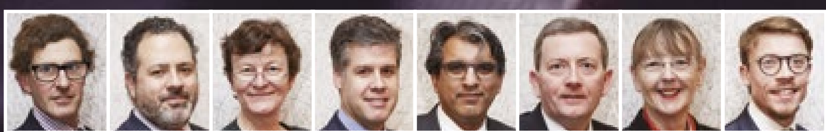
Fixed income

Moving up the risk curve for yield



Ben Shaw | Andres Sanchez Balcazar | Kate Hollis | Edward Farley | Salman Ahmed | Peter Martin | Christine Farquhar | Sebastian Cheek

APRIL 2017 | PORTFOLIO INSTITUTIONAL ROUNDTABLE


storm.
Fixed Income is no longer secure and calm, it is challenging and uncertain. Lombard Odier is fundamentally re-assessing ways to construct fixed income portfolios.
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Sebastian Cheek

Editor, *portfolio institutional*

Moving up the risk curve for yield

Investors across the globe have been forced into new asset classes to deal with a backdrop of low interest rates and loose central bank monetary policy, not to mention the looming threat of inflation and heightened political risk.

Traditional asset classes have slowly lost their lustre. Some areas of government debt have seen negative real yields while parts of the equity market have become too hot to handle for most as valuations have rocketed on the back of Trump's election and a drop in sterling.

In order to close expanding funding gaps and meet liabilities in a cashflow-starved environment, investors have had to either work their existing assets harder or look to new forms of income.

In the fixed income space this has meant moving up the risk curve into higher yielding, illiquid securities sometimes carrying higher leverage. Popular choices among institutions include high yield bonds, infrastructure and other private market assets such as direct lending and leveraged loans.

But with this search for yield has come concern from some quarters that investors are reaching too far to find it – and in doing so are teetering on the brink of sliding back into the murky pre-crisis world of high leverage and risk disguised as quality.

Some people fear investors have begun to develop unrealistic expectations of the long-term returns that can be extracted from bonds without taking excessive risk.

This roundtable discussion featuring asset owners, consultants and asset managers addresses the opportunities in fixed income and the various ways institutional investors are accessing them. It also considers the macro-economic factors at play and aims to shed light on the risks inherent in these strategies.

As always, the importance of fully understanding an investment before allocating to the different areas of fixed income can never be emphasised strongly enough.

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Andres Sanchez Balcazar

"The macro drivers are far more important than the bottom-up."

Andres Sanchez Balcazar

In the lower-for-longer monetary policy dominated world, how should investors approach investing in fixed income? Should it be from a top-down or bottom-up perspective?

Peter Martin: I lean more to a multi-asset approach with a bottom-up stock selection. This should be done in the context of a top-down overview, just to make sure the risks are managed and that you look at it holistically. It's about trying to generate some return from somewhere in a sensible risk fashion; I am wary of people pushing the envelope and taking the risk too far in the lower-for-longer tight credit spread environment.

Andres Sanchez Balcazar: The macro drivers are far more important at the moment than the bottom-up; you need to be very, very careful about the type of macro risks that you take. It would be more towards an 80% top-down and at best 20% bottom-up view, in the sense that refinancing is very available for maintaining idiosyncratic risk in credit. Default rates are very low and so the differentiation in returns that you're likely to obtain in your security selection bucket is very little, whereas your portfolio can be subject to a number of macro forces. If you just focus too much on the bottom-up then you are going to be run over by the volatility.

Edward Farley: Obviously, macro is a key driver. However, with corporate spreads across the board much tighter than they were, this is an environment where detailed bottom-up analysis is critical. There are all sorts of pitfalls within individual names, where just relying on the top-down view could lead to holding some issues that may blow-up.

Martin: The more you get in to areas which people are less familiar with, such as emerging market credit, then the bottom-up is very important. But you still need to be aware of what the US Treasuries curve is doing and how that would impact in terms of the tactical strategic allocations to these markets.

Salman Ahmed: The central banks' usage of fixed income as a policy tool is unprecedented. During the Great Depression the lowest yields were 2.5% in the US and the economic fundamentals were way worse than what we have encountered over the last 10 years. And now there is a strong geopolitical influence as well. Also due to regulations, banks are unable to provide liquidity, which has huge implications for portfolio management.

So in fixed income markets usage of market cap benchmarks are heavily challenged in this environment because you can't get in and out as quickly as you used to before.

Martin: The market cap benchmarks are very much unconstrained and Libor-plus approaches are how you get the best ideas to get the best risk-adjusted return. People are perhaps not abandoning those market cap benchmarks but they'll become less important over time. You just have to work harder and smarter to get returns and to embrace new areas. These days there's much more product in distress, opportunistic credit.

As these things are looking to fund quite quickly, so you need the understanding to get the money quickly enough. Investors all of a sudden can afford to be lenders, direct or otherwise and syndicated. You have to embrace new language like trade finance or regulatory capital which sounds scary at first but when you understand it, is quite helpful.

Ben Shaw: From my experience there are quite a lot of niche bond-like instruments you can buy. We're quite a small scheme relatively, so to buy a couple of million, five million of something actually can turn the needle and be worthwhile, whereas if you're a billion pound scheme it's not going to do that.

Kate Hollis: That's when you've got to be really careful about people reaching too far for yield, particularly in private markets. You have so much less transparency on what's going on and you could have a strategy which does beautifully for a couple of years and then suddenly blows up, because the fund manager is taking on too much money and reaching too far to allocate the capital.

Christine Farquhar: But do investors really think about fixed income as lending money and thinking about, "We're going to hold this until it matures"? Part of the problem is investors regard high quality fixed income as a cash machine, an ATM. "Yes I'll put it in that government bond fund but if I need cash, I'll just take it out tomorrow".


Kate Hollis

Shaw: As a pension scheme only five to 10% of your liabilities crystallise in any one year in a worst case scenario and therefore you can afford to lock up chunks of capital. Quite often a bond fund might be one of those areas where you don't need to lock it up because that's your area of liquidity or if you've got equities, equities can be your liquidity.

Martin: But again, it's what you're using that bond money for. If you need bonds to be liquid – if you have a collateral call, if rates do rise – then you need those monies to be obtained.

Ahmed: But what is cash equivalent fixed income now? Due to the Basel III liquidity coverage ratio, banks will be forced to hold more sovereign debt and the ECB is holding more than 30% of German outstanding debt; it's going to be 35%, it's going to be locked on their balance sheet. This is not investor-based locking, this is regulatory non-investor based locking and a significant chunk of the free float is out of the market.

