Fixed income asset allocation insights

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JAMIESON COOTE BONDS

What are the signposts that your portfolio is overweight in equity risk?

In this short paper, we look at why the asset allocation of portfolios may need to be re-weighted in light of years of low volatility and attractive returns. Against the prevailing economic and financial market realities, we examine the performance over time of higher risk securities versus high grade bonds and how a well-blended mix of high grade bonds can help defend and protect portfolios in different environments over time.

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ASSET OWNER ATTITUDES AND ISSUES

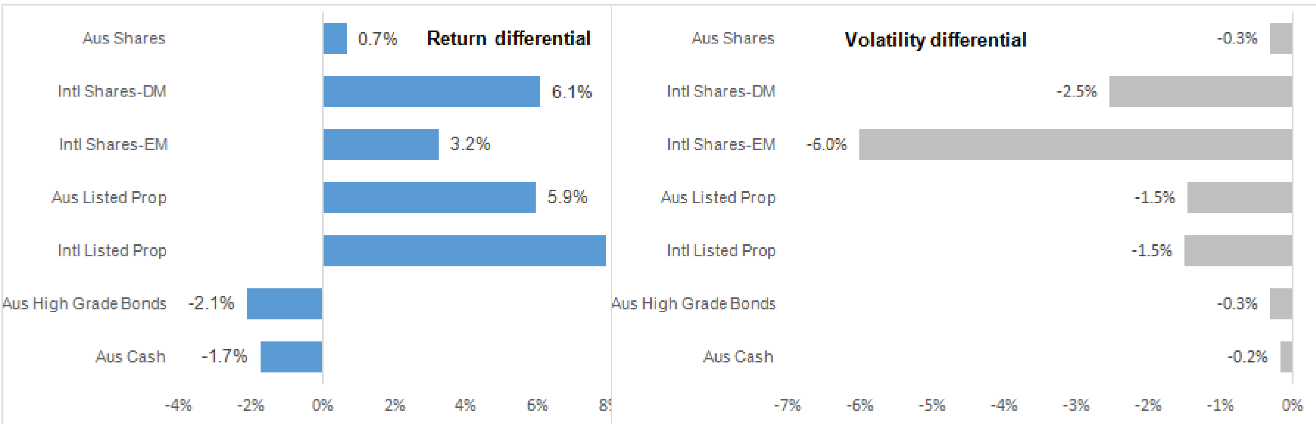
Since the Global Financial Crisis (GFC), investors have enjoyed benign conditions that have translated into higher investment returns with relatively low volatility compared to long term trends (see Figure 1). Whilst these results have delivered attractive performance with seemingly muted volatility, the danger is that many investors may become complacent with their portfolio holdings and their inherent risks. This is due to a possible misallocation of assets (i.e. size of positions across asset/sector/security), a portfolio bias toward growth assets (such as equities and property), or a reliance on credit-oriented investments, all of which can translate into unintended risk concentration within a portfolio.

This can be a naturally occurring phenomenon as these types of assets have delivered outsized performance, and hence holding balances have expanded over time – possibly moving investors outside their risk tolerances. If a correction eventuates or the world encounters a major shock, investors may find they abandon their strategy by selling their higher risk securities at a time when prices are falling. Investors could suffer outcomes similar to that of the GFC which was largely a consequence of the same misallocation of assets mentioned above.

Many investors may have been lured into a false sense of security with regard to asset allocation and risk. Investors may need to consider looking at rebalancing back to their long term strategic asset allocation to help determine returns for the level of risk they are willing to take.

Figure 1: Since the GFC, returns for higher risk securities have been elevated whilst volatilities have been suppressed.

Return and volatility differentials (per annum) of common asset classes – recent vs long term trends.



Source: JCB analysis, based on data sourced from Bloomberg, from December 1994 to March 2018.
Notes: Australian Shares: S&P/ASX 300 Index TR; International Shares DM: MSCI World ex-Aus in AUD TR; International Shares EM: MSCI Emerging Markets Index in AUD; Aus Listed Property: S&P/ASX 300 A-REIT Accumulation Index; International Listed Property: FTSE EPRA/NAREIT Developed hedged in AUD Net TR; Aus Cash: Bloomberg AusBond Bank Bill Index. All coupons and dividends are assumed to be reinvested into the index. Past performance is not an indicator of future performance.

