Fixed income

Which way now for investors?

In conversation:
Mark Cernicky | Joe Abrams | David Greene | Christine Farquhar
Jonathan Platt | Pete Drewienkiewicz | Ben Shaw | Sebastian Cheek

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Fixed income: which way now for investors?

This year has so far been a bumpy one across financial markets as both developed and emerging equity markets have tanked, the oil price remains low and liquidity and capacity issues have blighted fixed income.

The Federal Reserve's decision late last year to increase its funds rate by 0.25% has exacerbated the lack of liquidity in fixed income. The asset class has remained popular despite the low interest rate environment, but low levels of liquidity means areas of the credit market could be affected if just a few significant investors were to lose confidence in certain high profile funds.

The ongoing search for yield has seen investors move capital away from a traditional market cap-weighted indices and towards smaller areas of the market that come under the alternative credit banner.

Investors should be aware that if demand continues to outstrip supply, this movement could see some funds facing a capacity crunch and be capped sooner rather than later.

The opportunity set in the fixed income market has subsequently become limited meaning investors will have to carefully stock pick in order to select winners.

But before committing, investors need to ask themselves a few key questions: what assets is the fund holding? How diversified is it across issuer, sector and duration? Does it hold direct cash bonds or use derivatives? And how similar are its holdings to other funds?

This roundtable sees a panel of industry experts, including asset managers, consultants and asset owners, discuss these questions and more, including the outlook for global fixed income as well as how to select opportunities in the asset class.

Sebastian Cheek
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Breaking the bonds

Unconstrained credit is not new but investors are seeing the potential for searching the globe for a diverse array of credit risk, ultimately allowing for higher risk-adjusted returns. *Lynn Strongin Dodds* takes a closer look at the sector.

Adopting an unconstrained approach to credit is not a new theme but one that has gained momentum over the past year. A combination of sluggish yields, the ever present threat of a US rate hike late last year and China's economic slowdown has cast a long shadow over the bond markets. As a result, institutions are searching for the best ideas across the yield curve and regional borders.

Unlike past turbulent times though, there are no favourite stomping grounds.

As Sandra Crowl, member of the investment committee at Carmignac notes: "Over the last 10 years the developed market credit asset class has been the stalwart for non-benchmarked fixed income funds that have been able to surf the deleveraging wave that started in the US at the end of 2008. After rolling down the US rating curve as valuations became rich in A-AAA-rated bonds, opportunities were then rife in the European corporate credit market as deleveraging among corporates was necessary in the financial and sovereign crisis."

Fast forward to today and the hunt for yield in a depressed rate environment has created market distortions where some credit sectors are priced too low for the risk taken, according to Crowl. She points out that investment grade spreads have moved from 180 mid-2012 to below 50 in March this year following the onset of the European Central Bank's latest round of quantitative easing. Since last summer and following on from the contagion of the US energy market selloff, low commodity prices have raised the insolvency risk of commodity producers so raw material sector credit has sold off significantly.

"One of the interesting features of today's market is the unwillingness to accept bad news and this has translated into an inability to allocate assets," says Richard Ryan, fixed income fund manager at M&G Investments. "When bad news hits valuations fall or positions are sold off until there is more clarity. This does not happen when markets are robust and there is a high degree of risk taking. People are able to rationally look through the negative news."

PRIME TIME FOR PICKING

Instead of being overly anxious, Ryan along with other fund managers believes this is prime time to identify reasonably priced individual opportunities. By applying a bottom-up approach to credit, akin to equity stock picking, Ryan sees pockets of value in out of favour sectors such as metals and mining with spreads that are in some cases wider than those in 2011 when Europe was suffering from its sovereign crisis.

"The bad news is already built in and you do not have to take heroic bets. In general, it is about doing the analysis, kicking the

tyres, and asking questions such as what am I being paid for?"

Mark Cernicky, managing director, global fixed income at Principal Global Investors, is also looking at independent energy as well as midstream companies that are involved in shipping and storing the oil, because they are much less sensitive to the vagaries of the oil prices.

"Other areas we are focusing on are shareholder friendly companies such as pharmaceuticals and financials that are de-risking," he says.

Overall, fund managers are treading cautiously in the investment grade space due to the supply overhang. Both Europe and the US have been hit by a deluge which has knocked investment performance and led to a higher risk premium or extra yield between riskier corporate and the safe haven government bonds. In September 2015 alone, Thomson Reuters figures showed investment grade issuance in the US hit $60bn (£39bn) with companies in Europe selling around EUR 60bn (£43bn).

Companies are taking advantage of the low rate environment and rushing to raise finance cheaply as well as support the spate of mega mergers such as Anheuser-Busch InBev's purchase of SABMiller. The brewer is expected to set a record for debt issuance by selling bonds worth as much as $55bn to finance its staggering $106bn takeover.

"If you are an ambitious CEO, you will be taking advantage of current low borrowing costs to fund a deal," says Owen Murfin, portfolio manager on the Blackrock global bond portfolio

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> Joseph Mayo

team. "The InBev/SAB Miller deal will involve a sizeable bond issue and one question is which market will they chose to sell them. I would like to see more diversification from the US but it is not that easy in Europe to get a big deal away. However, there has been high event risk, causing an overabundance of supply especially on the investment grade side."

HIGH YIELD WOES

Managers are also applying caution in the high yield arena where the US continues to be the main contender, albeit its share of the Bank of America Merrill Lynch (BAML) Global High Yield index, which tracks $2.2trn of assets, has been whittled down to 53% from 89% in 1998, according to data from Hermes Investment Management. Europe's contribution by contrast has risen to 21% from a mere 8%, while the rest of the world accounts for 26% compared to 3% during the same period of time.

US high yield bonds have had a difficult year and have underperformed their European peers mainly because of their strong ties to the energy sector. Roughly a fifth of US high yield debt outstanding has been lent to the oil and gas industry and defaults seem likely as many of these companies borrowed money when oil prices were toppling over $100 a barrel. Now they are struggling with the current $50-60 price range. In addition, the sector also took a greater hit than Europe when the Chinese economy started to splutter.

