bond strategies experience such losses?

This is perhaps the most important issue for bond investors to consider today. Traditional core bond strategies have for years tended to track or exceed a market index, such as the Barclays Global Aggregate Bond Index ('Agg'), which has become dominated by interest rate-sensitive government and government-related issues.

Investing this way over the past 30 years has been a winning strategy, since interest rates have gradually declined while inflation remained in check, leading to strong average returns.

However, with yields likely to rise further, the risk of negative returns and heightened volatility is high. Investors need to consider a different approach to their (non-matching) fixed income allocation.

What are the challenges facing fixed income investors today?

Global central bank intervention has made today's fixed income market dynamics quite complex. While the US may soon emerge from its era of financial repression, we believe much of the rest of the developed world is likely to remain in a monetary easing mode for some time to come, largely to allow for continued deleveraging.

The rise in bond yields globally reflects some degree of economic normalisation, with solid economic growth in the US, Europe emerging from recession, a reduced possibility of hard landing in China and slowing emerging markets growth. Any normalisation of monetary policy in the eurozone and Japan is likely to run well behind that in the US.

The ultimate result of that is a divergence in fixed income performance by region and asset class. We would argue that the normalisation in interest rates across the globe, and the many secular forces influencing this change, are key factors that will drive markets in the time ahead.

Once we accept this argument, and take account of the fact that policy and rate change will differ markedly by country, the capital allocation implications of the current environment become clearer.

> **"A dynamic, flexible portfolio that is 'unconstrained' has the option to invest across a broad universe, allocating to different sectors and seeking out a diverse range of investment opportunities"**

Simply put, flexibility and opportunism are the watchwords for fixed income investors as markets adjust rapidly to changes in economic prospects, monetary policy and secular dynamics that promise to play out differently in various parts of the world.

Time for a new approach for investing in bonds?

Benchmark-constrained global bond strategies could be challenged in today's low interest rate environment. Consider

---

[1] *Barclays Global Aggregate Bond Index as at 31 May 2013. With yield at 1.8% in May 2013, the index lost −2.9% over the month*

[2] *Sources: Merrill Lynch, Morningstar, Bloomberg as at 20 August 2013*

one of the leading fixed income benchmarks, the Barclays Global Aggregate Index. Due to the way it is constructed, the Index replicates the debt sold in the market. Given the extent of central banks' bond purchase programmes, it is now heavily weighted toward interest rate-sensitive securities, such as US Treasuries, UK gilts and German bunds. In fact, currently around 80% (up from about 75% five years ago[3]) of the Index is made up of the kind of government and government-related debt securities that are typically extremely sensitive to the movement of interest rates.

This means that investors in strategies that closely follow the index would subsequently be overweight interest rate risk at a time when it is providing the least value in the past 30 years. The danger for such investors is that even a modest rise in yields on core bonds (US Treasuries, UK gilts and German bunds) can have a significant impact on portfolio returns.

As Chart 2 illustrates, investors also have less protection against interest rate volatility than historically would have been the case. Investors in search of yield have had to take on ever-higher levels of duration while yields have continued to fall, leaving traditional portfolios exposed to changes in rate expectations. For instance, in September the Barclays Global Aggregate Bond Index only offered a 0.33% buffer against the risk of a 0% total annual return[4].

Markets are further distorted by an imbalance of supply and demand and a lack of liquidity, and neither trends are likely to disappear soon: ageing populations and pension fund demand outstrip supply, while regulatory changes such as Basel III mean that many traditional liquidity suppliers are withdrawing from the market. Both developments increase the risks associated with a benchmark constrained approach.

On the positive side, we are witnessing a significant widening of the opportunity set, ranging from the burgeoning supply of emerging market debt to the opportunities created by continued bank deleveraging and developments such as peer-to-peer lending. Benchmark constraints, however, mean traditional fixed income investors are typically unable to exploit these opportunities.

In contrast, a dynamic flexible portfolio that is 'unconstrained' has the option to invest across a broad universe, allocating to different sectors and seeking out a diverse range of investment opportunities. This approach grants an unconstrained strategy the benefit of being exposed to different types of risk and return opportunities.

Flexibility and diversification to improve risk-adjusted returns

Having the **flexibility** to adapt to volatility and the changing risk/return landscape allows a manager to seek the optimal balance of investments within the portfolio. If a bond manager is constrained by a benchmark, it forces that manager to basically replicate that index (with some limited room to 'tilt' the portfolio), limiting the portfolio's potential for returns and potentially exacerbating risks.

While **diversification** does not assure a profit or protect against a loss, it has been shown to smooth the ride and provide for more consistent results over time. As fixed income markets move away from the era of global deleveraging and government intervention, having the flexibility that could protect against rising interest rates and to invest where the best opportunities lie will be crucial to navigating the new era.

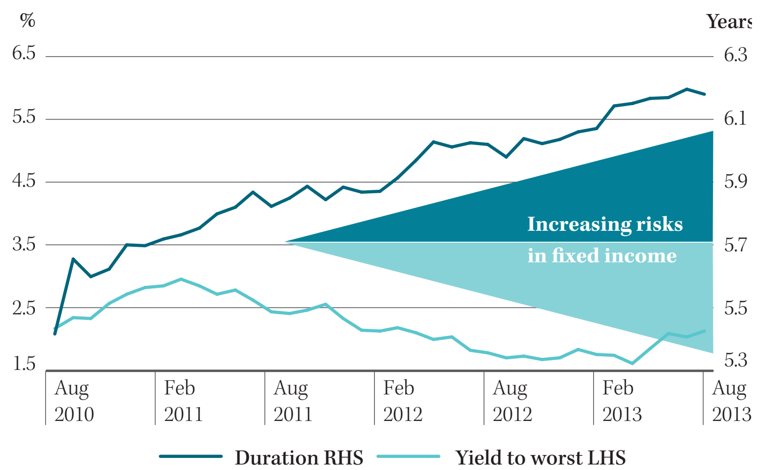
Adapting to less benign times

We believe that investors seeking total return with lower volatility should consider re-allocating a meaningful portion of their traditional benchmark-oriented fixed income portfolio to an actively managed, flexible strategy.

This would allow them to benefit from flexible and risk-managed diversification across sectors and duration.

A flexible investment strategy that is not tied to benchmark constraints has the ability to create an optimal balance of exposures from the broad opportunity set in the fixed income market. An active approach that rotates portfolio allocations across sectors with an eye towards protecting returns on the downside aims to provide investors with attractive risk-adjusted returns and avoid arbitrary benchmark exposure.

CHART 2:
More risk for less return*



*Barclays Global Aggregate Bond Index
Source: Barclays Live, BlackRock as at 30 September 2013

Arno Kitts
Managing director, head of BlackRock's UK Institutional Client Business
www.blackrock.co.uk

[3] *Barclays Global Aggregate Index as at 3 July 2008 and 5 July 2013*
[4] *Barclays Live, BlackRock as at 30 September 2013*