

# INVESTING IN FIXED INCOME, EUROPE 2014

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The fourth annual report which considers investing in fixed income assets in an era of low yields and heightened sensitivity to a potential interest rate rise.

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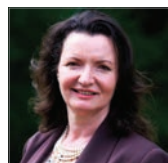


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# INVESTING IN FIXED INCOME, EUROPE 2014



**Helen Roberts**

*Investment Policy  
Lead Adviser, National  
Association of Pension  
Funds (NAPF)*



**James Bevan**

*Chief Investment  
Officer, CCLA  
Investment  
Management*



**Andres Sanchez -  
Balcazar**

*Co-Head of Global  
Bonds, Pictet Asset  
Management*



**Mark Hedges**

*Chief Investment Officer,  
Nationwide Pension  
Fund*



**Mark Cernicky**

*CFA - Managing  
Director, Senior Product  
Specialist, Principal  
Global Investors*



**Ian McKinlay**

*Pensions Investment  
Director, Aviva Staff  
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- *Anthony Simond, Research Analyst, Emerging Market Debt, Aberdeen Asset Management*



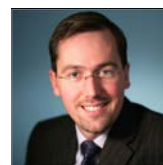
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*Chairman, Bank of America Trustees and Independent Trustee, Pi Consulting*



**Alan Cauberghs**

*CFA – Investment Director, Schroders*



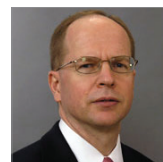
**Alex Veroude**

*Head of Credit, Insight Investment*



**Anton Eser**

*Deputy Head of Fixed Income, Legal & General Investment Management*



**John Redding**

*Vice President, Portfolio Manager, Eaton Vance*



**Nick Gartside,**

*International Chief Investment Officer for Fixed Income, J.P. Morgan Asset Management*

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# SECTION 1

## THE GLOBAL ECONOMY AND A CHANGING RATE ENVIRONMENT

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### 1.1 ROUNDTABLE

Is fixed income evolving from a liability matching to a return seeking asset class?

### 1.2 WHITE PAPER

Bond investing is changing. Are your strategies still fit for purpose?

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## 1.1 ROUNDTABLE

### Is fixed income evolving from a liability matching to a return seeking asset class?

#### Moderator



**Elizabeth Pfeuti**  
*European Editor, CIO*

#### Panellists



**Andrew Cheeseman**  
*Chairman, PAN Group*



**Helen Roberts**  
*Investment Policy  
Lead Adviser, National  
Association of Pension  
Funds (NAPF)*



**Ian McKinlay**  
*Pension Investment  
Director, Aviva Staff  
Pensions*

**Elizabeth Pfeuti:** Given the economic outlook and expectations of interest rates normalising, what does this mean for fixed income markets?

**Helen Roberts:** What is normal? Historically 4% was thought of as the average level for UK base rates but the consensus is now pointing to 3% as the new normal. Markets however are expecting base rates to reach 2 to 2.5% by 2017, so new or old, we are far from any normalisation of interest rates for many years.

All assets are judged to be very expensive at the moment so our pension funds are finding it hard to find value anywhere. For the first time for many years, some pension schemes are adding to their cash holdings. In terms of what could surprise the fixed income markets, I disagree with the opinion that Quantitative Easing (QE) unwinding is off the agenda because of the losses that would be crystallised. At the time when QE was introduced, Monetary Policy Committee (MPC) members at the time publicly stated that they fully expected losses when QE was unwound and this would be a price worth paying to avoid a recession. With most pension funds and also economists believing that QE will not be unwound, the big fly in the ointment is that even a partial unwind would be a huge shock to the market. Remember the impact of the taper

tantrum in the U.S: any selling of gilts in the UK could have a dramatic impact on UK assets.

The bottom line is that fixed income yields are expected to go up very gently during the course of the next year. Pension funds are still desperate for yield, so they will continue to hold and most likely add to their fixed income holdings.

**Ian McKinlay:** I look at it differently in that trying to predict or guess what is going to happen to the path of interest rates is extremely challenging so can you align your portfolios to insulate yourself from that particular risk? By way of evidence, the ability of markets if you look at the predicted forward curves, have been so wrong for quite a while now. We are also in the middle of the biggest financial experiment that the world has ever seen so we really don't know how it is all going to end.

Instead I try to think in terms of the bank rate and can I beat the bank rate. I feel that I can beat the bank rate but I can't predict interest rates as it is just too difficult. For those who don't like LDI that's just tough because that is what it means!

Returns from here are going to be pretty low and we are going to have to grind it out. Accepted there are some managers who can and will be able to

do better than that, but returns and opportunities are much thinner or less scalable than even a couple of years ago. Generally as a group of investors we need to be prepared to grind it out.

**Andrew Cheeseman:** The term normalisation is a problem for me, as I see normal as wherever we are at the time, and how we are trying to cure a particular event.

I am a pension trustee and when people say that interest rates will rise, that is short-term interest rates not long-term rates. Even in the past few years I have seen interest rates which go up or down or flatten and so there is no normal rate. Even if short-term interest rates rise there seems to be this undying belief that long-term interest rates will go up by the same amount and it may not happen because we know it hasn't always happened before.

Pension funds aren't everything, but Regulators are. The biggest drivers at the moment are the Regulators. As an example a small part of our business deals with individual pension arrangements which until recently required us to have a liquidity reserve of £50k. Then the Regulator decided in its wisdom that although we are trustees we will be required to increase our liquidity requirement to £500k. This is a big change and an example of how Regulators have a big impact on the



banks and financial service industry, and that will have an impact on where we will have to keep our money as we will have to go much shorter term.

The biggest impact though comes from the one off events as they occur all the time now, and so we will have to adjust for them as they do affect interest rates. The honest answer as Ian said is that no one has a clue what normalisation means and there are too many events which are outside the modelling of what the academics do. We could end up with short-term interest rates remaining where they are for some time.

**Elizabeth:** Do you think that the role of fixed income within an investment portfolio has changed?

**Andrew:** Why do we invest in fixed income? We invest in it to match liabilities, and liabilities are driven by other things.

The first thing to decide is whether you are really looking for cash flow and what your true liability is. I am forced as a trustee into using a system of valuations which are of no use to me whatsoever. All it is doing is driving me towards fixed interest. Because interest rates have been dropping, people are under the misnomer that this is producing growth and is fantastic, but this is offset by the way in which we are valuing our liabilities. If we went back to just using discounted cash flow we would probably be better off.