"You have to be selective in the US high yield universe because we are going to see more companies file for bankruptcy under Chapter 11," says Joseph Mayo, managing director, head of credit research at Conning. "This will impact the entire market because of its increased retail investor focus, which makes it more prone to undulating swings in performance. But, we see opportunities in fundamentally-sound companies."

Many managers such as Gregoire Pesques, fund manager at Amundi Asset Management have a bias towards European high yield because it still offers better value and companies are more domestically oriented. For example, three quarters of the 30 largest high yield borrowers that disclose revenues are generated within its borders.

"If you look at the US, the high yield energy index was down 9% and that is a significant part of the main benchmark," he says.

Others are looking beyond European credit to secured loans for value. Thierry de Vergnes, global head of debt fund management at Lyxor Asset Management, believes these assets are a good diversifier and offer exposure to high yielding debt with a floating rate income profile that ranks at the top of the capital structure of the issuer.

"We see these as the 4-by-4 assets of the fixed income universe," he adds. "If you think of a bearish scenario, then you

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>
> Fraser Lundie

are in a better position because they are secured and offer better protection than typical high yield bonds, but if you are bullish then you can expect to get an increased yield as the coupons paid by the loans will benefit from the increase of the euro Libor return."

STEPPING BACK INTO EMs

Not surprisingly, the industry is also pursuing different strategies in emerging market (EM) credit.

"They have suffered a double whammy – the uncertainty over the Fed's return to normalisation and the lower growth trajectory of many countries," says Yves Bareau, chief investment officer, emerging market debt at JP Morgan Asset Management. "This has resulted in underweight positions and questions over when to re-engage. One of the lessons though of the financial crisis is that at some point you need to step back in."

Bareau favours US dollar sovereign over local currency debt, largely given the fundamentally weak backdrop for EM foreign exchange and is more cautious over corporates due to the late cycle. In terms of countries, Central Eastern Europe is at the top of the list because of its strong economic fundamentals as well as India, which is enjoying higher growth, lower inflation and a relatively stable currency thanks to Modi's reforms.

"We are also moving back into Russia because it had a massive sell-off and valuations are attractive," he adds. "There is a concern over geopolitical risks such as Syria but we think the economy has turned the corner and is over the worst."

Fraser Lundie, manager of the Hermes Multi-Strategy Credit fund, also notes that larger emerging market companies are in much better shape than 10 years ago and that the gap has narrowed with their developed market peers from an environmental social and governance (ESG) standpoint.

"There is greater transparency and stronger governance," he says. "For example, today you can readily compare a sector the way the sector looks at itself – take a company such as Mexican-based Cemex with German based HeidelbergCement – two global cement competitors that can now be analysed as the peers that they are; breaking down the EM/DM silos."

Their hard won efforts, perhaps, explains the furore created by the investment community last summer when Bank of America Merrill Lynch threatened to exclude EM issuers in its broader global high yield index.

"By embracing corporates from across the globe, investors can access risk from a diverse array of locations and credit qualities – allowing for higher risk-adjusted returns," says Lundie.

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"To me, the risks are asymmetric. Even if you get an unfavourable – or deflationary – backdrop, the kind of potential returns you're going to get from your traditional fixed income classes are going to be limited." David Greene

We've had one of the worst starts to the year since 2000. Risk aversion and investor nervousness have led to broad-based weakness across equity markets globally and the outlook for fixed income isn't particularly great either. So, which areas of fixed income will appeal to institutional investors? Where should they be looking?

Ben Shaw: Given the likely rise in interest rates and where yields are, what you want to try to be doing is moving away from the traditional market, to where you can get debt opportunities as an off-market, at fixed yields, that are very attractive. That's available from unusual financing, such as peer-to-peer lending. We're getting easily double-digit returns for institutional investors taking first and second charge on property and other slightly more unusual assets, such as cars and aircraft.

If you choose the right alternatives- you're going to get the best risk-return in this kind of market.

Jonathan Platt: The outlook for fixed income markets really depends on your macro view; given my relatively upbeat macroeconomic views, I don't think the outlook is good. However, it could be argued that we're in, in effect, the end of the recovery period which started in 2009. The worry is that the central bank has basically used up a lot of ammunition, and this is the late part of the cycle. A more deflationary view of the world would support fixed income markets.

Pete Drewienkiewicz: It depends how late-cycle you think we are. If we are in the twilight of the credit cycle, we might muddle through for another couple of years. Then it's possible to create quite a positive story for quite a wide range of fixed incomes. But if we are about to lurch back into recession, that's a different story.

David Greene: To me, the risks are asymmetric. Even if you get an unfavourable – or deflationary – backdrop, the kind of potential returns you're going to get from your traditional fixed income classes are going to be limited.

General fixed income might make 2% to 4%, but there's the potential you could lose 3% to 5% if interest rates do rise. In that environment, you want to be a little bit duration agnostic, if you can. You don't want to be betting too much on that style of management.

Moving away from benchmark-constrained management towards absolute return, or multi-credit type or even alternative type investments is a good step.

Joe Abrams: It very much depends on what the client is trying to achieve. We'd advocate looking at efficient ways of allocating to different betas and alpha where it suits an objective. You might consider that there are some opportunities to come given the current market environment – perhaps local currency emerging market debt, or some parts of the sub-investment grade credit market – and you might want to keep some powder dry for a beta allocation.

But you should only really look to do so if you're a long-term investor. Trying to time markets over the shorter to medium-term horizon is harder to do. For keeping powder dry in the shorter term you could look at an absolute return type approach which has a lower correlation to market returns.

Christine Farquhar: We're seeing clients looking at alternatives, not so much alternatives to traditional fixed income, but as some diversification from equities. So, less liquid, direct lending, lock-up strategies. People are more open-minded, but they're not thinking about these strategies in the fixed income space.

Shaw: If you're in fixed income in the traditional classes over the long term, you will be lucky to get 3% to 5%. If you're going to get 5% you have to take a bit of risk. Will 3% really achieve your objective of technical provisions? Probably not, and that's why we're seeing people looking at putting an allocation they can still call fixed income into what other people might call an alternative asset class.

Christine Farquhar

Farquhar: Do they accept that what they're really capturing is the illiquidity premium? Is that well understood?