So the question is what is cash now? Because the flexibility between bond and cash is broken. Because the repo market volumes in German debt is collapsing at the moment so if we think, "Oh I have this bond and I'm going to go and repo it in the market and get cash" there is a problem because that market may collapse.

Farqhuar: And in the old days liquidity in bond markets was, "I'll sell the bond". Nobody says that now, it's repo, it's borrowing.

Farley: When managing a bond portfolio, if there are potential cash calls or it has swaps and needs collateral, managers must be very cognisant that investment banks have shrunk their balance sheets. The markets whipsaw much more today. If there's bad news and you ring up a bank they may very well say, "Hey, we're the same way round as you," the bid disappears. So, it varies client by client based on their needs and objectives. For example, a long-dated sterling-centric portfolio for a UK pension fund that invests in swaps must have buckets of proper liquidity so that during adverse market conditions, it's not a forced seller of corporate bonds, which can end up quite expensive.

Sanchez Balcazar: As an asset manager you need to be very clear to clients in terms of the liquidity risk you're taking. For portfolios that are unconstrained it's very important that if you are promising daily liquidity that you're able to support it. But you're not safer on the benchmark either, which has massive concentration risk. So asset manager responsibility is much higher in terms of communicating liquidity risk to clients and the concentration risk. If you're running a diversified, unconstrained portfolio, having big concentrations in smaller credits would be a huge risk for the portfolio; it could wipe out your yearly returns.

That is why macro risk needs to be the main driver, because you don't have the choice with current liquidity conditions to generate too much in security selection and being very concentrated on a few credits, given the asymmetry of the asset class as well; the risk-rewards are just not there.

Farquhar: I rely on fund managers to make the initial credit selection the right way round, so that they're ready for the full term, that they're not going to have to sell, that they're not going to have to try and scramble out of something that's nearer to default than it should be. So that bottom-up element is even more important.

Ahmed: We have to remember in the credit space the rating and default risk is normally in a relationship that exponentially increases after double-B. If you do a time-series analysis, what you find is the nature of credit is also changing, i.e. if you just forget about the labels and start to think about duration risk and credit risk as drivers of returns, it's only after double-B you find credit risk dominating.

In fact, investment grade credit is now 90% driven by government bond movements, more so in the US than in Europe. So a label that says 'corporate bond' doesn't necessarily mean it's a corporate bond. A high quality corporate bond acts like a government bond.

Farquhar: The spread is so tight, do you actually think there really is a risk premium for investment grade credit?

Farley: Yes, if you do a historical analysis and ask, "Do corporate bond spreads compensate for default risk versus owning the underlying government bond?" I believe the conclusion is they do. If you take out the government rate and just look at credit spreads, an argument can be made that spreads are a little bit wide of their historical norm. But an argument cannot be made that spreads are enormously cheap at the moment and therefore the best place to invest. However, it really depends on the investor's objective. If a pension fund is trying to take a long-term spread over gilts in an environment where it believes it's more than compensated for the default risk and is prepared to take a more buy and maintain approach, then the risk premium in a corporate bond more than compensates.


Ben Shaw

Martin: When you're saying how you should approach investing in fixed income, all the discussion has been in the context of a fixed income portfolio. In practice, it's a question of how it fits together in a holistic portfolio. Sometimes we need to step back a bit to see it's about portfolio construction, because although you might be investing in equities, credit and other good diversifiers, it's still very interesting to note that markets do move together, especially last year when yields were falling, equities and bonds were moving in roughly the same way.

Edward Farley

"Just relying on the top-down view could lead to holding some issues that may blow-up."

Edward Farley

Shaw: The way you can address that is by having non-listed fixed income as direct investments.

Hollis: Just because something doesn't have an updated price, doesn't mean the risks aren't there; it just means you find out later.

Shaw: I don't agree. A lot of what we have to deal with is marking to market and the problems that causes on balance sheets. If you can avoid that because there's a market downturn and everything else is hit because it's illiquid and you're holding it to maturity and it should pay back £100m, then you ignore the underlying risks when you bought it in the first place, but it means it doesn't shift when the market shifts and that's quite important.

Hollis: You've got to differentiate between the intrinsic risks of the instrument and the mark-to-market risk.

Martin: Until there's impairment, investors could have a false comfort that there is no risk and no volatility, just like we saw in the property market, there is volatility but it's over a cycle, it's just hidden volatility.

How is geo-political risk impacting fixed income investing?

Sanchez Balcazar: There is a huge amount of resource right now in our industry employed in trying to forecast these types of events, which by definition are non-forecastable. We failed miserably on the last two occasions and I don't think we're going to be much better in the following ones. But a lot of that can actually be at least protected if you have the right portfolio construction. If you have the right sizing of your trades, if your portfolio is stress tested in a meaningful way. You need to look at other events, you need to look at your portfolio, how it would behave longer term in different crises to see if your portfolio

is ready for the next one.

Hollis: But all this is talking about fixed income as return-seeking; fixed income as liability-matching is completely different. First of all, active is perhaps not the way to go because if you're liability matching, you're de-risking. Almost by definition you're placing less emphasis on return and trying to add active management on top to mess up your liability match to add a bit of extra return which is counterproductive to what you're trying to do. De-risking the liability-matching part of the portfolio is really where you can use the illiquid credit because you can afford to just sit there and wait for the asset to run off. But in liquid fixed income, you almost don't need the liquidity, you just design your portfolio to match your cashflow profile, you

"We invest in loans usually secured by property assets and we achieve returns near to double digits."

Ben Shaw

have to manage the default and downgrade risk which will be there. You have to monitor it, but otherwise you just leave the portfolio and lock it up.

Ahmed: At the end of the day, maybe you have to be more realistic in terms of how much value you're going to add through active management and how much risk you're going to budget for that in your liability portfolio?

Hollis: No, because there are so many ways you can match liabilities; you don't have to do it directly with cash bonds. Once you've done as much liability-matching as you can, and there is some liability-matching you just simply can't do with fixed income, like longevity hedging or inflation, the rest of the portfolio is return-seeking and as Peter said it's then how holistically do you manage the risk? Do you want to take it in equities? Do you want to take it in active fixed income? Do you want to take it in commodities?