I don't agree that people will move towards cash as cash is not an investment, so the first thing is to define cash which is not just money in the bank. With a bit of luck some of the providers will work things through and start to see more innovative solutions. With the likes of absolute return bonds why would you go into cash - why would you give up the return?

The only time I went into cash was when I sat in a trustee meeting and we did not know where to invest our

money prior to the recent crash, which may be true at the moment because I am worried about equities and bonds. In one of my trustee meetings we went around the table and asked everyone where they invested their money and everyone said cash so we cashed out and missed the crash. So sometimes it does work out although it was a very brave decision and I don't think too many pension funds would do it.

The title of this debate – is fixed income evolving from a liability matching to return seeking class, is possibly a little back to front? In the good old days where interest rates were 15%, fixed income was a bit of ballast or diversity, but to me is evolving into a liability matching class in its own right. I know there are managers out there who may have absolute return and have more trading type strategies but we are moving in a different direction. The one thing that worries me about trading strategies and fixed income and particularly credit is whether the inventory is there to support trading strategies. I wonder if there is something of a paradigm shift within the banks because capital requirements are stopping them absorbing trading flows. Trading strategies may not be as scalable as they once were. So we are moving our portfolio away from aggregate type credit towards a 'buy and maintain' which has a longer duration, which will then be run down gradually, whilst providing a match for a specific cohort of liabilities.

It will be global so we need longer dated cross currency hedges, so it means a bit more engineering and the like, but that is what we are going to try and do so it's a different way of using fixed income and more credit.

**“Pension funds are increasingly using fixed income assets as both liability and risk seeking assets.”**

**Elizabeth:** Is fixed income now seen as a return seeking rather than a liability matching asset class, or is this a misconception, and actually specific to certain types of fixed income only?

**Helen:** Pension funds are increasingly using fixed income assets as both liability and risk seeking assets. Liability surrogates that look and act like a bond but offer a superior yield to gilts are becoming increasingly popular. Examples of such investments include social housing bonds, infrastructure, leaseholds, and ground rents. What pension funds are looking for is sustainable, long-term cash flow with a reasonably robust credit rating and a decent yield of around 2% in excess of gilts. Accessing these assets however is problematic so the average pension funds have only a small allocation to these wanted assets. Pension funds are increasingly ready to take on more illiquidity in their portfolios if they are compensated with extra yield but getting hold of these assets is not easy.

**Andrew:** My pension funds range from a DB start up with zero assets to billions and the problem is, at the lower end, trustees are restricted in what the market offers them. At the higher end yes we do everything we can to get them stable income and reduce risk but it is about finding the products and analysing them properly. I don't feel that when investment consultants come to us that they actually understand half the things that they are offering us.



**Elizabeth:** Has the prolonged low yield environment permanently changed the dynamics of asset allocation, so that investors now diversify to a much larger extent, or will they return to their old strategies when the economy improves?

**Andrew:** The question is wide and the way that I would normally look at portfolios at the moment is that I have my asset matching path on the liability side and growth. The difference over recent years is that people have realised that corporate bonds aren't liability matching because of the duration and so we are looking at that part of the portfolio as a growth asset. There is a subtle difference in the way that people have been educated but we will probably go back to other things when the economy improves but options will be restricted by the maturity of the scheme. At the moment what makes a finance director happy is not have a big blip on his accounts within the years that he is in the job.

**Ian:** A lot of investment ideas amount to old wines in new bottles and we are just trying to tinker with them. We haven't talked about DC but the DGF for the accumulation phase has become a bit of a standard. That diversity has become baked in, and it had been criticised during the crisis for not working but if you actually look it maybe didn't work as well but we still saw diversifying effects coming through with lower drawdowns than say, equities. Illiquidity has changed as well.

**Andrew:** The current problem is that we agree that DGFs have their use and will control the volatility, so we designed DC lifestyle strategies to incorporate them. Then somebody comes along and says that you have to have a default strategy which has a maximum charge of 75 basis points. The first thing is that you can't run a DGF and do the administration as well as everything else for 75 basis points. But even worse is that if everyone is in this wonderful plan that you have

designed, and they don't want to come out of it you are forced into only charging 75 basis points because another rule that has been thought up is if your lifestyle fund has more than 80% of the membership utilising it you have to reduce costs to 75 basis points. But you can't reduce your costs so you can't have it as your default strategy so actually the government is forcing everyone into passive funds which is downright ridiculous.

If you actually look at the budget I would never put a pension plan in and would just give people termination payments as DC does not fit the new regime.

**Helen:** In the 'old' world pension funds would have had a 60% equities, 40% fixed income split. By today, asset allocation has been turned on its head. Given the huge regulatory change that we have seen, I believe fixed income will be a key characteristic of pension schemes going forward with equities being the poor relation. Diversity of assets and strategies is also likely to be an enduring theme for pension schemes. The globe has become a lot smaller with a wider opportunity set, for example in China and the emerging markets. As long as these assets can be accessed easily and at a competitive price then pension funds are likely to invest.

Just a word to finish on DC investing. The National Association of Pension Funds (NAPF) is supportive of the flexibility that was announced at the Budget but is also concerned that a number of questions remain unanswered with only five months to go before implementation.

**Elizabeth:** Thank you all for sharing your insights into this topic.

**"A lot of investment ideas amount to old wines in new bottles . . ."**

## 1.2 WHITE PAPER

### Bond investing is changing. Are your strategies still fit for purpose?



**Alan Cauberghe**  
CFA – Investment  
Director, Fixed Income,  
Schroders

**B**ond markets are changing. For many years interest rates have been falling. This has been positive for traditional core sector bond managers who will have seen the assets they manage surge higher and higher. However we are now at the end of this trend. Short-term interest rates are close to zero and have little room to go any lower. In fact markets are pricing in interest rate rises over the next few years. This leads us to believe that bond funds investing in traditional core sectors will no longer be expected to experience such favourable returns.