Shaw: Well, it's not that illiquid, because we operate a secondary market.

Mark Cernicky: If high yield bonds are illiquid, indirect lending is going to be less liquid.

Shaw: I think it depends on your type of institutional investor. A pension scheme is looking to wait out to maturity. If you're locked in for six months or three years, it's not really relevant to your 20 or 30-year time horizon. If you're a fixed income fund, and mark to market every day, and get a lot of redemptions, it's a different matter.

Drewienkiewicz: Even if you're trading in relatively liquid markets, you probably want to have an alternative approach. You can either go for more alternative assets, or look at traditional fixed income managed in an alternative way. People are waking up to these options.

Cernicky: I would agree that, if you're going to start looking for these pockets of opportunities, there has to be some kind of liquidity or ability to gate or limit that. I think bank capital structure investing is a great place to be now. Banks benefit from improving credit fundamentals and are not prone to shareholder friendly activity. There are some really valuable places to invest, contingent convertible capital securities (CoCos), preferreds, and legacy tier one debt. But there is a risk of some banks going into resolution, which means you need to be concentrated in your holdings.

Drewienkiewicz: When people talk about fixed income, it now covers a multitude of areas. This is what would be regarded not as alternatives, but the evolution of mainstream investment. The number of opportunities investors have is very different from 20 years ago, so you have to have a broad mind-set in fixed income investing now.

Cernicky: We've started seeing a demand for US municipal bonds by non-US investors. There's no tax benefit, but in Europe and Asia – particularly Japan – we're seeing demand for higher credit quality assets, as there is less default risk associated with a lot of these compared to investment grade credit.

Greene: How cognisant do you think these investors are of the credit they're buying? One thing we've all seen over the last five years is investors moving further and further along the credit curve. Quite often you find investors buying something – I think yield, rather than buying the credit.

Drewienkiewicz: I would challenge the notion that everyone needs core fixed income. Outside of liability hedging, it goes without saying.

There is a bit of split on the place for traditional fixed income among some investors.

Shaw: Even schemes that don't look at it specifically as liability matching have advisers telling them they must have a sizeable proportion of both fixed income and equity, to try to match up your deferreds and your active members.

If you're lucky, you'll get a proportion in alternatives. Less than 20 years ago, you had just fixed income and equities but people are moving to alternatives.

Greene: That's a good point. I've heard a number of regulators speak, both to the UK, Ireland and many continental countries, saying schemes are being unrealistic in the return assumptions, therefore you need to allocate more to fixed income in your DB schemes to try to close this gap over the long term. So there is a pressure on scheme directors to increase allocations to fixed income just at the time that they don't want to do it.


Joe Abrams

Shaw: One of the regulator's core tasks is to protect the Pension Protection Fund and it doesn't want a scheme taking what it might see as risky investments.

Drewienkiewicz: Perhaps I'm only talking of larger, more sophisticated funds, but if you can show TPR a sensible path back to full funding and a framework for how you're going to manage the asset mix through time with a substantial amount of liability risk off the table, then there can be flexibility about what you do on the asset side.

Shaw: Yes, but when you've a weak company covenant on the table, they're very dogmatic.

What advice are the consultants offering?

Abrams: Every client is different, and when we talk about the need to allocate to traditional fixed income, there's a need for hedging (e.g. pension scheme liabilities), which I see as separate from the need for growth. There are opportunities to achieve growth (returns) within what you probably define as the

“In Europe and Asia – particularly Japan – we’re seeing demand for higher credit quality assets, as there is less default risk associated with a lot of these compared to investment grade credit.” Mark Cernicky

traditional fixed income sphere. But it becomes ‘alternative’ fixed income in the way that the products are managed and set up. These strategies are objective-oriented as opposed to benchmark relative. There are also opportunities in the more illiquid or private markets as well, so you do have to look at each client based on their own requirements.

Objective-oriented alternative fixed income strategies, which make use of traditional fixed income instruments include, for example, absolute return fixed income strategies that should preserve capital and look to generate some alpha, which is dependent on manager skill. There are also, for example, multi-asset credit-type strategies, where manager skill is a component, but it’s also dependent on sub-investment grade credit beta. So, when the market sells off those strategies will underperform cash.

There is an array of strategies which spans the spectrum between those based purely on alpha and beta within outcome oriented fixed income strategies, Helping clients understand the differences between those is something we have to work hard to do.

When the return stream is more dependent on the beta, rather than alpha component – including strategies which are benchmark relative – the client has a lot more transparency about what they’re getting. For outcome-oriented fixed income strategies, where more of the return is dependent on manager skill, we have to do a lot more work in manager research to ascertain the value that a manager is adding.

Drewienkiewicz: And Joe’s absolutely right. The kind of range of non-traditional fixed income strategies,

whether it is traditional assets being managed non-traditionally, or real alternative assets – it's completely non-homogenous. There's a huge range of stuff to look at. I think it's all about trying to communicate that to clients, and trying to help clients find the strategies that they need.

Farquhar: 2015 has been useful in sorting out some of the higher yielding sheep from the absolute return goats. The people who got caught out most last year were the ones capturing risk premia in the markets.

Drewienkiewicz: The general approach to risk assets from 2011 was every time this stuff sells off, buy it, because it will come back. Then I'll have captured a bit of alpha from the fact I just bought a dip. I think 2015 was basically the year when everyone tried to buy the dip repeatedly.

Abrams: There were periods in 2015 when you could own a portfolio of absolutely everything, and absolutely everything sold off apart from Japanese cash.

Cernicky: You need to have these multiple sources, these different types of levers you can put on a portfolio. This will carry you forward slightly better in this current environment.

Greene: I'm not so sure the macro opportunities are gone, because volatility provides plenty of opportunities. If you're willing to stand up and capture some of that volatility.

Abrams: Clients should be looking at the world, and comparing managers and strategies to what else they can get out there. If you think about this as objective, or outcome-orientated investment, as the world changes, the objectives they're trying to achieve will change over time. So, you would expect the landscape to change, as well.