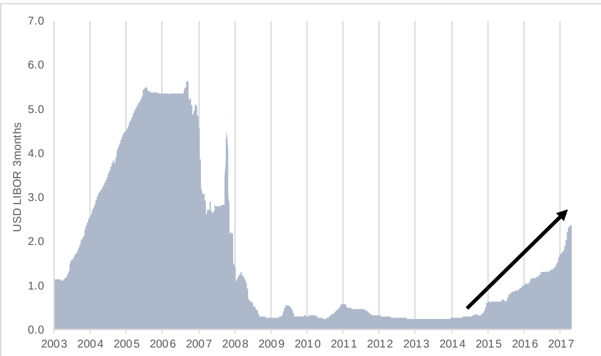
Most recently, the conditions around the cost of capital, volatility, credit liquidity, geopolitical risk and equity market risk are changing. News flows around possible trade wars and Syrian/Russian geopolitics have appeared to improve, which has allowed risk markets to rebound. The more concerning aspects that investors should be aware of include two current examples – the impact of rising funding costs combined with decay in economic data.

1. Funding costs

Funding rates in both USD and AUD markets have tightened in recent weeks, far outrunning the pace of U.S. Federal Reserve rate hikes. Figure 2 illustrates this through the U.S. LIBOR level over time (the rate at which banks in London lend to each other). This is the reference rate on more than US$3.5 trillion of loans and as it climbs, so do interest payments on that debt burden. This illustration is often seen as a marker for financial system stress as liquidity becomes an issue. LIBOR rates have risen by the equivalent of three U.S. Federal Reserve rate hikes in 2018 alone. The Federal Reserve is widely expected to continue to increase interest rates as soon as June 2018.

Figure 2: Potential liquidity squeezes with real implications for the global financial system.

U.S. LIBOR levels over time.



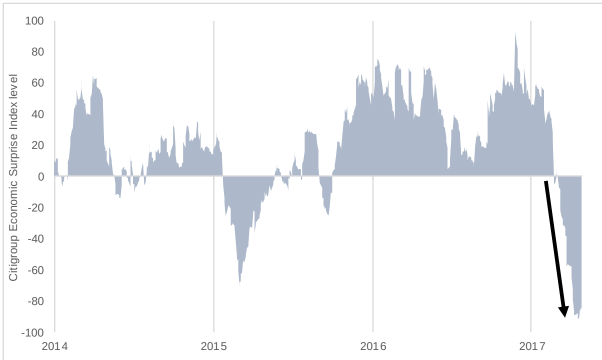
Source: JCB analysis, based on data from Bloomberg.

2. Decaying Global Data Velocity

Of additional concern is the rapid decay in global data velocity, particularly in Europe. The Citigroup Economic Surprise Index shows the collapse of European data when compared to expectations. This is a concerning forward indicator. The synchronisation of European data with that of Asia and the U.S. was seen as a marked turning point in a sustained global recovery that has just decoupled.

Figure 3: Decay in global data velocity, particularly in Europe.

Citigroup Economic Surprise Index.



Source: JCB analysis, based on data from Bloomberg.

WHAT DO LARGE INVESTORS THINK?

Whilst global growth was heralded as being synchronised at the beginning of 2018, that path has been altered by faltering regions via policy changes and other disappointments. Central Bank policies have driven robust asset class returns as noted above. The tightening bias that is foreshadowed by the bond market moves (in the U.S.) will impact those same asset classes that have enjoyed the tailwinds that come with historical Central Bank policies. Whilst the world appears to be on sure footing since 2009, debt loads have exploded at essentially record low yields. Rising interest rates and rising inflation, being led by the U.S. will bring significant pressure right across the asset class spectrum.

Today we find ourselves late in the credit cycle. Risk is likely to be more keenly priced than before, and certainly more so than under the heavily distorted emergence from the GFC. This will affect all asset classes, with returns likely to be tempered relative to recent experiences, and volatility is likely to return to normal levels.

Given this context, investors may need to make a number of portfolio changes if they are to adjust for the environment ahead and set realistic return targets. Some key questions include:

- How much longer will the sharemarket continue its record run post the GFC?
- What alternative ways exist to generate return and/or yield?
- What additional assets can be secured to bring more portfolio diversification and capital protection?

Most recently, JCB has noticed a growing trend of attention to 'defensive' exposures (led by large institutional investors). Some of the themes discussed with JCB at an Investment Committee level include:

- **Asset allocation:** are current asset allocation levels to defensive assets appropriate moving forward?
- **Risks:** are we aware of, or comfortable with, the risks being assumed in terms of current defensive assets?
- **Capital preservation:** what assets can properly perform the role of defending and protecting over different market environments?

