FOCUS

Flexible in fixed income

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In the current environment of expected higher rates, investors' first instinct is to shorten duration to minimise risk to their portfolios. However, we think differently; longer duration can deliver value and help manage overall portfolio risk.

While the consensus is that short duration works best to control risk, we do not think that is necessarily true, because it can lead to undue concentration of risk. As investors seek to avoid duration without suffering negative returns on short-term sovereigns, they have crowded into short-term high yields and taken on more credit and liquidity risk than they would normally consider as acceptable.

Adrien Pichoud
Chief Economist & Senior Portfolio Manager

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- Many investors are worried about rising rates and therefore favour short duration government bonds, credit or high yield investments in their fixed income portfolios.
- We think this is not the best way to manage risk, and can lead to undue concentration risk. Long-term government bonds bring value to fixed income risk management.
- In the lower-for-longer growth environment and even lower interest rates, the opportunity cost of holding cash will remain very high.

Long-term government bonds are still attractive

We believe that long-term government bonds bring value to fixed income risk management. This is particularly true if the world suffers a "growth accident", like in 2008. When spreads suddenly widen and liquidity disappears, long-term sovereigns offer a cushion.

The majority of investors fear losses on longer-dated holdings and think that cash and short duration are less risky – but this strategy will forego a significant source of return, should rates remain low for a long time.

Yield is not the same as total return

Much of the sovereign bond world is already suffering from 'Japanification' – a long period of low growth and even lower interest rates. In such an environment, the opportunity cost of holding cash will remain very high as central banks maintain accommodating policies to support growth. This stance will be supportive for long-term bonds.

The Japanese experience demonstrates clearly investors opting for cash because of low long-term yields lose out over longer timeframes. Over 15 years to the end of 2016, the yield on JPY cash was on average 0.24%, versus 0.92% for JGB 7-10y, a relatively small pickup at first glance for long-term bonds. But the difference in total annualised returns has been significantly higher, with an annualised 2.44% for JGB 7-10y against just 0.34% for cash.

Take advantage of rolling down the yield curve

Cash investors give up more performance than they think. Holders of long-term bonds accumulate the carry and can benefit from a positive yield curve slope to generate returns via the roll-down.

Even so, investors are right to worry about what hit they may take if and when rates actually rise. While benign in the scenario that rates rise gradually, the impact can indeed be significant when rates rises rapidly. However, even then, the potential damages are often overestimated. We have looked back at US Treasury rate rise since 1977, gauging each long-term rate increase for its maximum drawdown impact and how long it took to recover from these losses. We found the duration of recovery times to be relatively self-limiting.

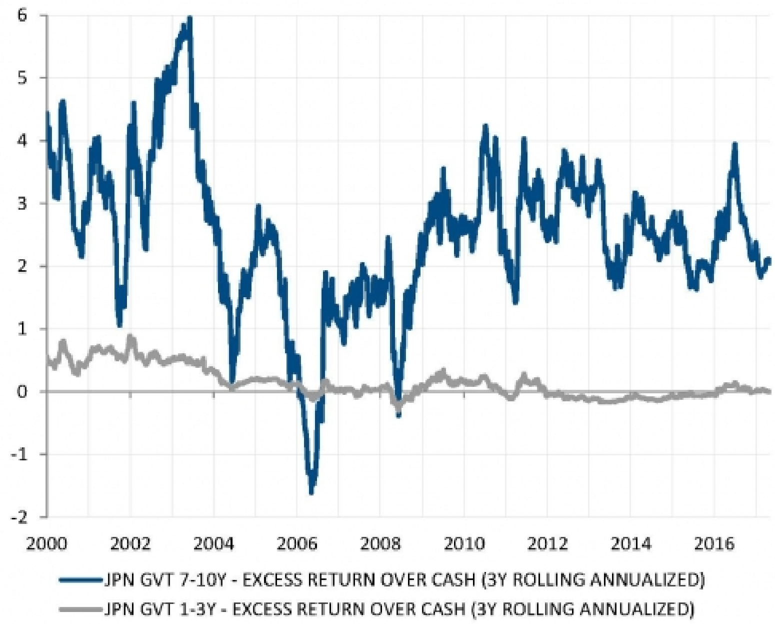
First, being able to reinvest coupons at higher rates contributes to the recovery. Secondly, there is an embedded pullback in any rate rise, especially for economies with high indebtedness levels. Indeed, rate rises are triggered by higher expectations of growth and inflation. But once rates have actually moved up, they impact negatively on growth and inflation prospects, driving long term rates back lower. The combined coupon and pullback effects result in portfolios recouping all of their initial drawdown in about a year at most.

Keep calm and carry a long-term view

At SYZ, we sit opposite to those foreseeing a bear market. As Japanification beds in, we expect rates to remain fairly low, close to where they are today. Thus, in such an environment, flexible strategies including duration can deliver outperformance by using a relative value approach. But even the most active of strategies cannot be ahead of the benchmark at all times. With the strategies free to invest outside of their respective indices, there are periods when either could lag, but over the long-term, these strategies are designed to deliver outperformance.

Over the last two or three years, short duration investors did not win when rates moved up; they just lost less at best. But those short duration investors also missed the best part: they failed to gain on the upside by not participating.

Extra return of short and long-term bonds over cash



Source
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