Farquhar: It worries me that clients still look at market benchmarks as comparitors for absolute return bonds, and I think that at the back of their minds they would like to think there is a magic bullet to cope with rising interest rates. So consultants must remain the gatekeepers.

"2015 has been useful to sort out some of the higher yielding sheep from the absolute return goats. The people who got caught out most last year were the ones capturing risk premia in the markets." Christine Farquhar

Platt: Often, we're now being asked with what are termed fixed income assets to deliver equity-type returns. That's a big challenge. Multi-asset credit, for example, is basically competing head-on with equity. That is a big, big challenge for managers.

Drewienkiewicz: But the prize there is that, if people demonstrate an ability to do something like that, then there isn't a great deal of point in owning equities.

Do UK institutional investors have to approach this from an active stance? Is there a place for passive in this area?

Drewienkiewicz: I've seen some reasonably smart work about smart beta – factor investing – in credit. I think it is quite interesting, but not the way you should invest money. At the end of the day, you've created a passive portfolio, and then you still need to run it past your fundamental analysts. To me, it's all about fundamental active management in credit.

Platt: Over a long period of time, there was definitely clear evidence that active management, because of the complexity, actually does deliver those positive returns. Not always, but, over the longer term, I think there's very clear evidence that active management works.

"There's definitely a question of fee and one of the issues that challenges the industry is that we're expected to widen the range of what we do. More complexity, but clients are not prepared to pay more for it." Jonathan Platt

Drewienkiewicz: And benchmarks are poor in fixed income.

Greene: The global bond index is market cap-weighted and is stuffed full of all the countries you don't really want to buy. If you're in a passive mandate, do you want to be assigning an even bigger part of your portfolio to a country like Italy that's got a trend growth rate of 0.5%, with debt spiralling out of control, and politically, doesn't seem to be able to reform? That's why some look at something like GDP-weighted bond indices, which were quite popular, but haven't quite got going yet. I think smart beta evolved because passive just doesn't work.

Drewienkiewicz: But coming up with smarter benchmarks that are better aligned to what clients are trying to achieve, is a really sensible place to spend a limited amount of time. But even when you've done that, why wouldn't you ask someone to actively manage over that, anyway?

Platt: There's definitely a question of fee within this and one of the issues that challenges the industry is that we're expected to do widen the range of what we do. More complexity, covering all those different factors we've talked about. But clients are not prepared to pay more for it.

Drewienkiewicz: That's an interesting place to bring about the liquidity conversation.

Abrams: Capacity is a very hot topic, as well, because when you're moving away from a market cap-weighted index, you're inherently pushing capital towards smaller areas of the market. Some managers need to get their head around the fact that, due to this dynamic, they might be capped out sooner.

Are consultants as well as managers experiencing pressure on fees?

Greene: To be honest, yes. It's understandable. We come under pressure to lower our fees, then we say the same to everybody that supplies us with stuff. That's just part of the disinflation environment we're in. But you can legitimately make a point to a client that, at this fee level you cannot expect the same kind of service from me. Particularly in the more illiquid or alpha-seeking or skill premium areas of the market.

Farquhar: Clients are getting more picky about saying: "Well, actually, a lot of this portfolio is not being actively managed, so the base fee shouldn't be any different from passive. We'll pay you for performance, but we're not going to pay you these extra basis points across the whole piece."

Platt: With any industry, that scale has its advantages in terms of just reducing the cost of doing business. But it comes with some pretty big disadvantages, as well, from the end clients' viewpoint. And I think the way the industry will go ahead is that you will see the very large players emerge.

But their ability, then, to differentiate themselves in that marketplace will become very, very difficult. So, going back to your point, I think there is definitely value within knowing where your limitations are, in terms of the assets you can take on.

Don't try to compete in that big space, because you'll probably never get scale and differentiate what you have to offer. I think things like ratings agencies are great, from my viewpoint. I think they create some opportunities for the active investor to trade against that. I think the scale of some of our larger peer group is great, as well, because they are more constrained on what they can do. I do think that does work at the alpha side.

Abrams: Clients are beginning to get a bit smarter about their budgeting. You used to have risk budgeting which simply assumed liquidity was a constant factor across different markets. But now clients are budgeting in terms of risk, liquidity and fees as well, so it has become a lot more multi-dimensional. Clients are getting smarter and paying a little bit more where they recognise that managers do need the resource to exploit an opportunity. It's something we'd certainly try to encourage clients to think about.

Pete Drewienkiewicz

Cernicky: There isn't one set fee anymore. Now, there are so many different customised approaches that it's hard to see, whether we are getting paid less or more.

Every time we turn around, the client wants something slightly different, and that may require more or less active management. So, from our standpoint, we've got a raft of different fees to manage, depending on the needs that the clients or the big institutional clients, typically want.

Has illiquidity created opportunities for managers?

Drewienkiewicz: I'm not sure many managers would say they loved all the illiquidity in the market in 2015. The challenge is there are different pockets and natural holders of different types of risk in the world, in asset markets in general. And there are certain areas in fixed income where it is becoming apparent that there are not natural holders of certain risk at certain levels.

A whole variety of factors can make it very difficult for inappropriate holders of risk to hold risk in certain areas. And so what happens is, if a risk needs to be shared, and there isn't a natural, long-term holder of that risk to come in and buy it at that level, then the asset will trade down until someone sees it as appealing. And that is a really challenging environment.

Platt: Picking up on that point, I think the big issue about liquidity is when you buy an asset that you think is liquid, and it then becomes illiquid, as opposed to buying an asset as part of a portfolio, part of a strategy that you know is illiquid. It's the challenge, and we saw that in 2015. Parts of the market that people would assume were liquid became very illiquid, very quickly. And that's the big challenge.

Greene: This illiquidity wave washes ever closer to the epicentre of the fixed income universe which is the sovereign market. But EM people say they've been managing this illiquidity risk for years. To them, it comes in waves and they're not worried about it.

And it just struck me last week whether we need to separate or break the illiquidity down into a cyclical and a structural component? We all know why things became liquid, because the banks who were there beforehand are now constrained and withdrawn. But if the cycle works, in three to five years' time, those self-same banks will be flush with capital, adding huge amounts of profits and thinking about market making again. I wonder, if we are facing the illiquidity issue for the next two years.