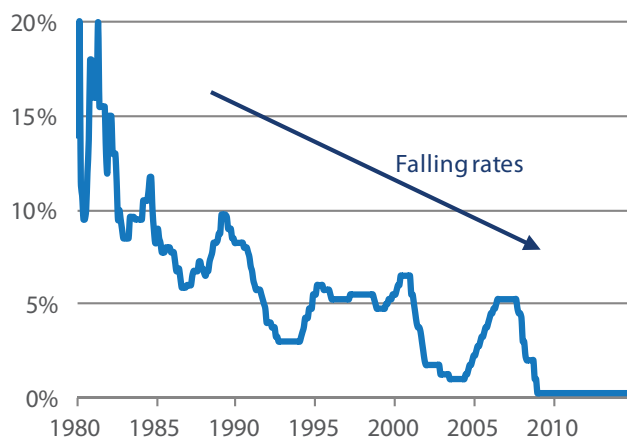
In this short paper we discuss how a different approach to managing bonds, away from the traditional core sectors may now be appropriate. We believe that investors should be considering a bond strategy that utilises:

- **A cash benchmark and 'cash plus' target.** Bonds may fall in value going forward. Cash though could be expected to grow with interest rates. Strategies that target a 'cash plus' return can deliver even further value.
- **Unconstrained, diversified return strategies** in place of reliance on traditional core sectors. Core bond funds typically have a large reliance on the U.S market. Diversifying away from this one factor can help improve the consistency of returns.

#### A raising interest rate environment

**Figure 1: Historic and future expected interest rates**

##### Historic U.S interest rates



- **A liquid approach.** Strategies that are nimble enough to change tack if the market direction turns may now be sensible.

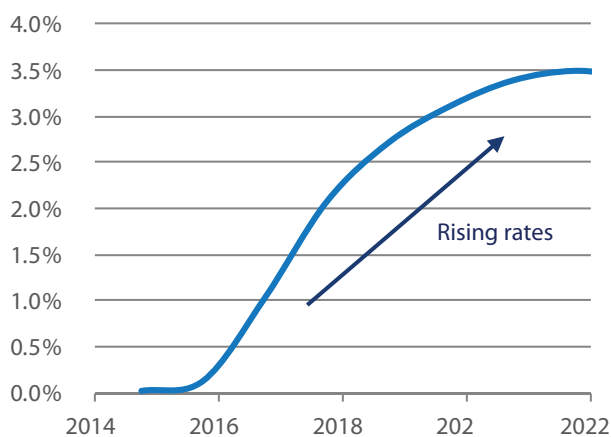
As shown in Figure 1, U.S interest rates have been falling for over 30 years. This trend has also been in evidence in most other developed economies. High interest rates were adopted in the 1970s in an effort to reign in rampant inflation. This largely worked and short-term interest rates have been trending downwards ever since. Decreasing rates, have not only been good news for bond assets, they have also been beneficial for companies and have helped foster wider economic growth.

However, as can be seen in Figure 1, short-term interest rates are no longer falling. In fact the Figure shows that government bond markets are expecting interest rates to rise back to more 'normal' levels in the coming years. In this type of environment, we would expect returns from traditional core bond sectors to not be as strong. Returns are expected to be much more moderate or even negative.

#### Effective bond strategies in a rising rate environment

Given that the investment landscape is changing some notable issues should be considered to evaluate whether current approaches to bond investing are still fit for purpose.

##### Future U.S interest rates expected by the U.S Treasury market



Source: Schroders, US Department of the Treasury ([www.treasury.gov](http://www.treasury.gov)), the Federal Reserve Board ([www.federalreserve.gov](http://www.federalreserve.gov)) and Bloomberg, 30 September 2014. Historical Fed Funds Rates are shown as well as future expected Fed Funds Rates expected by the US Treasury forward curve.

## 1. Cash benchmarks and targets

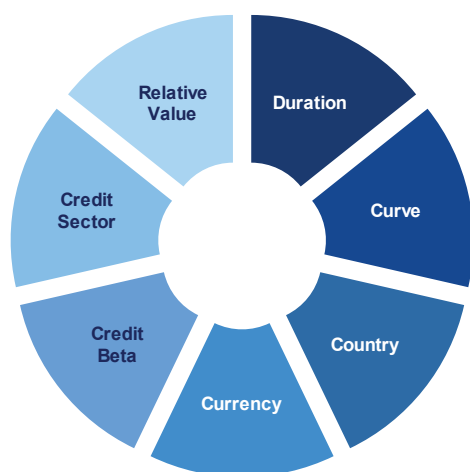
Traditional benchmarks may no longer be appropriate. As interest rates rise the returns that can be expected from traditional bond benchmarks would be expected to be adversely impacted.

One way to guard against this effect is to change the benchmark around which your bond strategy is managed. A cash benchmark would be expected to grow with rising interest rates. Furthermore bond managers can target 'cash plus' returns to deliver additional value. Managers can do this by having the flexibility to take overweight and underweight positions around the cash benchmark, for example say overweighting the UK relative to the U.S. This is also known as an absolute return type of investment approach as positive returns are targeted.

## 2. Diversified return streams

In a rising interest rate environment returns from core strategies, such as government and corporate bonds, are not likely to be as strong. Bond managers can benefit from looking elsewhere to diversify their sources of return. As shown in Figure 2, as well as taking government bond (duration) and corporate bond (credit beta) positions bonds managers that are able to add value from other sources will be helpful. Managers who have the suitable skills can add extra returns through currency, country, curve, credit sector and relative value strategies.

**Figure 2 – Potential bond strategies in a rising interest rate environment**



Source: Schroders, for illustration only

Furthermore many traditional core bond funds have a large single reliance on the U.S bond market. In these types of funds predicting the direction of this market can be the key

determinant of returns. Diversifying away from this market can help if the U.S does not perform as anticipated. It can also help improve the long-term consistency of returns.

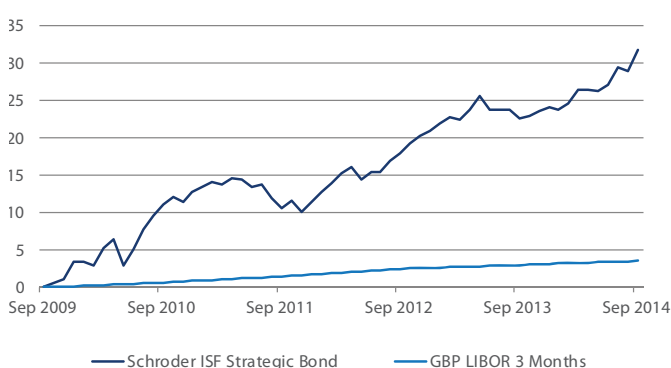
## 3. Keep it liquid

There has been a noticeable recent trend amongst bond investors to enhance potential returns by investing in higher yielding assets. This search for yield has seen investors turn to the more illiquid parts of the market such as loans and structured credit. Whilst these strategies may enhance returns over the long-term by rewarding investors with an illiquidity premium, they may also be expected to fall in value when interest rates rise. The issue here could be more pertinent than when considering conventional bonds. As these sectors of the markets are more illiquid they will likely be harder to get out of when the market falls. Investors should be mindful to keep their bond strategies liquid and nimble enough to move should markets take a turn for the worse.