Ahmed: It's an interesting point you raised. Is the government bond or the corporate credit a best match of your promise to a benchmark? Because at least in my mind, the promise a benchmark makes or an insurance company, it's a corporate bond, it's not a government bond – because governments have printing presses behind them. The reason why I ask is, what goes into that LDI portfolio now?

Hollis: It depends what your liabilities are. You say very correctly that governments have printing presses whereas a lot of pension fund liabilities are to some extent inflation-linked in which case you need the inflation. Even more so you need the inflation if you think the government is going to reach for the printing press. And the other problem is with pension funds in particular, the liabilities are so long, 50, 60, 70 years, do you really want to buy a 60, 70-year corporate bond? I know you can buy 100-year EDF, you can buy a 100-year Mexican bond, is this a prudent match for a long-term liability? Do you have the transparency and the clarity? You certainly don't have the transparency and the clarity in governments at the moment; still less so do you have it in corporate bonds.

Farley: You can't solve all the long-term liability issues with corporate bonds alone. But in a world where a synthetic position requires an enormous liquidity pool to match it in collateral, what steps can a pension fund take to say, "Actually I can use corporate bonds?" You don't need to reach for a 100-year bond to add duration but it can reduce the need for cash which is not earning very much in this environment. And if you do that, what steps are best? Is it better to have an active view or a passive view? Investors with a passive view are effectively stuck with whatever is in the benchmark. Especially in long-dated sterling with long-dated UK company risks that may masquerade as diversity. But there may be all of eight different water companies, eight different electricity companies, eight different banks. They're all UK, exposed to Ofwat and other regulations. So investors may need to extend beyond the UK. Going more global suddenly introduces a lot more liquidity. It also introduces currency risk that may need to be hedged, and then there is duration risk in a foreign currency; what do you do with this risk? Do you look at the long-term correlation between dollar interest rates, sterling interest rates?


Christine Farquhar

Martin: And then currency hedges are more expensive with margin calls now.

Farley: Yes with collateral calls exactly. However, the cross currency isn't so much the issue, it's more the interest rates that will cause the collateral calls.

Hollis: The thing about doing it synthetically and then leveraging it up, you may not need government bonds to provide your collateral; it may be more efficient to do it with equity and so if you can achieve your duration synthetically in a leveraged manner, you have a much more efficient portfolio because you have much more return.

Martin: These days it's much cheaper often to repo equities than to repo gilts.

How do schemes deal with inflation risk?

Sanchez Balcazar: If you're concerned about inflation, forget about your fixed income portfolio, because it should be something else, real assets or so on, but yes that's another strong disclaimer to make to your clients, that a fixed income


Salman Ahmed

"It's only after double-B you find credit risk dominating."

Salman Ahmed

portfolio is not going to do well if you expect inflation to go to 4% or even 5% in the developed world, which is not our view. The elephant in the room is that there is no solution for inflation in the fixed income portfolio.

Martin: But again with inflation, given the caps and collars around pension scheme liabilities, a 1% or 2% change in inflation has significant impacts on liabilities, but if inflation gets well above 5% then it's capped.

Sanchez Balcazar: I run in to a lot of scepticism on many sides and correctly so because negative duration – structural negative duration – positions in a fixed income portfolio have been a losing proposition for the last five years. But there is also implicit negative duration propositions when you were talking about for example zero duration credit, which for me is a leverage short on rates. So, the flexibility needs to be there but when we are talking inflation, we are really referring not to short-term inflation surprises, like for example the ones we've had recently, but a more protracted rising inflation and then in that situation managers would be much more successful at using that flexibility.

Martin: For pension funds and other investors like myself, inflation is an interesting challenge and how you source that in fixed income or other assets to get a decent yield. That's where an awful lot more effort in terms of smarter solutions needs to be achieved.

Hollis: Well that's why we're using illiquidity of all sorts, whether it's ground rents or long lease property or infrastructure.

Martin: In terms of ground rents or secured property, everyone's chasing that, so it's becoming harder and harder to source without taking on too much risk. So, either you've got to reduce the yield that you expect or you've got to widen the parameters. And again, you have to be a bit wider in your view of what is fixed income or what is inflation-proof, whether it


Andres Sanchez Balcazar

"The elephant in the room is that there is no solution for inflation in the fixed income portfolio."

Andres Sanchez Balcazar

be social housing debt – even that comes with regulatory and political risk behind it – or whether it be infrastructure debt. It's being more open and seeing how you can source inflation products even in a wider context.

Because just buying linkers these days is not the answer; it's part of the solution but with real yields of 1.5% to 2%, there's only so far you can go.

Farquhar: The idea of shorter dated being a better reflection of current expectations of inflation brings you back round to buying things which are less liquid but at least won't suffer too much, and that comes round to loans rather than fixed income. So, floating rate loans, senior secured, less – further down the capital structure, start to look relatively interesting. I don't know how many people around this table can remember when interest rates were 12%, 13%, 14%, it felt not fully protected from inflation but the floating rate nature, if there is a genuine inflation surprise out there, will give you protection.

Martin: We have seen periods of time where inflation expectations have risen and yields have fallen – 2016 being a case in point and we saw that prior to the financial crisis. Inflation went to 5% and lending rates fell. I agree on loans that inflation linkage is there but it's very subtle and may take time to arise.

But loans are a very good asset class in the floating rate and I've been very keen on them for the last five years, but it's also been fascinating to see how the spread has been maintained, even with all this interest. But there again you see in the markets it's not just senior secured, if people are looking at yearly tranches whole loans, they're looking at financial engineering to maintain the yields.

Farquhar: That's where you come back to the value of bottom-up stock selection being really important. Because this is leverage coming in by the back door again and if and when Libor does rise, how many of those borrowers' business plans are actually going to stand up, because I can't think of a corporate management that's actually lived through a rise in rates.

Shaw: We directly invest in loans secured usually by property assets and we achieve returns near to double digits, but they're small ticket sizes and it's more like bridging and you need to trust your manager to do that successfully for you.

What other opportunities are out there?

Shaw: In aircraft leasing the risk you're taking is the covenant of the airline and the value of the aircraft in 10, 12 years' time, although it might be levered so you're taking a residual value. If you can assess those risks and you're getting a coupon all the way along, that's available in £100m chunks.

Farquhar: Rail freight, a similar space. Litigation finance, that's a good one. Corporates can't really afford to take on big legal cases because funding the case comes out of repeatable earnings.