Drewienkiewicz: But the market has grown by so much, that in fact, you'd need people not to get back to their 2007 market-making capacity, but two or three times bigger than that.

Farquhar: But have people forgotten the fundamental principle that the credit space isn't a perfect substitute for cash? You shouldn't be holding corporate bonds if what you really need is liquidity. This shouldn't be where you keep your liquid reserves. But, if you do have an appropriate investment time horizon of three to five years, then you could get your full value out of bonds and credit.

Drewienkiewicz: Surely people are holding credit most of the time for the income it provides, and therefore, that tends to lead to a longer holding period.

Greene: So, arguably, if you see people holding short-term credit funds as a substitute for cash, then this is another example of how QE has completely distorted the price of risk.

Farquhar: That's right. That's absolutely fine if your client is big enough to have their own, separate buy-and-maintain account, and they've got short-term credit waiting until that matures. That's where we're seeing cash flows.

Cernicky: I'd be surprised, in my experience, that you have a client using an equity fund for cash.

Greene: We would tend to see them pile it into a very short-term credit fund, that's got a duration of three months, or four months.

Cernicky: In my opinion, if you could have perfect liquidity in every market, and if you wake up in the first two weeks of 2016, and you're down 6%, it's challenging to tell your client they have perfect liquidity but lost 6%.

Ben Shaw

Greene: The problem with that is you end up selling the assets that are liquid and you don't necessarily want to sell, because you can't sell the ones that you should be selling.

How can investors identify true manager skill in the fixed income space?

Drewienkiewicz: You've got to see how they react to market stimuli. See what the decision-making process is through time and how portfolios evolve and theses play out.

Abrams: You've got to look for an ethos, some kind of competitive advantage that you believe is going to be persistent and repeatable over time, and evidence that that is not being eroded by external or internal factors. And you've got to work hard to identify this. An active approach may not always be best, and is

Mark Cernicky and David Greene

"Performance is always going to be a key driver, but investment process is also very important. If you are transparent about how you deliver whatever you deliver, that is very well respected." David Greene

certainly more appropriate in some areas than others.

Farquhar: Not being flippant, but the five-year risk-adjusted return is only one useful tool. We've got several pretty interesting manager data points going back through 2015, 2013, 2011 for Europe, and for yield, and 2008/09. It's referencing the manager's style, what did they physically do? What happened? What do those periods spotlight and show as to what they might do next?

Abrams: And as we move into the benchmark-agnostic space, how true are they going to be to their ethos, and is this objective going to change?

Greene: I know performance is always going to be a key driver, but investment process is also very important and you will be respected for it. If you are transparent about how you deliver whatever you deliver, and you can be totally open with people, that is very well respected. The client and the consultant need to know what they wake up to.

Any other thoughts on the management side?

Platt: One of the problems you have with the industry is, well, who are you judging over a five-year period? Who has been managing those strategies? Have people changed over those time periods, when the turnover in the industry is fairly high? So, who are you actually judging when you're looking at those historical performances? It's a lot more qualitative in terms of making those judgements.

Shaw: The qualitative side is very important in getting to know the people, processes and resources.

Jonathan Platt

"One of the problems you have is that an element of credit analysis is subjective, but a lot is hard, factual, and when you're then looking at ESG factors, they become more qualitative." Jonathan Platt

Platt: Yes, you need both sides of the equation. Absolutely.

What risk management techniques and systems are currently being used for managing fixed income portfolios?

Platt: It's interesting that we're talking about trying to widen the opportunity set, but we have to understand how you manage the risk in that.

Cernicky: The key is to put a fence around a bigger sandbox (unconstrained fixed income).

Shaw: You need the balance of the independent rigour of the backwards looking stats, as well as personnel independence. But these systems, to be attractive, have to be flexible enough to incorporate what the manager is trying to do on an individual basis.

Cernicky: Before you get to the systems – and there are plenty of them out there – you would need to have a philosophy and an ethos around risk management. You have ex-ante risk budget at the portfolio and security levels, and also ex-post limits at the portfolio and security levels.

Greene: I think that's very important. We tend to focus a lot on drawdown management. I always had the theory that making the good decisions, making the good investment decisions, wasn't the hardest point. The hardest point was knowing when to get out of a bad one.

Cernicky: You've got to admit the mistakes with regards to the bonds purchased.

Drewienkiewicz: We aren't big fans of hard-stop losses. Hard-stop losses in credit are very difficult.

Farquhar: But on the bottom-up side of risk management, we've seen some interesting developments on the ESG side. Managers who put more emphasis on governance have come through some of these recent blow-ups relatively well. Maybe as you get the decompression in monetary policies and the free money goes away, it's going to be more important to see who's running the business well, and who's not. It will be interesting to see if that trend continues.

Platt: One of the problems you have is that an element of credit analysis is subjective, but a lot is hard, factual, and when you're then looking at ESG factors, they become more qualitative. Perhaps it feels a bit counterintuitive to a lot of analysts who have grown up with perhaps a more rigid approach. I think that is part of the change in the mentality in the way we lend to companies.

Drewienkiewicz: The interesting thing is that if you are a company that is self-aware, knows you are not as creditworthy as the rating agencies think you are or as well-run as the world thinks you are, then you are heavily incentivised to issue more debt. As Christine said, one of the interesting things about some of these companies that had question marks over some of their governance structures is they got themselves into hot water. In a lot of cases now, with hindsight, it looks like they had almost systematically over-issued debt. So, there's a lack of alignment there between issuers and investors.

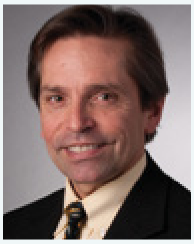
Farquhar: Traditional credit analysts are comfortable with negative screens, but it is harder to get those analysts to think of tilting credit selection more positively towards better governance, even if it's an additional benefit that is not in the price.

Cernicky: There's probably a little bit more focus today, but there has always been this sense that fixed income analysts have used ESG factors to evaluate the management of companies issuing debt. For us, it becomes a little bit easier to bring in ESG because our research incorporates those factors.