## Schroder International Selection Fund Strategic Bond Fund

A fund that has an approach using these ideas is Schroder ISF Strategic Bond. This targets returns of cash plus 4% per annum from diversified and liquid return sources. As shown in Figure 3 the fund's bond management team have delivered steady consistent returns above cash over recent years. We believe that in current market conditions this type of approach continues to look a sensible way for investors to allocate to bond assets going forward.

**Figure 3 - Fund performance over the last five years versus its cash benchmark**



Source: Schroders, 30 September 2014. Schroder ISF Strategic Bond's inception date is 30 September 2004. Returns are based on I Acc GBP Hedged accumulation share class.

## Conclusion

Bond markets are changing. Short term interest rates have been falling for over 30 years. We are now at a point where they are likely to rise. A few issues should be considered to

1. Schroder International Selection Fund is referred to as Schroder ISF

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## Bond investing is changing. Are your strategies still fit for purpose?

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make sure that bond strategies are still fit for purpose going forwards. These are namely:

- **Are you using an appropriate benchmark?**
- **Can you target returns across a number of diversified sources?**
- **Are your bonds suitably liquid?**

One such fund that aims to address these issues is Schroder ISF Strategic Bond Fund. If you would like to discuss any of the topics raised in this paper or the Fund please contact James Nunn ([james.nunn@schroders.com](mailto:james.nunn@schroders.com) or 0207 658 2776) or email [ukpensions@schroders.com](mailto:ukpensions@schroders.com).

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# SECTION 2

## THE CHANGING USE OF FIXED INCOME STRATEGIES

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### 2.1 INTERVIEW

The move towards fully funded status – the adaptation of the liability matching process

### 2.2 WHITE PAPER

U.S vs. European floating-rate loans: Why the edge goes to the U.S

### 2.3 EXPERT DEBATE

As equity holdings are being reduced, is fixed income still the natural trade-off or are asset owners better served by turning to alternatives?

### 2.4 WHITE PAPER

The future is flexible: why, when, what next?

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## 2.1 INTERVIEW

# The move towards fully funded status - the adaptation of the liability matching process

### Interviewer



**Jenna Gadhavi**  
*Senior Publisher  
& Training and  
Development Manager*

### Interviewee



**Anton Eser**  
*Deputy Head of Global  
Fixed Income, Legal  
& General Investment  
Management*

**Jenna Gadhavi:** What view do you have on the economic backdrop?

**Anton Eser:** It is important to set the scene for where we are in the economic cycle. This is not an ordinary business cycle that we would have seen prior to the banking crisis in 2008. The major issue is the sheer size of the debt built up in the system, which in many ways is now a more widespread problem. Total global credit, according to a recent report from the BIS, has increased by some U.S.\$40 trillion over the past six years, adding a staggering 40% to the size of the debt in the system.

This debt overhang is no longer a developed market problem, with the bulk of that U.S.\$40 trillion coming from governments, emerging markets and China, in particular. Indeed, credit creation in China over the past six years is historically unprecedented.

In terms of future economic trends, this debt overhang, worsening demographics and productivity, will all lead to a continued ratchet down in global growth rates. The only solution for politicians and central bankers since the crisis is to continue to create more and more debt by holding interest rates at close to zero and monetising the debt through Quantitative Easing (QE). The Federal Reserve has purchased some U.S.\$4 trillion of securities through their QE programmes since the banking crisis and we have seen similar programmes at the Bank of England, Bank of Japan, as well as a growing likelihood that the European Central Bank (ECB) will join the party.

Above all, the system will implode if we do not continue to create more and more credit. This is the central bank's primary objective and it's incredibly dangerous.

In this context, we can look at some of the shorter-term themes or trends. Over the short-term, we are seeing a pick-up in U.S. growth while European data is looking weak, with the increased probability of a triple-dip recession. We're also seeing weakness in emerging markets with Brazil and Russia at or close to recession and Chinese electricity production, housing and inflation data telling us that their economy is most certainly under pressure. A great signal for emerging market (EM) growth concerns is being played out in the commodity market which has been under pressure all year.

Stronger U.S. growth brings us to the most important theme dominating current market thinking – U.S. monetary policy. We're sceptical about the ability of the U.S. to increase interest rates much over the long-term, given the structural issues, but with QE coming to an end and talk of rate hikes from here, we are focused on this 'perceived' monetary tightening. QE has fuelled asset prices and it is coming to an end. So, while we can see a slight cyclical pick-up in the U.S. over the short-term, we don't see a sustained recovery. The thing to watch is the U.S. dollar. With U.S. strength and global weakness combined with QE ending, dollars are going back to the U.S. That dollar flow out of the U.S. was a big driver of global markets. It's going to be an interesting and, in my opinion, difficult

period ahead for economic growth and financial markets.

**Jenna:** Given robust YTD performance of global credit markets, where do you find value at present as an active manager?

**Anton:** QE is a policy which is designed specifically to keep credit flowing and increase asset prices. It is designed to get the equity market up and tighten credit spreads through the reduction in yields of government securities, which gives corporates a much lower cost of funding, and thus increases the wealth effect.

This policy has led to highly inflated asset prices, particularly within fixed income markets. With corporate bond yields at all-time lows and issuance levels at all-time highs, we see a disconnect between valuations and the longer-term structural issues I discussed earlier. Consequently, we're running defensive credit portfolios with lots of liquidity and ensuring we remain disciplined in terms of not being forced to take on risk by 'reaching for yield'. We also don't want to be exposed to highly cyclical credits, which will underperform in a weak economy.

In terms of relative value, the U.S. is generally in a much stronger position compared to Europe, so the U.S. credit market is a much better place to take risk. Within this market, we like the long end due to the structural demand from U.S. pension funds for long-duration credit. If we want to buy quality, defensive credits in the investment



grade space, we look to the U.S dollar market primarily.

Away from this, there has been quite a lot of pressure in high yield and EM markets recently. While we do not want to add sub-investment grade securities to the portfolio, we do see pockets of value in certain EM countries such as Mexico.

**Jenna:** What can pension funds do to further diversify their growth portfolios? How can fixed income support the secular trend of de-risking from equities whilst still providing growth?

**Anton:** It is a very difficult time to be making investment decisions for a pension fund. Thanks to QE, large parts of the market, be it equities or bonds, are very expensive. We've had a great run but, unfortunately, the past 30 years of fantastic returns are a thing of the past and I think we're facing a difficult decade of returns from here. Consequently, schemes need to manage down their risk but also look at creating more flexible investment strategies so they can access broader parts of the market.