Shaw: Yes that's a bit more of a black box because you can't see the individual things going in there, whereas with a leasing fund or infrastructure, you know the underlying asset that you're investing it. Whereas litigation is a bit more amorphous and that in theory does well, and there are some arbitrage trades that in theory are riskless, but in fact is may not be riskless; they're a bit black-boxy.

Farley: All of those issues have their own risks, as well. Going back to aircraft finance in the early 2000s, for example, there were loads of planes sitting in the desert, not being used. Value depended on the type of plane you owned and whether five years later it was in or out of fashion; some companies went bust with aircraft still in the desert.

Shaw: But at least you understand the risks you're taking up front. You're taking a risk of an airline which is your primary thing and your secondary risk is you own the aircraft and that's no different to a bond; a bond you get an underlying business, whether you like it or not and then it may, if you're very lucky, be secured; it probably isn't though.

Peter Martin

What role is fixed income playing in institutional portfolios?

Ahmed: To me the drivers of the asset allocation are more driven by regulation than anything else. Generally I see as a strategist that fixed income is actually non-return seeking. So for me, what interest rates are doing in the economy, they have become more and more policy tools. I don't think they are now applicable for savers.

Sanchez Balcazar: I would disagree with that. So, the yield is a very good proxy of the average return but is a very bad proxy obviously of the fat tails that fixed income usually has. So, for us the way you manage fixed income needs to change. The old days of getting a benchmark and getting a running yield and you always close it, opened your portfolio again and saw that it was up 4% or 5% or 6%, are over.

But as you correctly pointed out, there is no viable replacement for your whole fixed income portfolio, even in the return-seeking sense and you need a part of your portfolio that's stable, a part that acts as a bit of a wedge with the equities or the more risky and illiquid parts of your portfolio.

Martin: Trustees and other advisers and investors need to be flexible and to understand that the role of fixed income will change. So, it can meet your needs but you just need to be smarter, sometimes adopt more complex solutions to get to where you want to be.

Shaw: The regulatory environment is not really about what pension schemes were originally set up to do. The pension scheme was set up, not to be mark-to-market, but to get a decent return on its investments and pay its liabilities and now you've got this ridiculous overlay that says, "We're going to mark it to market every quarter or every year for planning purposes", therefore all the advisers say, "Well you've got to hold a whole load of fixed income because if interest rates move or inflation moves you're going to have your liabilities thrown out" and that's fundamentally wrong.

The regulatory environment for pension schemes is no longer suited for purpose.

Kate Hollis

Edward Farley

"You can't solve all the long-term liability issues with corporate bonds alone."

Edward Farley

What is the role of fixed income in DC?

Martin: Some people will still buy annuities to protect their purchasing power, so I don't think that's dead. I think fixed income will be part of a multi-asset income producing portfolio for those people who are fortunate enough to have sufficient pots to keep it in drawdown for a period of time, they will have their money invested and they will draw the income. Fund managers will have to evolve their product set to find an affordable solution to provide those answers.

Shaw: I think you're missing a point on that actually, which is that in my experience 95% of people are invested in DC default schemes and certainly stakeholders are invested in the whole portfolio. So they're not making an active choice about whether they want your investment fund or somebody else's investment fund, they're just leaving it to somebody. So unfortunately DC isn't really relevant for [active] managers like you, in my opinion, unless you can structure a product that's going to fit in the default category.

Ahmed: The critical part is the changing demographics, people who are going towards retirement where their income demands start to pick up, that's where the focus will be. A lot of the solutions which are coming through are age-based solutions. That is a default option but it's a dynamic default option.

Going Green in Your Investment-Grade Portfolio

Bertrand Gacon
Head of Impact Office
Lombard Odier

Many investors have decided to take on more credit risk as the duration in investment-grade bonds begins to look increasingly risky. We think that is a sensible strategy – but for those who cannot give up investment grade completely, a sophisticated climate bonds strategy offers a way to compensate low yields with positive environmental impact.

For 35 years investors looking for capital preservation and coupon income were able to meet those objectives with investment-grade bonds. Now, however, income investors face widespread low or negative yields in key developed markets and, if they have extended duration to find positive yields, heightened sensitivity to interest rates as well.

At Lombard Odier Investment Managers (LOIM), we think less-constrained investors should venture a little further into credit risk rather than duration, and we feel that the "crossover" sectors – bonds rated BBB or BB – are an especially compelling alternative to investment grade.

Some investors cannot abandon investment grade completely, however. They have to accept low yields. But what if there was a way to make that capital work harder in another way? We would suggest that a portfolio of climate bonds can be constructed to mimic the return-and-risk characteristics of a broad investment-grade allocation based on the Barclays Global Aggregate Index, while delivering additional positive environmental impact.

A growing market

The best-known part of the climate-bond market is the $160bn Green Bond universe. In December 2015, 223 countries signed up to an agreement to limit global climate change to 2ºC above pre-industrial levels. The World Economic Forum, using International Energy Agency and OECD data, reckons that this requires an extra $700bn of investment, annually.

Green Bonds - issued to raise ring-fenced finance for projects that either mitigate or help the world adapt to the effects of climate change – were specifically designed to address that shortfall, and it was therefore no accident that the $81bn issued during 2016 almost doubled the $42bn put out the year before. This asset class is going mainstream.

Investment-grade ratings and yields, but not a perfect overlap

In many ways, however, it was always mainstream. The Green Bond innovation of ring-fencing proceeds represented the first opportunity for impact investors to go beyond their private-market niches into large, listed household names among multilateral organisations, financials, utilities and multinational corporations. That profile also means the Green Bond market's overall credit quality and yield look very similar to those of the broader investment-grade market, which is what makes it such a promising potential replacement for part of a core bonds portfolio.

However, investors thinking in these terms should be aware that the overlap is not perfect. Green Bonds' currency exposure might differ from that of the Barclays Global Aggregate universe; maturities are on average slightly shorter; and they exhibit sector and regional tilts versus the broader market. Simply replicating a Green Bonds Index will not deliver equivalent exposures to the broader investment-grade market.

Nonetheless, constructing a portfolio from Green Bonds that does replicate those characteristics is eminently possible for an active manager – and expanding beyond labelled Green Bonds to include other "climate-aligned" bonds can further help manage these differences.