Joe Abrams

Navigating the breadth of credit opportunities through a multi-sector approach

By Michael Temple, director of credit research, US, Pioneer Investments



An obvious but misplaced assumption is that investors need to move down the credit curve to boost their yields and plump those spread cushions as much as they can. But doing so, we believe, is asking for trouble. In our opinion, ill-conceived unconstrained strategies, ever-riskier credit products and the false promises of defensive index-centric strategies need to be avoided as general credit risk levels appear to be rising. "Unconstrained" can turn to "uncontrollable" if risk gets lost in the mix.

We believe that investors should consider something more robust. If they are fighting on multiple fronts, they need a multi-sector approach run by managers with the strategic allocation and tactical skills to guide them safely through the battlefield.

Risks in unconstrained

At Pioneer Investments, we do not think that unconstrained strategies are the complete solution, but that a measured, risk-anchored philosophy does and could work better. Yes, we do voyage beyond the constraints of the typical bond indices. But no, we avoid pursuing yield at any cost. We strive to avoid duration, credit, and liquidity risk if there is inadequate compensation.

There are obvious potential benefits to a multi-sector risk-led approach. First, it can provide a wider opportunity set and better diversification than a single sector strategy can. It can also offer the possibility of improved liquidity and the potential to allocate dynamically to those areas of the credit market that could provide better risk-adjusted potential returns at different points in the credit cycle.

There could also be a pleasingly simple benefit to the governance challenges faced by pension scheme clients. The strategic decision to follow a multi-sector approach could allow a scheme to invest tactically in the opportunities of a broad range of fixed income assets without having to appoint specific managers for each sub-asset class. Trustees maintain control with their decision to use a multi-sector credit manager, but delegate the strategic decisions to experienced investment managers.

Limitations of alternative approaches

Higher quality portfolios that focus on developed world govies, mortgages and investment grade corporates may face a particular duration sensitivity risk. But stripping out that duration would leave them with practically zero return today. If that duration bet is wrong, it could be difficult to offset the performance loss since there may be little else to cushion the portfolio.

Other dangers lurk, even for those with credit spectrum flexibility. In the past, it was difficult to rapidly adjust credit quality during significant spread-widening events. Liquidity in the lower quality credit segments typically dries up fast. Managers often sell lower quality assets at unpalatable prices when investors and internal risk departments want out. This is also true on the way back up. Given the continued shrinkage of investment bank balance sheets, this is likely to get worse.

Broad credit strategy

Thus, we believe a broader strategy is needed that strives to find opportunities from the entire risk spectrum, across capital structures and from all geographic territories. A broader credit mandate allows the manager to choose what they believe is the optimal place in the capital structure.

At Pioneer Investments, our Credit Opportunities and Dynamic Credit strategies are designed to leverage our proprietary research and global reach and at the same time seek to manage risk. Our active and flexible approach is designed with the aim, to transform market challenges into investment opportunities.

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Addressing the fixed income challenge: time to consider a new investment approach

By David Greene, client portfolio manager European & global IG fixed income, Pioneer Investments

Traditionally, investors have regarded fixed income bonds as a "safe" asset class with low volatility and steady, predictable returns. But in today's uncertain financial marketplace, fixed-income investors could find themselves facing a "worst-case" scenario: holding high-risk assets that have lost value and produce negative returns.

"Being aware of the evolving fixed-income market is the first step when seeking to avoid return-free risks," says David Greene, client portfolio manager, global & Euro IG fixed income, Pioneer Investments. "Finding an appropriate strategy designed to protect existing capital and create positive returns in all markets should be a priority for fixed income investors."

Greene notes that the policies of the US Federal Reserve (the Fed) and the central banks of Europe, UK and Japan have dominated the fixed income sector in recent years. Their quantitative easing (QE) asset purchase programmes have virtually removed volatility from the fixed income sector, while pushing yields to historic lows.

But a gradual recovery in developed economies, coupled with the commencement of rate hikes in the US, could put upward pressure on bond yields.

Considering the growing level of risk, Greene believes it's time for fixed income investors to take a careful look at their positions and consider ways to reduce risks, while still aiming to achieve positive returns.

An absolute return approach offers potential benefits

We believe an absolute return bond strategy that is uncorrelated to interest rate or duration risk has the potential to generate positive returns regardless of market trends and can be an effective approach for investors seeking to minimize their risks without settling for minimal returns.

Greene says an absolute return strategy should have four key characteristics:
1. Cash benchmark – in order to avoid any duration bias.
2. Negative interest rate and credit spread duration.
3. Highly diversified and uncorrelated sources of alpha.
4. Disciplined risk management process.

Greene notes that a careful use of derivatives is an important tactic in executing a successful absolute return strategy: "Derivatives can be an effective tool to help you manage your fixed income portfolio. They allow managers to access the swap market and forward interest rate market to uncover pockets of value. You can't do that with cash bonds."

Another advantage is liquidity, leading to more efficient trades. "Liquidity in derivative markets is much better and bigger than in the cash bond markets. You couldn't execute those alpha strategies as quickly and efficiently if you are only using the underlying cash bonds."

Greene believes that the right approach for fixed income investors in today's economic environment would be to seek strategies that use sophisticated tools and disciplined management in a manner that have the potential to deliver performance in small increments, regardless of market conditions.

Pioneer Investments' Absolute Return Bond strategy has been managed according to a process known as the matrix structure since December 2010, a process that has been successfully used in other investment grade fixed income strategies over the past six years.

PIONEER Investments®

Translating a multi-sector approach to a single industry: How greater focus can aid bond investors and generate returns

By Stephen Holt, head of institutional business, Principal Global Investors

- ***Multi-sector credit strategies are an attractive solution for return-seeking bond investors in a complex investing environment.***
- ***Typically these diversify not just by sector but across industries.***
- ***We believe that the finance industry offers particularly attractive opportunities as capital structures are de-risked and re-structured driven by ongoing regulatory change.***
- ***Global Capital Structure Opportunities is a multi-sector style of credit strategy that focuses on the full capital structure across a single global industry to deliver mid-to-high single digit returns with relatively low volatility.***

These are difficult times for bond investors. The challenge of maximising returns without taking exceptional levels of risk is complex in an uncertain environment. Selecting from the range of mainstream single-sector solutions — Gilts, investment grade credit, high yield, etc — presents a classic Hobson's choice.