From a fixed income perspective, we've seen a clear shift in UK pension funds given the low level of bond yields and number of schemes looking at their risks in more detail. For credit mandates, the bulk of the exposure will sit in the matching portfolio, which is typically formed of long-duration investment grade credit. We're now seeing other parts of the credit universe sitting in the growth pot under emerging market debt, high yield and more recently multi-asset credit. These strategies can help pension funds bridge their twin objectives of de-risking their equity portfolios while generating returns to close the funding gap.

**Jenna:** In credit portfolios, investors and their advisors have been considering benchmark-agnostic, low

turnover strategies.

**What is your view of this lower risk Buy and Maintain approach and how are you positioned?**

**Anton:** Looking at the fixed income business at LGIM, a big part of our asset base is insurance-based mandates where we run £35 billion of Annuity Fund assets for L&G Group. We have decades of experience in managing insurance money linked to UK pension funds which are looking for long-term and stable cashflows. The fixed income business was built on managing cashflow-oriented insurance and pension mandates, so we have a strong history and level of understanding of how to manage benchmark-agnostic Buy and Maintain mandates. We have a large global team, a very strong macro-thematic approach as well as a well-regarded bottom-up research effort in investment grade credit.

Overall we are very well positioned for this trend.

It is important to understand why we're seeing this trend in the industry. Going into the banking crisis in 2008, financials were a major part of the UK corporate bond benchmark. Within that, companies like AIG and Royal Bank of Scotland were major issuers of debt, so that even if your credit manager was underweight, a pension fund still had significant exposure to those credits. That's clearly sub-optimal and hence the shift towards benchmark-agnostic strategies. It's also connected to a scheme's asset liability matching (ALM) requirements and more demand for bespoke bond mandates.

This all makes a lot of sense to us. We've launched pooled funds and added more resources to our team to capture this trend. There is, however,

**"It is a very difficult time to be making investment decisions for a pension fund."**

a word of caution worth noting. Benchmarks, with all their flaws, do provide an important reference point to assess the value that a fund manager is creating or detracting.

By moving away from benchmarks, we lose that frame of reference. In a bull market, similar to what we've seen for the last six years, that's fine because the client is making money. When the market does turn however, resulting in losses similar to those witnessed in 2008-09 and a potential pick-up in defaults, it will be difficult to assess the fund manager's skill. That could lead to some difficult conversations.

Overall, we see the merits of Buy and Maintain and are supportive of the strategy; however, we also need to recognise that, by removing one problem, we introduce another one. I'm sure the next stage of the cycle will provide us with more questions and possibly some answers.

**Jenna:** Thank you for taking the time to share your thoughts on this topic.



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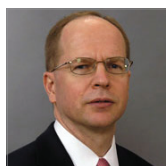
**Simon Males**  
Head of Active Fixed Income Distribution  
+44 (0)20 3124 3284  
[simon.males@lgim.com](mailto:simon.males@lgim.com)  
[www.lgim.com](http://www.lgim.com)

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## 2.2 WHITE PAPER

### U.S. vs. European floating-rate loans: Why the edge goes to the U.S.



**John Redding**  
Vice President, Portfolio  
Manager, Eaton Vance

The global search for yield has pushed rates on floating-rate loans down in both Europe and the U.S, with rates converging to about 5%.

- With little capital appreciation potential in either market, the bulk of total return is likely to come from income. That favours solid, larger, more creditworthy companies – issuers that we see as more abundant in the U.S market.
- The U.S recovery is strong compared with Europe, which has been weighed down by high unemployment, weak industrial production and a strong euro. Such factors are headwinds for European loan issuers, and are reflected in markedly higher European default rates.
- The U.S loan market also has relative advantages in terms of liquidity, dealer support, transparency and creditor protection.
- We believe that U.S floating-rate loans should continue to comprise the bulk of a portfolio's allocation to the asset class — about 90% to 95% — and include European loans opportunistically.

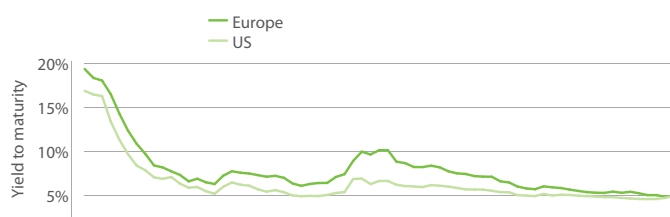
#### With yields similar, best value comes by way of lower risk

Over the past several years, global markets have shared two related themes: the search for yield in the face of historically meagre interest rates, and increasing risk tolerance on the part of investors. In the floating-rate loan market, this has translated into higher issuance volume on both sides of the Atlantic, and downward pressure on rates that has led to a convergence of yields (Exhibit A) at about 5%. The decline in Europe has been especially dramatic, with the rate halved from the fourth quarter of 2011. Nevertheless, with other alternatives, such as sovereign debt, yielding substantially less, loans continue to attract attention.

As a result, we believe this is a particularly appropriate time to compare relative value between the two markets. Europe has come a long way from 2012 when institutional demand barely topped €2 billion in the fourth quarter. However, with yields now comparable, it is especially important to evaluate the macroeconomic environment and the fundamental strengths of the respective markets in key areas such as liquidity, transparency and market structure. We will outline our view of why such criteria amount to a significant edge for the U.S floating-rate loan market.

#### Exhibit A: The global search for yield has pushed rates down in both Europe and the U.S

##### Yield to maturity



Source: S&P LCD Leveraged Loan Review – U.S./Europe. And European Leveraged Loan Index (ELLI) 30 September 2014. The U.S is represented by the S&P/LSTA Leveraged Loan Index, an unmanaged index of the U.S institutional loan market. Europe is represented by the S&P European Leveraged Loan Index, an unmanaged index of the euro-denominated institutional loan market. Past performance is no guarantee of future results. It is not possible to invest directly in an index.

#### Macroeconomic environment

The U.S recovery has been sluggish and uneven but it is strong compared with Europe, which has been weighed down by high unemployment, sluggish income growth, weak industrial production and a strong euro. Inflation has trended lower for the past three years. The European Central Bank introduced new stimulus measures in June, and again in September. In contrast, on October 29, the U.S Federal Reserve formally ended its stimulus program of quantitative easing that involved the purchase of long-term U.S Treasury bonds and mortgage-backed securities.