From Green Bonds to climate bonds

For example, there are non-labelled bonds issued by "pure-play" corporates that derive at least 95% of their revenues from climate-aligned business; bonds issued by corporates that derive substantial revenues from such business that are ring-fenced but not labelled; and Social Bonds that help mitigate some of the effects of climate change. The Climate Bond Initiative reckons this universe is already worth almost $700bn, and we think it will reach $1 trillion within the next three years – giving traditional bond investors a much-enlarged toolkit to work with.

Clearly, going beyond Green Bonds can introduce as well as mitigate risks, assuming that one of the main reasons for including them in an investment-grade portfolio is to enhance its environmental impact. Non-labelled climate-aligned bonds do not offer the same enhanced transparency, monitoring and reporting protocols as Green Bonds, greatly increasing the potential to be misled by "greenwashing".

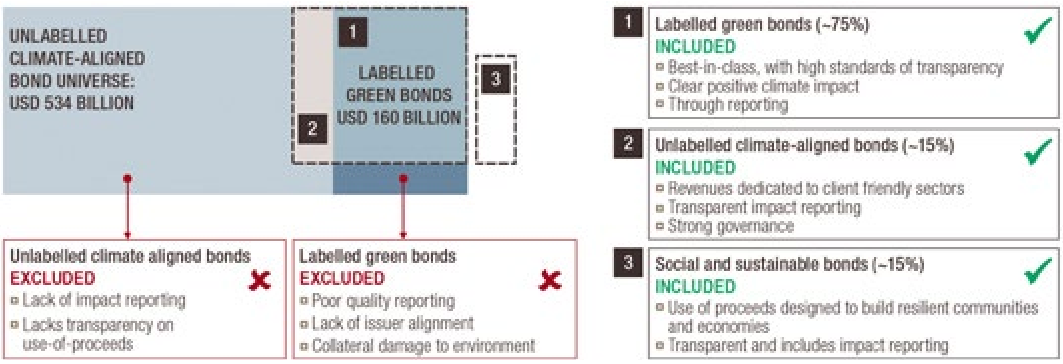
Then again, at LOIM we find that 15% of labelled Green Bonds fail to meet our impact criteria. For example, on paper the €1.2bn Green Bond from French renewable energy and power company Engie, which finances renewable-energy and smart-meter projects with annual reporting on installed renewable capacity and energy-consumption reduction, looks perfect. However, one of its projects was a UK hydroelectric installation criticised for its negative impacts on the local freshwater ecology.[1]

In short, labelled or not, to maintain integrity while investing in these markets investors need a robust impact verification process that requires extensive resources, data and research capacity to establish selection and monitoring criteria for both bonds and their issuers. No credit portfolio manager worth her salt would buy a bond just because Moody's or S&P had put a "BBB" label on it. Why behave differently in the climate bond market?

In a low-yield, high-risk environment for investment-grade fixed income, climate bonds could help make that part of your portfolio that cannot move further down the credit spectrum work a little harder. The Green Bonds market is a good place to start looking, but expanding the universe can make it easier to bring the return-and-risk profile in line with the broader investment-grade benchmark, as well as ensuring you have the right bonds to meet your true impact objectives. An active approach based on a robust impact verification process is critical, but with a little additional effort a part of your portfolio that has become a challenge itself can become a part of the solution to one of the greatest challenges ever – the challenge of climate change.

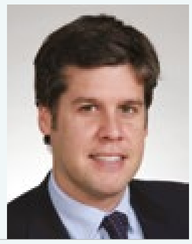
[1] Any reference to a specific company or security does not constitute a recommendation to buy, sell, hold or directly invest in the company or securities. It should not be assumed that the recommendations made in the future will be profitable or will equal the performance of the securities discussed in this document

Our view of the climate-bond market: more than just Green Bonds



Source: Lombard Odier. Illustrative only. Shows the climate-bond universe expanded in accordance with Lombard Odier & Affirmative Investment Managers' investment criteria. Other mandates may differ.

Risk: On or Off? Adding Value in Global Investment Grade Corporate Portfolios



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While we believe the underlying tone of the European corporate bond market has been constructive so far in 2017, political undercurrents are flowing faster in the run-up to several national elections across Europe. France took the spotlight in February as electoral rhetoric and poll results led to growing concern over a more populist agenda. French sovereign and corporate bond spreads both rose sharply, with the peripheral markets following suit. In fact, 10-year French sovereign yields converged with those of similar-maturity Ireland bonds for the first time in 10 years.

As much as political noise is spurring market volatility, and will likely continue to do so, we note that from a relative value perspective, the ripples from these periodic events can also provide attractive entry points, especially considering still favourable fundamentals and a host of stabilising technical tailwinds. The negative interest rate policies of the European Central Bank and Bank of Japan continue to steer investors toward higher-yielding securities, and the ECB and Bank of England's corporate bond purchase programs provide a strong underpinning.

At this juncture, the markets are still encouraged by the ECB and BoE's assurances that they will remain accommodative to keep the economies on track, despite uncertainty surrounding the timing and potential fallout as central bank support fades.

In the U.S., meanwhile, the Federal Reserve is signaling a series of short-term rate hikes over the next several years, and the new administration is expected to initiate a potential inflation-fueling economic stimulus package.

Even against these backdrops, both U.S. and European corporate spreads narrowed sharply over the past 12 months, as is illustrated below. Considering these cross currents and tighter spreads levels, should the developed corporate markets be 'risk on,' 'risk off,' or just more diligent?

Consider exploiting cross-border inefficiencies

Rather than a hard stop, we note that a more diligent, actively-managed approach across developed market corporates can still add value. Adding carefully-researched, fundamentally-sound credits following a period of spread volatility can take advantage of inefficient market pricing, especially across regions and currencies. By considering cross-border relative value opportunities in the euro, sterling, and USD corporate bond markets, investors can uncover price discrepancies for the same or similar credits caused by different economic, market, and technical conditions and lack of name recognition. Add to that varying political backdrops, regulatory and tax policies, and eligibility for central bank purchase programs, and the opportunity set multiplies.

These opportunities have become even more pronounced given the volume of non-euro and U.S.- based, reverse yankee companies issuing in the lower-yielding European markets—more than €124 billion, or about 43% of total issuance, in 2016. These credits are often priced at discounts to where they trade in U.S. dollars and offer a generous spread pick-up over similar-quality euro or sterling debt. Over time, we would expect the market to price these issues more efficiently as technical unwinding can lead to attractive, long-term opportunities.

The 'all in' borrowing costs of these cross-border trades can vary depending on interest rates, foreign exchange rates, and market spread levels. In many instances, issuers appear to have been much more rate sensitive than spread sensitive.