So what's the alternative?

As returns have trended downwards, return-maximising bond investors have tended to increase allocations to credit, reasoning that higher yields will compensate for the additional credit risks they are assuming.

- Some have increased allocations to illiquid credit.
- Some choose to actively manage their strategic exposures in liquid sectors.
- And some have gravitated towards multi-sector fixed income, or multi-credit strategies.

Successful managers of multi-credit strategies need a wide skill set: top down sector allocation, duration and curve expertise, and bottom-up security selection across the widest possible global investment universe, particularly in U.S. fixed income sectors and U.S. dollar-denominated issuers which dominate global bond markets. At Principal Global Fixed Income, we are strong supporters of multi-credit fixed income investing. We believe, however, there are alternatives that return-seeking investors should also consider.

Taking a different approach

Multi-credit fixed income strategies rely on sector diversification for risk control, and sector rotation for return generation. They tend to offer exposure to a wide range of instruments, issuers, and industries. Here we advocate a different approach: applying a multi-sector approach to a single industry. In a financials context, this translates to: **multi-structure, single industry.**

In 2013, we launched a strategy that focuses on a very specific opportunity set – the debt issued by investment grade-rated financial companies. Financials are a much maligned subset of the fixed income universe, for good historical reasons given their role in the Global Financial Crisis (GFC). However, it is the very actions taken to strengthen these institutions that have created exceptional opportunities within this single industry.

Our strategy is called **Global Capital Structure Opportunities (GCSO)**. In essence:

- GCSO is a single industry, multi-structure credit strategy that invests primarily in bonds issued by investment-grade rated financial companies to benefit from the secular de-risking and improving credit fundamentals.
- It demonstrates high-conviction global security selection and manages risk by dynamically allocating up and down the capital structure based on our macroeconomic outlook.
- GCSO is a sustainable, high-quality strategy that seeks to deliver mid-to-high single digit returns over a full market cycle.

Why financials?

As the world emerged from the GFC, there was an unprecedented focus on addressing the risks posed by global banks. In 2010, a framework emerged from regulators to achieve the necessary secular de-risking. Reform has been comprehensive, focusing on:

- Higher capital levels and quality of capital (e.g. through loss sharing and bail-in provisions)
- Higher liquidity requirements
- Resolution plans
- Stress testing
- Forced de-risking of certain business lines (e.g. proprietary trading, and preclearance of dividend and capital plans)
- Reduction in event risk (e.g. caps on leverage)

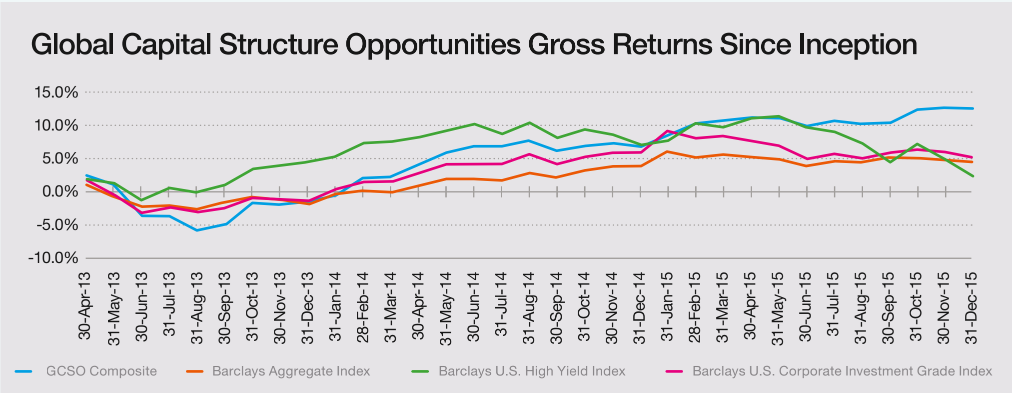
The reform process paved the way for more complex capital structures. Instead of a simple senior, subordinate, and hybrid debt capital structure, the industry began to move towards an expansion of the types of securities available and an increase in the number of levels within the capital structure. This process is ongoing and will continue to evolve for a number of years, altering the opportunity set along the way.

This increased diversity of opportunity creates an environment suited to the translation of a multi-sector style of approach to a single industry. The range of 'sectors' within financials (essentially levels of the capital structure) differs from those in a traditional multi-sector approach, but the skills required are very similar. With interest rates set to rise, financials debt offers exposure to an industry with improving fundamentals that is set to benefit from higher rates.

Global capital structure opportunities

GCSO launched in April 2013. The strategy allocates up and down the capital structure within a single industry like traditional multi-sector strategies allocate across fixed income sectors. Just as risk is more concentrated in a single sector strategy, focusing on only one level of the capital structure can be riskier, as volatility increases dramatically as we move down the credit spectrum towards contingent convertible capital ("CoCos"). We expect the strategy to deliver a yield in the 3-5% p.a. range, with additional returns driven by spread compression: between different parts of the capital structure, and between financials and the rest of the corporate credit universe.

Despite launching shortly before the Taper Tantrum, in an increasingly difficult credit environment, GCSO has delivered exactly as we would have expected, and has significantly outperformed the Barclays Aggregate, Investment Grade, and High Yield indices. Just as importantly, it has delivered these returns with relatively low volatility.



GCSO has been managed since inception by London-based portfolio manager Randy Woodbury, supported by a team of analysts focused solely on financials. It utilises a process with two key components: a top-down macro view of credit markets, and an intensive issue-specific analysis of each layer of the capital structure to identify mispricing and relative value.

Where does it fit?

GCSO should appeal to return-seeking bond investors searching for an alternative to single sector strategies in challenging markets. Such investors should find multi-sector strategies appealing. GCSO is a distinctive alternative, applying a multi-sector style of approach across the capital structure of a single industry.

GCSO is designed to deliver mid-to-high single digit returns over an economic cycle. As the de-risking process within financials continues, delivering consistently improving credit fundamentals, investors would do well to question whether such returns are available elsewhere.