DEFENSIVE EXPOSURES DESIGNED TO PRESERVE CAPITAL

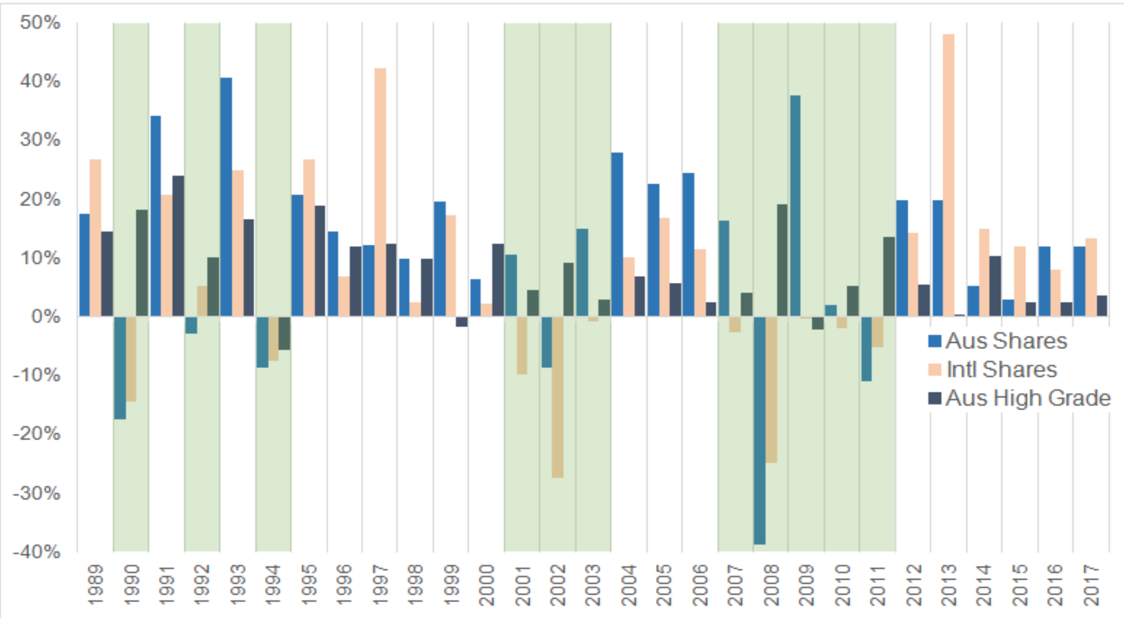
Investors who seek greater defence within their portfolios may be looking to secure some of these key components:

- **'Left-tail' risk protection** to diversify against higher risk assets in response to significant disasters or events such as earthquakes to large cities, nuclear moments and/or widespread contagions.
- **Principal and income stability** over different market conditions.
- **Premium over cash holdings** in a simple format.

AAA-rated and highly liquid high grade bonds, comprised of Commonwealth Government Bond Securities, State-issued paper and Supra-National paper issued in AUD – satisfy all of the abovementioned portfolio needs. While assets such as hybrids and credit tend to be backed by corporates (specifically the financial sector), high grade bonds are explicitly backed by highly rated Government entities which ultimately complement these corporate holdings. Australian high grade bonds historically have dampened negative effects from domestic and global shares (see Figure 4).

Figure 4: High grade bonds have historically defended and protected when needed.

Calendar year returns of Australian shares, international shares vs. Australian high grade bonds.



Source: JCB analysis based on data from Bloomberg. Notes: Australian Shares: S&P/ASX 300 Index TR; International Shares: MSCI World ex-Aus in AUD, TR; Australian High Grade: Bloomberg AusBond Treasury Bond Index 0+ years. Calendar year returns to 2017. Assumes all dividends and coupons are re-invested into the index. Past performance is not an indicator of future performance.

Over eleven (11) calendar years of negative performance for Australian or global shares (as shown by the green shaded years in Figure 4), high grade bonds have protected on nine occasions, representing an effective diversifier against higher risk assets and ultimately protecting on the downside.

The ability to improve portfolio efficiency is evident when looking at the 'efficient frontier' of Australian shares partnered with a mix of bonds (both high grade bonds and credit – see Figure 5). High grade bonds are explicitly backed by highly rated Government entities which ultimately complement these corporate holdings. By introducing this mix to an Australian share portfolio, JCB calculates the incremental return that is sacrificed as small (-0.33% p.a. in the case of having a 50/50% split), while the volatility reduction is over -6% p.a.