While Eurozone economic growth has recovered and stabilised in recent quarters, it has lagged other economies since the end of the 2007-2009 crisis, and the region's aggregate GDP is still lower than its 2007 level. In November, the European Commission downgraded its 2014 forecast for GDP growth to 0.8% from the 1.2% forecast last spring. The growth gap between the U.S and Europe is illustrated by industrial production– Europe has yet to achieve pre-crisis output levels.

The economic headwinds faced by European loan issuers may be reflected in the steady rise of the loan default rate in 2014. The floating-rate loan markets have greatly benefited from the “risk on” attitude that has driven equity and credit markets in the past couple of years, so concerns about credit quality issues may have been underemphasised.



However, the return of equity market volatility in October 2014 is a reminder that investor sentiment may be changing. The combination of an increasing default rate in Europe and renewed risk aversion by investors could be troublesome looking ahead.

In the U.S., the default rate for the S&P/LSTA Index as of 30 September 2014 was 3.3%, significantly lower than the 5.4% in Europe. However, if we analyse the numbers the effective gap widens even more in favour of the U.S. There was a large spike in the U.S default rate in April 2014, due to the default of Energy Future Holdings (EFH, formerly known as TXU). As of 31 December 2013, EFH represented about 3% of the S&P/LSTA Index, according to S&P Capital IQ, so its default represents almost the entire current default rate for the overall market. If EFH is excluded, the loan default rate in the U.S drops to a scant 0.25%.

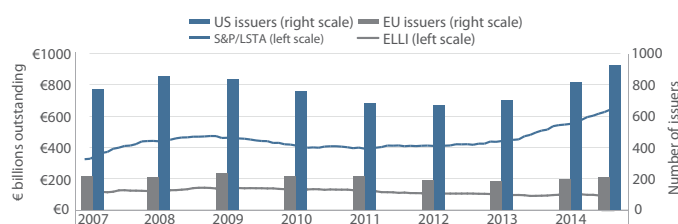
Once the EFH data point rolls off the 12-month default calculation in April 2015, we believe the overall rate will revert to well below the 2.4% long-term average. Among U.S issuers today, we do not see anything comparable to the EFH situation, in terms of size, degree of leverage and likelihood of default. EFH's condition was unique among large, highly leveraged companies whose issues predate the crisis.

### Structural Differences

An appraisal of the relative value of the European Leveraged Loan Index (European market, or "ELLI") vs. the S&P/LSTA Leveraged Loan Index (U.S market, or "S&P/LSTA") would be incomplete without also considering the structure and function of the market, which can have a direct bearing on both risk and total return.

**Volume** – With U.S.\$805 billion in outstanding volume and 917 issuers, as of 30 September 2014, the U.S market dwarfs Europe by factors of six and four, respectively (Exhibit B). But just as importantly, since the start of 2009, the U.S has grown in volume (by 39%) and in breadth (by 11%) as measured by number of issuers. In contrast, while Europe has added more issuers since the start of 2009, outstanding volume has fallen by 29% to €98.7 billion.

### Exhibit B: The U.S loan market has grown in volume and breadth; Europe has not.



Source: S&P LCD Leveraged Loan Review – US/Europe, 30 September 2014.

In addition, larger, higher-quality issuers generally are more prevalent in the U.S. For example, for 2014 through 30 September, there were 113 deals rated BB/BB-according to S&P/LCD, and just 5 were European. Also, the European issuers who did make the list tended to be significantly smaller. Measured by cash flow (EBITDA), the average European issuer had €389 million in annual EBITDA compared with €732 million for the U.S average. A bigger market of larger, higher-quality issuers means greater liquidity, and more opportunities for investment, diversification and portfolio risk management.

**Dealer support** – A key pillar of market liquidity is dealer support, which in turn is greatly enhanced by a robust universe of buyers and sellers. There are more than 20 trading desks making active markets in the U.S, according to S&P/LCD, and about half that number in Europe, as of 30 September 2014. The investor base is also broader and deeper in the U.S, especially given the retail segment that is almost completely absent in Europe.

This disparity in the two markets is reflected in the bid/ask spreads of dealers. As of 30 September 2014, the bid/ask spread in Europe averaged 124 basis points (bps) compared with 71 bps in the U.S, according to S&P/LCD. The wider bid/ask spread in Europe means investors are likely to pay more to establish positions and receive less on the way out versus the U.S – something that can obviously be a drag on total return.

**Price transparency** – Informed investment decisions cannot be made without accurate pricing information, but that is not often easy to come by in the European market, based on our experience. In the U.S, loan "marks" change daily, based on real-world market data collected by third-party pricing services. In contrast, it is not uncommon for European loans to be priced only once a week, especially for smaller issuers. Further, most issuers in the U.S have a public debt rating, which makes it easier to obtain substantive information about companies. In Europe, issuers frequently have no publicly rated debt.

We should emphasise that these differences are mostly a function of a market's growth curve, as it attracts participants over a number of market cycles. Europe's market only began to evolve from one exclusively composed of banks about a decade ago, and transitioned to the booming CLO period and crisis aftermath in relatively short order. We believe it will take more time for the European market to reconstitute itself, as it indeed has begun to do with re-establishment of CLO demand over the past couple of years.

**Creditor Protections** – A reality of investing in speculative-grade corporate credit like floating-rate loans (and high-yield bonds, for that matter) that defaults, bankruptcies and recovery rates are important components of the total return expectation. In the U.S, floating-rate loans have a historical

average default rate of 2.5% over 10 years, according to S&P, as of 30 September 2014. However, due to their senior and secured status, loans have a long-term recovery rate of 70% historically, based on Eaton Vance research. Recent research by Moody's indicates that recent recovery rates on European floating-rate loans have been comparable to the U.S.

However, Europe has a disparate array of bankruptcy codes and different traditions for dealing with distressed and defaulted borrowers. A good example is the insolvency of Petroplus, Europe's largest independent refiner by capacity, which had banks call in U.S.\$1.75 billion of debt in 2012. We do not believe Petroplus had any institutional floating-rate loans affected, but the example is instructive, based on the prospects faced by holders of its high-yield bonds. Creditors have had to pursue claims in as many as five jurisdictions across Europe, each with its own distinct bankruptcy provisions, and face the likelihood of substantially higher legal costs.

On the other hand, we believe that the key advantage of the U.S Chapter 11 bankruptcy code is that it offers a well-established, uniform roadmap for all claimants in the process – something that is often lacking in Europe. We haven't seen the potential drag of bankruptcy costs in Europe quantified, but we believe it is a valid concern for investors. It's worth noting that dollar-denominated tranches of European issuers comprise about 10% of the S&P/LSTA Index. Thus, within the S&P/LSTA universe, investors have a straightforward way of gaining exposure to larger European issuers, with many of the advantages of the U.S market that we have discussed.