Principal® Global Investors

The institutional investment environment for 2016

By Jonathan Platt, head of fixed income, Royal London Asset Management

The US Federal Reserve (Fed) may have finally moved on interest rates, but in many other ways, 2016 promises to be much like 2015: Economic growth will be sporadic, without clear momentum. Policymakers will continue to exert significant influence, with monetary policy changes unpredictable and data dependent. The market will remain vulnerable to 'shocks' be they economic or geopolitical. Against this backdrop, there will be opportunities in fixed income, but they will not be abundant and they will need to be chosen carefully.

The trend for developed market government bond yields is likely to be higher with the Fed setting the tone. However, rises will be slower than the market currently expects. With the continued low oil price likely to depress inflation, expectations of rate rises may be pushed further into the future. This will create some natural support for fixed income markets. That said, we are in a rising rate environment, however slow. This means that all fixed income investors need to be realistic about the type of returns that can be achieved.

Institutional investor positioning for 2016

There remains only limited value in many government bonds, and, where institutional investors have flexibility, most currently prefer high yield or investment grade bonds, primarily on yield considerations. Where they want to retain some government bond exposure – or where their mandate dictates – these investors have focused on absolute return funds. Where they have invested in 'straight' government bonds it has tended to be in short duration and duration-hedged bonds, taking out the sensitivity to rate rises.

Within this environment, non-core assets - high yield, emerging markets, multi asset credit (MAC) and absolute return – have an important role. Although the performance between these assets has been disparate in 2015, there are opportunities. Notably, we have a much higher allocation to asset-backed securities than many of our peers. Taken back to first principles, asset-backed securities have assets that investors can call upon if the business can't pay its cashflows. During the financial crisis, these securities were leveraged many times, which created problems, but the underlying principle is sound.

Security is always an important part of our analysis, but becomes particularly important in a more volatile climate. Bonds backed by infrastructure or other assets provide this security. Our approach in credit is holistic, rather than necessarily dividing securities into different categories. We look at each security, the interest it pays and the security it offers, without assigning it a 'label'.

The landscape of fixed income investing has changed massively over the last few years. This reflects choice within capital structure as well as the wide range of asset types that are captured by the term "fixed income". This has been matched by higher expectation of the returns that can be captured, with some fixed income strategies competing with equity. This search for yield will continue in 2016 and for the medium term, but these strategies are clearly not without risk as evidenced by the performance of emerging market debt in 2015.

The liquidity dilemma

Pre-crisis, the presence of the investment banks in bond markets created an illusion of liquidity. Equally, the booming structured credit market created significant demand that also flattered liquidity figures. Since then, the structured credit market has receded and greater regulation has seen the banks shift away from holding bonds on their balance sheets. This has undoubtedly created a squeeze on liquidity in bond markets.

For all our portfolios, diversification is a key consideration. We hold a higher number of diversified positions. In this way, if we are required to trade out of a position, it is easier to liquidate a series of smaller positions than one large position. This is an important means to manage liquidity.

However, we would argue that many of the larger institutional buyers do not need liquidity. They are in a position to be able to buy bonds and hold them to maturity. This turns illiquidity to their advantage – the market compensates for illiquidity with higher yields.

Our 'buy and maintain' mandates are built on this premise. These look to select a diversified portfolio of investment grade corporate bonds (of BBB equivalent or higher). Managers will focus on covenants, security and structure, selecting bonds with good asset-backing, that are higher up the pecking order in the event of default and with investor protection embedded in the legal structure. They will then aim to hold those bonds to maturity. This enables investors to capture the liquidity premium and to invest in higher yielding bonds without increasing the overall risk of the portfolio. This strategy swaps liquidity for higher returns and security.

It is worth noting that there are initiatives in the market to improve liquidity. A number of platforms are emerging, including Market Access and Liquidnet, that offer a more 'peer to peer' trading option: buyers and sellers can reach an agreement without going through the banks. This should act to improve bond market liquidity in the longer-term. In the meantime, we aim to manage liquidity in an appropriate way for individual clients.

Active versus passive?

Although passive fixed income investment has become a more popular approach in recent years, we believe that it has real limitations and an active approach, done right, can deliver far greater value. An active manager can carefully select those bonds offering a compelling balance of income and risk. Risk in fixed income should be understood not simply in terms of default, but with reference to the type of recovery payment a bond-holder might expect.

Also, we would argue that there are structural flaws in capitalisation-weighted fixed income benchmarks, because they are naturally skewed to those companies or governments with the highest debt. These remain the most widely-used type of benchmark, though there have been attempts to launch alternatives.

The right manager

In selecting the right active manager, we believe experience is particularly important. RLAM takes a team-based, collaborative approach. The collective memory this creates is particularly important in the current environment, where prior to December's rate hike it has been almost a decade since there has been a US interest rate rise. Fixed income managers operating in the market today may not have experienced a different market cycle.

Historic performance can be an indicator of a capable manager, but investors need to interrogate that performance through different interest rate cycles. This means looking over 10-years or more, and ensuring that the team responsible for the performance is still in place.

Risk management

We use traditional risk measures for portfolio management and have strong and established risk systems in place. These can examine overall risk at a portfolio level, in addition to the risk of individual securities. However, we also believe that proper analysis of the output from these systems requires some healthy skepticism. These systems produce huge amounts of data, which needs to be properly understood. Risk systems need to be supported by quality judgments. The problem in the financial crisis was that there was an over-reliance on quantitative systems. One challenge will be how risk systems cope with the wider range of assets that now form part of fixed income portfolios.

At a wider level we think that Environmental, Social and Governance (ESG) factors will play a greater role in the assessment of credit risk. For our long-term clients, we need to consider a wider range of factors of which ESG is of increasingly importance.

We believe that fixed income markets always require a thoughtful and considered approach, but this is likely to be particularly important in 2016 as the market cycle starts to adjust. In a more volatile and unpredictable climate, balancing strategic and tactical exposure will be vital. Being responsive to changes in the market environment will also be essential to managing risk. An active approach run by experienced managers, we believe is the key to navigating these more difficult times.

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