For example, a U.S. motion and control technology company came to market in February 2017 with a multi-currency deal. Its 10-year USD issue priced at a euro-adjusted level of mid-swaps +21 bps, compared to an 8-year euro-denominated issue priced at mid-swaps +65 bps—a curve-adjusted difference of almost 50 bps in favor of the euro issue.

In December 2016, a U.S. orthopedics firm issued a 10-year bond in euros at mid-swaps +168 bps, a discount of more than 50 bps compared to a similar-maturity bond from the same issuer trading in the U.S. secondary market. Plus, unlike the U.S. issue, the euro bonds have a coupon step up if downgraded to high-yield status.

And in November 2016, a U.S. multinational pharmaceutical company issued debt in the euro market at spreads 100 bps wider, on a cross-currency adjusted basis, than a similar-maturity bond from the issuer in the U.S. secondary market.

Actively managing a global corporate portfolio's risk exposures based on technical shifts, including politically-driven fallouts, can also add value. For example, shifting risk to non-eurozone and U.S. reverse yankee issuers when the ECB and BoE corporate bond purchase programs compressed euro spreads to less attractive levels.

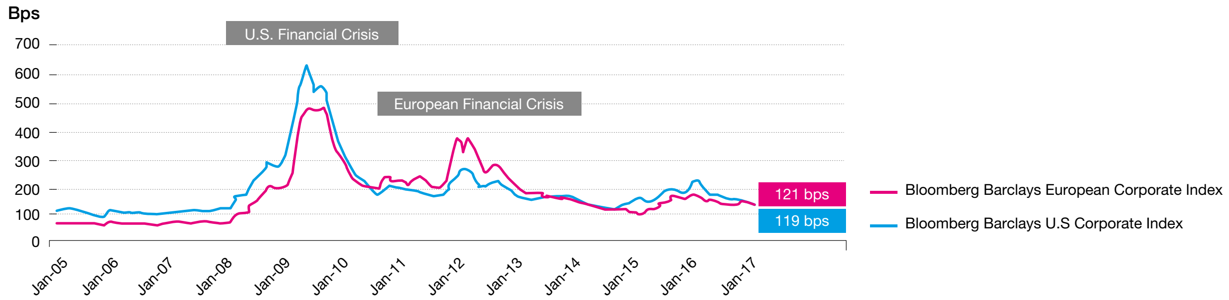
Expect the unexpected

We look for ultra-accommodative monetary policies to continue apace in Europe and Japan in 2017, setting the stage for a still favourable technical. The themes of rising populism and heightened political risk will also resonate for some time, leading to temporary risk-off appetites and liquidity limitations. Not just in France, but the Netherlands, Germany, and select European markets as Brexit negotiations advance. But just how much will the economic and political themes within individual countries carry over to other markets? Are these themes country-specific or more closely tied by a common thread in terms of underlying value?

Given cautious corporate management in Europe and the UK, modest economic growth, and negative interest rate policies that drive the search for yield, we believe intensive research and relative value analysis can still uncover value. The U.S. market also remains healthy considering the strong bid for its higher absolute yields, a potential uptick in economic growth, and the expectation for more favourable corporate tax policies.

Security selection is key across all regions, especially now that fundamentals are near or past their peak and leverage is inching higher due to lower earnings growth in Europe and ongoing event risk (M&A/share buybacks/dividend payments) in the U.S. Overall, we hold a constructive view on global investment grade corporates, acknowledging that spreads are narrow but may have room to grind tighter across various regions, currencies, industries, and individual issuers. Shifting risk between euro, non-euro, and U.S. issuers, discerning value in the same or similar credits across regions and currencies, and holding longer-term, fundamentally-based trades, such as overweighting U.S. money center banks relative to European banks, and Northern Europe vs. periphery country debt, should continue to add alpha to global corporate portfolios as the 'risk on or off' debate plays out in the headlines.

European and U.S. Corporate Spreads



As of January 31, 2017
Source: Bloomberg Barclays

PGIM FIXED INCOME

Absolute Return Fixed Income: a better way to invest in bonds in an uncertain world.

Andres Sanchez Balcazar
Co-Head of Global and Regional Bonds
Pictet Asset Management

Absolute return fixed income strategies can help investors ride out market volatility even when the unexpected happens.

Bond yields are rising sharply, central banks are getting ready to trim stimulus and clouds of political uncertainty hang over much of the developed world. In our view, in tough conditions like these, when bond investors can no longer count on falling interest rates to generate performance, flexible absolute return strategies will prove to be a more reliable source of income and capital protection.

The key is not just to identify pockets of value in the market, but also to combine that with stringent scenario analysis that aims to create a more favourable trade-off between risk and return. The result is a portfolio that we believe will perform well over the long term.

Riding through EM turbulence

How does that work in practice? Our investment positioning in emerging market provides a good example.

Emerging market hard currency debt is one of our key medium-term investment convictions; we like the asset class because it trades at cheap valuations and because emerging sovereign borrowers possess a relatively strong capacity and willingness to repay debt. During the first nine months of last year, this was indeed one of the best performing asset classes within fixed income, delivering returns of 8.5 per cent – unusually good in today's low-yield world. In November 2016, however, the tables were turned. Donald Trump's victory in the US presidential election and a stronger US dollar sparked a sharp sell-off.

But we were prepared. That's because when we decided to invest in EM debt, our scenario analysis showed the position could be a volatile one. So to shield the portfolio from any potential swings in that market, we combined the investment with short positions in EM currencies versus the US dollar. In doing so, we believed we could achieve a more favourable trade-off between risk and return. The position has begun to bear fruit.

As investors sold out of bonds from Latin America to Asia, the currencies of those countries dropped. In fact, the retreat on the foreign exchange market was more pronounced than in the fixed income space.

By being long US dollar EM bonds and short EM currencies, we were able to generate good returns from the combined position over the year, securing an advantage over investors just holding a long position in EM debt.

Preparing for Trump: a tale of two scenarios

We are sticking with this EM investment pair into 2017. The short currency position should generate good returns if the US president elect delivers on his pledge to crack down on global trade, while the bond investments should win out if he softens his stance on protectionism.