### What's next for floating-rate loans?

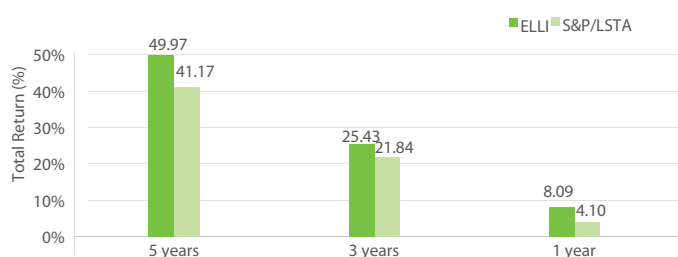
The embrace of risk by fixed-income investors over the past several years has led to dramatic returns in the floating-rate loan markets (Exhibit C), but the edge has gone to Europe, if only because it was starting from a deeper hole in the wake of the recession. In September 2009, the average bid on the ELLI was 81 compared with 85 on the S&P/LSTA Index, according to S&P/LSTA. But looking ahead, it is important to bear in mind that the large discounts that made such returns possible are no longer to be had: both markets trade in the vicinity of par. Loans generally haven't appreciated much above par because issuers typically move to refinance them at that level. Baseline return expectations of "coupon clipping" appear well grounded.

In other words, both European and U.S markets are starting from roughly the same spot in terms of price and yield. With little capital appreciation potential in either market, the bulk of total return is likely to come from income, as it has historically. That favours solid, creditworthy, larger companies capable of meeting their obligations over the long-term. In that regard, we believe the U.S has an overall advantage for relative value based on a host of factors including the macroeconomic environment, issuer size, liquidity, price transparency and creditor protections.

Given the ongoing, significant structural advantages of the U.S market, we also believe that U.S floating-rate loans should comprise the bulk of an allocation to the asset class – about 90% to 95%. This is a portfolio that broadly reflects the composition of the global loan market. Select European floating-rate loans can add value to the U.S core, through an investment process built on experience, expertise, and in-depth credit research, as part of a properly structured, diversified portfolio.

### Exhibit C: Recent returns for floating-rate loans have been extraordinary.

Periods ended 30 September 2014



Source: S&P LCD Leveraged Loans Review – U.S./Europe, and European Leveraged Loan Index (ELLI) 30 September 2014. The U.S is represented by the S&P/LSTA Leveraged Loan Index. Europe is represented by the S&P European Leveraged Loan Index. Past performance is no guarantee of future results. It is not possible to invest directly in an index.

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## 2.3 EXPERT DEBATE

As equity holdings are being reduced, is fixed income still the natural trade-off or are asset owners better served by turning to alternatives?

### Moderator



**James Redgrave**  
*UK Managing Editor,  
PLANSPONSOR*

### Panellists



**Mark Hedges**  
*Chief Investment Officer,  
Nationwide Pension  
Fund*



**Neil Morgan**  
*Senior Pension Trustee,  
Capita Asset Services*

**James Redgrave:** Alternatives versus fixed income as a natural de-risking and yield seeking asset. Could you first differentiate between the two asset classes and talk about what we mean when we say alternatives as opposed to fixed income – what is the dividing line?

**Neil Morgan:** First of all a pension scheme needs to set its objective which will generally be founded on a self-sufficiency basis, for example over the next 20 years. By setting this as the objective there then becomes a target return of say gilts +2% and from there a risk budget, in other words how much risk the trustees and company are able and willing to take. As far as the risk budget is concerned the point that was made in an earlier panel session about immature pension schemes, is that it is still very much of relevance to them, as interest rate risk is an unrewarded risk and really it is up to the trustees and the company to decide how much interest rate risk they want. This is now being driven to some extent by the pension regulator's new code of practice on DB funding so now everything goes back to the covenant so it is really a question of whether the investment strategy is supported by the covenant.

Then you break it down into your liability matching assets, so gilts are a necessary evil as an asset class to invest in and they are there to effectively match your liabilities whether they be inflation related liabilities or nominal gilts for managing your fixed liabilities. Your hedging ratio will be determined to some extent by the covenant of the company.

On the growth asset side that is where you are going to get your gilts +2% the extra bit over gilts and that is where the alternatives come into play. To a large extent people have diversified from equities over many years and one of the trends that took hold before the financial crisis was the diversification into those much more complex assets and strategies like hedge funds and private equity. This was led by the Yale Endowment Fund in the U.S and was the model that U.S and UK pension schemes have been trying to follow. The financial crisis did highlight a problem with the Yale model in that essentially hedge funds and private equity are very much related to the economic cycle so they all fell at the same time as publicly traded equities did, so there wasn't much diversification benefit. Also liquidity was a major problem as well.

Pension schemes are now looking in particular at their allocations to hedge funds in terms of diversification and we are seeing not only schemes in the U.S like The California Public Employees' Retirement System (CalPERS) but also local authority schemes in the UK questioning whether they should be in hedge funds as they aren't transparent, the fees are high and the performance has been mediocre.

In terms of what they are investing in on the growth asset side, they are looking at diversified growth funds - so with these you have a little bit of flexibility, they are a bit more dynamic, they are cheaper than hedge funds, and some provide similar hedge fund strategies as well.

You are also seeing the growth of smart beta products so you are getting alternative indexation and exposure to risk factors, mainly in the equity domain, like value but also low volatility, both of which historically have provided excess returns over traditional market cap benchmarks over the longer term.

There are a whole variety of growth assets but there has been a major shift into diversified growth funds and smart beta products and perhaps away from hedge funds, and also perhaps a questioning of whether private equity is too expensive and too correlated with the economy.

In terms of bonds we have spoken about the role of corporate bonds which are to some extent liability matching but they are increasingly on the growth asset side, and so you are also seeing that many more bond products are looking to provide cash plus returns. Absolute funds are often looked at as an alternative to cash, and there are a variety of bond strategies such as multi-asset bond funds, absolute bonds funds, unconstrained bond funds, investing not only in UK corporate bonds but also global corporate bonds, high yield and emerging market debt as well, so there are a whole variety of new asset classes and strategies that are out there that pension schemes can look at.

**Mark Hedges:** A pension fund has got a flight plan and will move from its return seeking to its matching asset over time if it out performs that flight plan to meet its destination. That means that it will move into assets

which aren't really return seeking and much more matching characteristics unless it has tried to immunise some of those liability risks through hedging with swaps, derivatives to remove some of that unrewarded risk. In part it depends where any particular fund is on that journey and how much it has used its ability to access swaps to immunise itself from those liability risks.