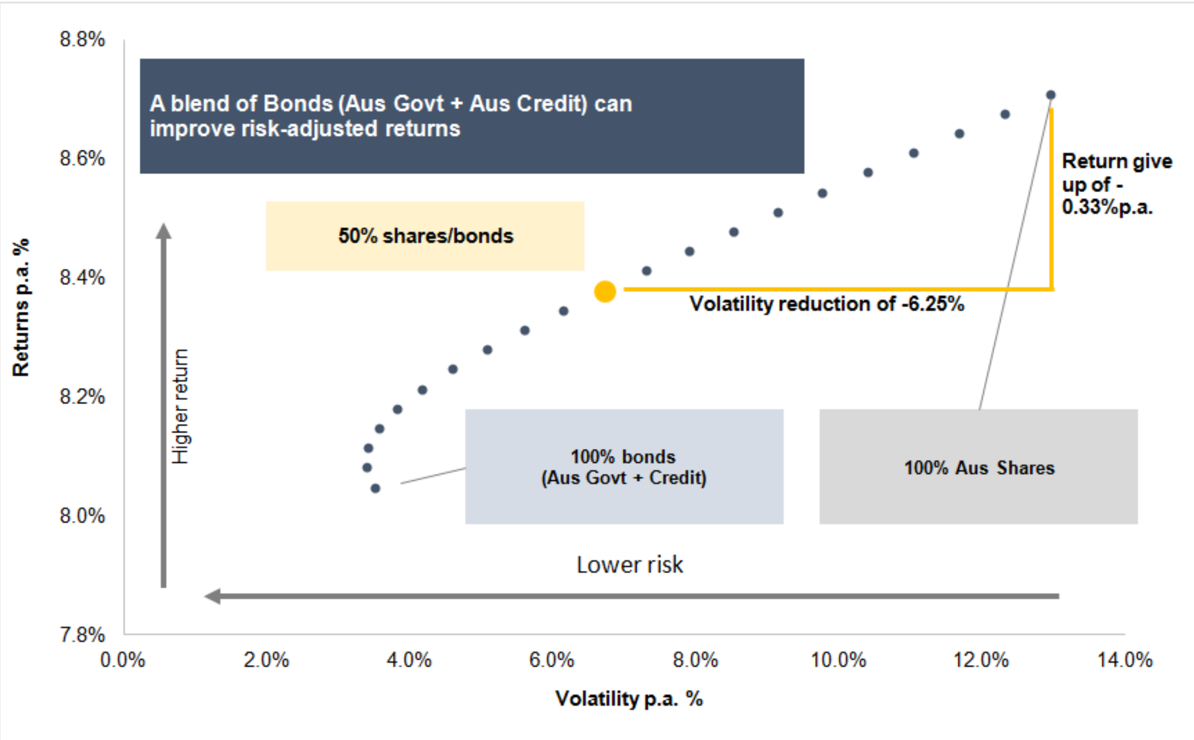
HIGH GRADE BONDS CAN DELIVER DEFENCE OVER TIME

Even in rate hiking environments, Australian high grade bonds perform well over time (see Figure 6). Since 1990, there have been three negative calendar years. Critically, it is not in itself a rising environment that is detrimental to high grade bonds, it is when there is material and sustained rate hikes.

Even then, with a negative calendar year outcome (for example, as in 1994 when rates increased by 2.75% within a six month period and remained there for two years), the subsequent three years resulted in robust index returns. This underlines the self-rebalancing nature of high grade bonds (in contrast to shares where fluctuations can swing dramatically and the asset itself lacks the income-accretive coupons attributed to high grade bonds). Additionally, high grade bonds typically exhibit lower volatility than shares – this becomes self-evident when contrasting the annual outcomes since 1990, as seen in Figure 4.

Figure 5: Australian high grade bonds (in partnership with credit) have dramatically dampened volatility with little return sacrifice for investors.