There are other ways in which we have accounted for potential Trump U-turns in our portfolio. In one scenario, we can see him go, metaphorically speaking, "guns a-blazing", and try to achieve as much as possible during his first 100 days as president. That would involve implementing his fiscally-expansive campaign pledges such a cut in the corporate tax rate to 15 per cent from 35 per cent and USD500 billion of infrastructure spending. To counter this fiscal stimulus and the inflationary pressures it would unleash, the US Federal Reserve would probably respond by speeding up interest rate hikes. In financial markets, the dollar would likely do well against emerging currencies, benefitting from both Fed monetary tightening and from a Trump-induced pick-up in economic growth.

Under a different scenario, we assume it would take longer for Trump to push through his policies and that some of them may be moderated or even abandoned along the way. The current status quo – of relatively modest fiscal stimulus, a friendly stance on global trade and gradual tightening from the Fed –will thus prevail for a while longer. In this instance, we would see value in longer-dated US Treasuries and investment grade corporates, both of which are priced for much higher levels of inflation than would be likely to materialise.

Instead of trying to predict Trump's moves – a thankless task as recent events have proven – we think a far more prudent approach is to prepare for all eventualities. That means going long the US dollar versus emerging market currencies, whilst supplementing the position with a small overweight in 30-year Treasuries and an allocation to bonds issued by US industrial firms. The latter position should do well under either scenario, with US industrials benefitting from Trump's domestic focus and his commitments to generate more US jobs and increase infrastructure spending.

Combined, these positions should help deliver attractive returns regardless of the path US president-elect Trump takes. Crucially, they all also offer attractive value in their own right.

Hedging European risk

There are, of course, countless possible scenarios that could play out across the globe and it is impossible to prepare for or even predict all of them. Fortunately, for the purposes of investment, many scenarios can be grouped together based on the binary outcomes that they are likely to produce.

The fate of Europe is a case in point. Here, risks abound, including the French presidential poll, the general election in Germany and the eventual unwinding of the European Central Bank's quantitative easing stimulus programme.

Together, these potential threats create a strong case for investors to be prepared for a sell-off in riskier asset classes. One way to insure portfolios against that eventuality is to hold a short position in Italian debt and, to a lesser extent, French debt against German Bunds.

The flipside is that all the hurdles may eventually be successfully negotiated, resulting in a strong pick-up in risk appetite and a rally in Europe's riskier assets in the second half of this year. To prepare for this scenario, we have built positions in corporate debt in the financial sector where valuations are particularly compelling at the moment.

The current politically-charged environment in Europe also fits in with our longer-term outlook for a stuttering and protracted path to euro zone reforms, with many risks – and investment opportunities – along the way.

Keep calm on inflation

All in all, there are a lot of things for investors to be concerned about in 2017. But one thing that we are not worried about – contrary, perhaps, to some of our peers – is inflation.

We accept that there is likely to be some short-term upward pressure on prices, not least because the favourable base effects from the past are now fading out. A recovering global economy is another factor, particularly through the prism of stronger US wage growth.

But inflation would be rising from very low base levels and global policymakers are standing by ready to act to contain it. Our view is that as long as the major central banks have a mandate to control inflation, we are unlikely to see price rises accelerate much beyond what is currently discounted by the market. We therefore don't think that inflation will get out of control in the coming months or reach levels that would warrant concerns from an investment point of view.

The wrong type of inflation?

Rising inflation looks to be a dead cert, but what form will it take and do schemes need to start thinking about hedging? *Emma Cusworth* investigates.

Inflation in the UK is all but guaranteed to go up in the short term, putting pressure on institutional investors trying to manage liabilities, especially where they are already cashflow negative. Over the longer term, the inflationary outlook is far from clear, however. The path to Brexit remains uncertain, but could prove decisive.

Institutions will face a tough decision on whether to hedge inflation risk despite significantly higher costs, or look through the short-term pain in the hope of lower inflation in the long term. Whichever way that goes, interest rates are unlikely to bring much relief in the short to medium term.

Inflation expectations appeared to take a sharp upward trajectory last summer as Britain surprisingly voted to leave the European Union. Recent months have seen a significant increase in the cost of inflation protection as implied by the differential between nominal and inflation-linked gilts. More demand for inflation-linked bonds means a greater premium on those assets, which has driven the differential out roughly 0.5% over the last few months. Investors choosing to hedge at today's levels would be paying that extra differential annually for decades, which would have a massive compounding effect.

According to Jignesh Sheth, head of strategy, investment consulting at JLT Employee Benefits: "If inflation doesn't go up, pension funds may be better off not paying that [additional cost]."

To a large degree, the price of inflation also gives a misleading projection of where long-term inflation expectations are.

Tapan Datta, head of asset allocation at Aon Hewitt, says: "Market inflation pricing has rocketed up in the last few months, which can be misleading as it suggests inflation expectations have done the same, but that's not the case."

Datta and other experts point to a considerable supply/demand imbalance in the inflation-linked gilt market as well as differences in underlying liquidity and relatively low issuance that give rise to what Datta says is a "very distorted" picture of the way inflation expectations have risen. "They have gone up a bit," he says, "but over 20 to 30 years it is unlikely a substantial rise will be sustained."

SHORT-TERM INFLATION DRIVERS

In the short term, at least, inflation is "guaranteed to increase", says Olivier Lebleu, head of international business at Old Mutual Asset Management (OMAM). "The question," he says, "is what nature that inflation takes."

The Consumer Prices Index (CPI) surprised on the upside by increasing to 2.3% in the 12 months to February, having hit a two-year high of 1.8% in January. This exceeded expectations in a quarterly survey by Barclays released in November which showed projections for inflation over the next year rose to 2.2%, up from 1.7% in the previous survey three months earlier. Looking out further, the survey showed inflation expectations one to two years ahead rose to 2.7%, up from 2% three months prior and the highest level since mid-2014. Five-year expectations rose 0.7 percentage points to 3.7%.

Much of the changing inflation outlook is based on relative currency moves. Over the last year, sterling has fallen 20%, fuelled mainly by the Brexit vote, after which the pound fell 15% against the dollar. That has given rise to the so-called 'Marmite Effect' of pushing up producer input prices given the translation effect of currency moves.

According to John Dewey, head of investment strategy at Aviva Investors Global Investment Solutions: "Producers are trying to raise prices as a result. While it's not clear how much can be passed on, there will be some direct pass through which will push up consumer prices."

CASHFLOW PRESSURE

The prospect of rising inflation paints a difficult background for many institutional investors. Those with liabilities to meet will see their cashflow needs increase, which will only be exacerbated as more scheme members reach retirement age in the coming years. Those schemes that are already cashflow negative will face a particularly challenging few years.