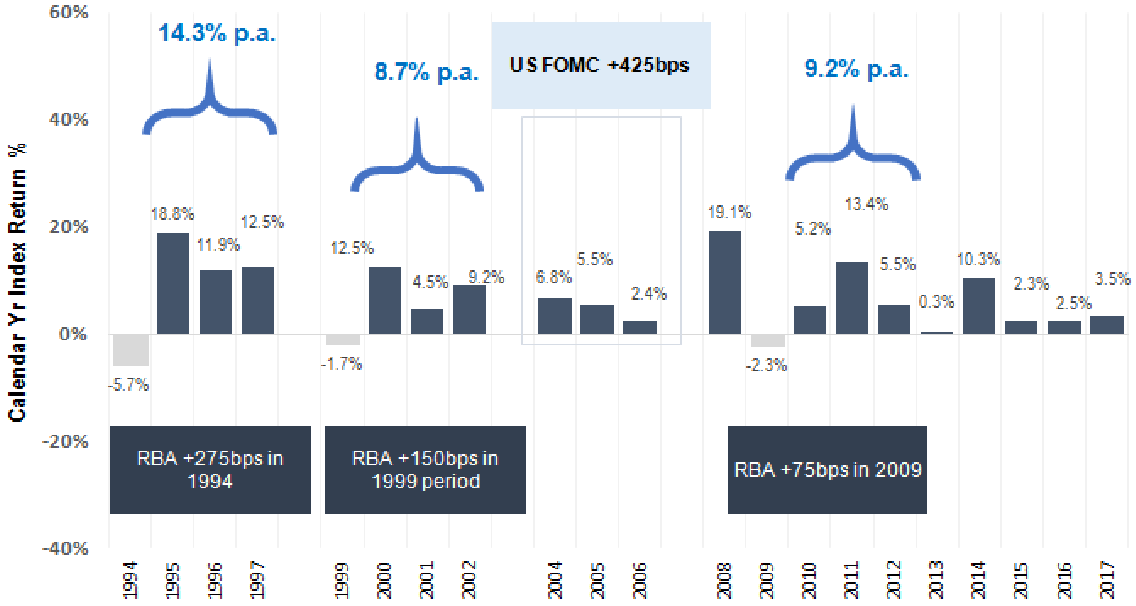
Notional efficient frontier of high grade and credit bonds with Australian shares.



Source: JCB analysis based on data from Bloomberg from September 1989 to March 2018. Notes: Australian Shares: S&P/ASX 300 Index TR; Australian Credit: Bloomberg AusBond Credit Index 0+yr; Australian High Grade: Bloomberg AusBond Treasury Bond Index 0+ years. A constant mix of 50% credit and 50% high grade is assumed within the bond allocation – this has been rebalanced back to neutral at month end. Assumes all dividends and coupons are re-invested into the index. Past performance is not an indicator of future performance.

Figure 6: Australian high grade bonds are self-rebalancing.

Calendar year performance for Australian high grade bonds.



Source: JCB analysis, based on data sourced from Bloomberg. Notes: Australian High Grade: Bloomberg AusBond Treasury Bond Index 0+ years. All coupons and dividends are assumed to be reinvested into the index. Past performance is not an indicator of future performance.

IMPLICATIONS FOR INVESTORS

JCB is somewhat concerned that any major and unforeseen economic, financial market, political/policy misstep or non-economic (e.g. geopolitical tensions, extreme weather and climate events) road bumps ahead may potentially impact unbalanced investors (as was the case during previous crises) especially for those in pre-retiree or retirement phase. Specifically, we consider that too much attention is being spent on growth assets as investors try to drive returns in a late-cycle stage.

Risk should be at the core of a well-considered and diversified portfolio. We believe investors should consider defensive assets within their portfolio, inclusive of a different source of risk in high grade bonds. We also believe that rational portfolio construction approaches, which rise above the market 'noise', will also serve investors well over time.

Against the prevailing economic and financial market realities, this paper serves to highlight that a well-blended mix of high grade bonds can continue to help defend and protect portfolios in different environments over time.

JCB believes an actively managed and well constructed portfolio of high grade bonds can:

- defend over time by providing the stability of principal and income;
- offer liquidity in all market conditions;
- provide good diversification against higher risk asset holdings (such as shares and property);
- represent a different source of risk (relative to other commonly held financial-sector risk present in portfolios). This includes corporate bonds, hybrids, cash/term deposits for amounts of greater than A$250,000 not guaranteed by the Government, negatively-geared property and major bank shares; and
- improve risk-adjusted returns when combined with credit in a balanced portfolio.

ABOUT THE AUTHOR

As Head of Investment Strategy and Research, Paul Chin provides macro input into the JCB portfolio construction process. He regularly engages with external investment committees, consultants, researchers, institutional investors, CIOs and trustees on asset allocation and portfolio related issues.

FURTHER INFORMATION

JCB is an investment manager partner of Channel Capital. To learn more about JCB and their investment strategy, please contact Channel Capital.

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