The interest rate rises that would typically be expected to off-set increases in cashflow requirements are unlikely to come through any time soon.

The Bank of England (BoE), like its US and Japanese counterparts, has already signalled its willingness to allow inflation to overshoot its 2% target. The bank revealed updated economic forecasts in early November showing the biggest overshoot in its modern history. It forecast that CPI would rise to 2.7% by November 2017.

Many economists believe it may overshoot even this forecast by some margin, however.

The National Institute of Economic and Social Research forecast in early November that inflation will jump close to 4% by the summer of 2017 while HSBC expects inflation will hit 3.7% next year. Aviva's Dewey says a 20% devaluation of the currency could reasonably result in 4% to 6% higher inflation than could occur without that depreciation.

As a result of this increased tolerance for inflation, interest rates are unlikely to go up significantly any time soon.

Andrew Tunningley, head of UK

strategic clients at Blackrock says: "Don't expect UK rates to go up in any meaningful magnitude for many years."

Andrew Pease, global head of investment strategy at Russell Investments, says it is plausible that the BoE could prove itself tolerant of inflation that is persistently above its 2% target for as long as five years.

The rates on longer-dated securities that underpin discount rates are more important to institutional investors, but as M&G head of institutional portfolio management, David Lloyd, says: "The biggest single determinant of bond yields is the official rate."

He goes on to say this presupposes that the market believes the central bank is either ahead of or on the curve. "Any notion the bond market gets that the authorities are behind the curve and markets will draw their own conclusions. We are not in that environment yet, though," he says.

Rates have fallen at both ends of the curve over the last year. Yields on six-month and two-year gilts fell 28 and 37 basis points respectively between the start of January and the end of October 2016. Yields on 30-year gilts fell 78 basis points over the same period.

Managing cashflows in a backdrop of rising short-term inflation, and low short and long-term interest rates will become an increasingly critical issue for institutions in the coming years. And, if rates stay low for as long as five years, this problem will continue to plague institutions into the medium term.

THE WRONG KIND OF INFLATION?

The hope among many is that the current increase in inflation will prove to be a short-term issue. The inflationary pressure of the falling pound is expected to ease off after a few years and inflation should correct itself.

A scenario based on lower growth resulting from Brexit would seem to support this argument.

Brexit will play a critical role in determining the path inflation walks and whether or not higher levels will be constrained to the short term. And even if they're not, will that necessarily be a good thing for institutions?

As OMAM's Lebleu says, the nature of the inflation will be key.

The "right" type is where inflation is no more than around 1% above target over the medium term and is driven by global and UK GDP growth surprising on the upside.

According to JLT's Sheth: "This is not the current driver of higher inflation and inflation expectations, which are to do with sterling depreciation and, possibly, a reduction in the supply of workers. The worst scenario would be one of ailing growth and high inflation (the stagflationary scenario). Here, the Bank of England's Monetary Policy Committee tools of the last several years – low interest rates and quantitative easing – would be less effective, if at all."

Brexit will have a big impact on which kind of inflation the UK experiences. If the UK is able to maintain a viable trading relationship with the EU, weaker sterling should act as a tailwind for the exports and the wider economy. "If the UK is not able to maintain that relationship, it will almost inevitably end up in a recessionary environment," says Aviva's Dewey.

However, although Europe is the UK's main trading partner today, the region is not likely to see much growth itself in the coming years.

"It may be better [for the UK] to tilt towards faster growing economies," OMAM's Lebleu says. He believes the question of a hard or soft Brexit is irrelevant. "There is only one kind of Brexit," he adds. "That is to leave the EU institution and become an external trading partner. That is not necessarily a bad thing in the long term, but I'm not sure the economy is up for the transaction costs [of changing the trade regime] in the short term. The transaction costs will be higher than people currently think."

He points to rent-seeking segments of the economy – car manufacturers, farmers and finance to name a few – where the costs of moving to a new trading regime will be higher than the aggregate cost of EU membership today.

"This weighs on growth and will likely lead to the wrong kind of inflation," Lebleu says.

There is currently no clear view on how Britain will navigate its exit from the EU, or what that will mean for the future of the British Union. It may be some time yet before we know exactly what kind of inflation UK investors are going to be dealing with. This isn't likely to be clear until the back end of 2017 at least.

TO HEDGE OR NOT TO HEDGE?

The prospect of a sustained period of inflation and the pressure that places on cashflows if rates stay low creates a dilemma for institutions. On the other hand, what if inflation does indeed settle back to lower levels further down the road? Global structural trends – demographics, automation, globalisation – all point further towards lower inflation in the longer term.

Aon Hewitt's Datta says the prices of direct inflation hedging in the UK look "too high to put on hedges". "They have already risen by quite an amount and there is arguably more to come," he says. "Investors are faced with a difficult choice of whether or not to hold out for better prices."

However, there is still significant concern that inflation risk could be higher in the future. Given that risk, schemes may still be happy to pay for hedging despite it being more expensive in order to take some risk off the table.

JLT's Sheth says funds should take a "phased approach" and look for opportunities to hedge that are not just limited

“The probability of a period of sustained high inflation has increased. That has driven up the cost of inflation protection, but it may still be worth protecting against.”

Jignesh Sheth, JLT Employee Benefits

to direct sources of inflation hedging such as gilts.

“The probability of a period of sustained high inflation has increased,” he says. “That has driven up the cost of inflation protection, but it may still be worth protecting against.”

He points to alternative inflation protection options including infrastructure, property and even equities for those who can stomach the volatility.

“These asset classes have a looser link to inflation, but offer better prospects for growth than government bonds,” he argues.

Pension schemes can also look to their sponsors to share the spoils of the weaker currency to reduce deficits. “If companies are enjoying the windfall effects of a weaker pound, then their capacity to pay more in is higher,” Datta says.

“It is reasonable for pension schemes to look for that, but companies may feel they have already done so,” he continues. “It comes back to hedging – if there is adequate hedging in place, then the sponsor doesn’t have to worry as much.”

Aviva’s Dewey believes investors should seek to hedge inflation risk in the most cost efficient way possible and in the battle to do so, being nimble is key. “Over the last year there have been a couple of instances where investors could have put hedges on at around half a percent less,” he says.

“Those opportunities do exist, but you have to have a plan and be ready to exploit them when they arise.”

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