Quite clearly funds that have gone down the route of trying to remove that risk ahead of any funding level de-risking move themselves into a different situation because they are now effectively exchanging that interest rate and inflation risk for a Libor related risk and that drives them very much into being focused on beating cash.

If you haven't immunised your risk then you've got a whole batch of return seeking assets and you might also find that equities have been very volatile. I would disagree slightly around private equity in that yes in a time of extreme crisis all assets are correlated to one another and everything does very badly. Do we expect 2007 to be exactly the same crisis we are going to get with another one? I would say no which may mean that we have a very big extreme and that everything correlates to one another again. Or it may mean that we get periods of volatility and down turn and recession where certain assets perform very badly and others don't and they don't correlate to each other as much. I don't know the answer but this means because of that I am better off being more diversified than being in one asset class as they may not all correlate to one.

My experience through Nationwide's own internal portfolio and the private equity folio that we have within the pension fund is that the private equity values have been more stable than public sector equities. One of the drivers for a lot of corporates is very much around how do movements in the pension fund affect the P&L. The

finance director focuses on this as he wants to keep the pension costs as low as possible and he doesn't want it to have a lot of volatility. That drives them to want us to do a lot of hedging as well as invest in things that are less volatile.

This is where the question arises of can you drive away from equities into other return seeking assets in my return seeking bucket that may have less volatility and I think you can and still preserve the return seeking target. This could come from having a broader range of credit and moves into things like infrastructure funds, private credit and a range of those ought to bring less volatility but potentially ensure that I still hit the risk budget allocation.

**James:** Are there factors creating demand for alternative assets rather than traditional fixed income and a move to equities long-term, or do you feel that there will be a backlash towards traditional assets? Do you feel that the demand for different types of assets will be created by different factors in the future?

**Neil:** There will always be demand for equities and market capitalisation weighted equities, the traditional index tracker funds, but there is this move towards this alternative indexation space so alternative indexation or smart beta is just alternatively weighted stocks in an index, which gives you exposure to such risk factors as value and low volatility. The rationale for going towards those kinds of indices is that the market cap index has got a lot of flaws with it and so people are now realising those flaws and moving towards smart beta products. The other driver for going into alternative indexation is the realisation that active equity management hasn't delivered and is very expensive, as well as the fact

**“...there is a move towards this alternative indexation space...”**

that the manager you employ might actually have systematic tilts to these smart beta factors, that you can get more cheaply through a smart beta investment strategy.

This implies to some extent that market cap weighted passive funds will reduce a little but I can't ever see them being replaced as a benchmark, so pension schemes will always have an allocation to market cap weighted index funds. They are increasingly having an allocation to smart beta equity funds and increasing their allocations to diversified growth funds as they do give you that flexibility in terms of tactical asset allocation. In addition, the lessons of the financial crisis have been that everyone needs to be smarter and more dynamic in terms of not just 'setting and forgetting' but actually moving around their asset allocations.

If you are a very large pension fund you can have your own granular allocation into the various bond, equity and other alternative categories but if you are a smaller pension fund then maybe a DGF is the answer as within it there will be those alternative asset classes like leveraged loans for example that were talked about earlier.

In the bond space you have seen an increase in the types of products being offered as a reaction to the very low yield environment on government bonds, so where pension schemes want more income, the search for yield has come in and new products have been created to cope with that environment. So you've got absolute return bond funds, unconstrained

## “...diversification is the answer.”

bond funds and multi asset funds as well as corporate bond funds.

One of the issues of having different bond portfolios is that when interest rates increase, there may be issues around liquidity. We have seen references to the idea that the liquidity in corporate bonds may not be as much as it used to be before the crisis, because the investment banks aren't making markets in corporate bonds to the extent that they used to. There is a slight danger that when interest rates go up and everyone starts to panic, people will be selling corporate bonds and there won't be the liquidity there so prices will go down further as a result.

Nobody really knows what is going to happen as regards economic growth and the path of interest rates so diversification is the answer. Hedge your bets so if it is going to be a high growth environment then go into more growth assets and diversify amongst those growth assets, but maybe towards ones that are cheaper rather than expensive and also to hedge against deflation you might go into bonds and have some gilts from a liability matching perspective but also as a hedge against other macroeconomic environments like deflation.

**Mark:** There is a drive towards more credit and alternative sources of funding given that a number of banks have retreated from a number of areas. I'm not too bothered that these may be illiquid as frankly 70% of my funds are in liquid assets so why would I

care about putting another 10% in illiquid ones. Too often in the pension sector people seem to be concerned with liquidity, if I have got enough cash coming in to meet my liabilities year on year why I am a fussed about liquidity so

much? It seems nonsensical to me. As the bulk of my assets are in index linked gilts, if I can't sell those then I have a major problem but the fact that I have some corporate bonds or credit is neither here nor there.

One of the things I should be doing is planning ahead with the cash flow needs of the pension fund so I remain somewhat concerned that often people raise liquidity issues for a business which is essentially about long-term cash flows not about what the price is today. Market to market movements impact on a lot of instruments, particularly credit instruments. But actually you should look at whether or not you are being rewarded from the return and the credit losses that you will take, as all of these instruments will take losses, to give the net return (and you will guess that working from a building society my background is credit). So it is about understanding the losses, what your return is and do you make a reasonable return after those losses.

If you can sustain through to maturity and get your returns then you shouldn't necessarily worry about the market to market. I talked about securitisation and I will continue to say that the best product in the world is probably UK mastertrust RMBS. As Granite (the Northern Rock securitisation vehicle) did what it said on the tin nobody lost any money from holding it unless they sold it at the wrong time. If you held onto it you lost no money all the way down to the equity piece. Where you do need to look at is some of the risks

around some of the alternatives that I see coming from a lot of hedge funds and people who are trying to package things up. They see an opportunity as banks aren't lending and so they want to create potential products as they feel they can get good deals and make themselves money.

Often you see a lot of small funds perhaps they are a hedge fund and they have recruited five people and are going to put on these extra loans. The problem with small pools of loans is that if your credit underwriting gets it wrong then you have blown your return. You need to have bigger pools so they can be granular so that you can look at the average default rates and that actually is what plays out because you have a big enough pool.

The challenge is that there is an opportunity as bank lending in Europe, the UK and the U.S is not likely to return to the previous levels So there are opportunities there, but you need to have someone who can build up a big enough brand that they are going to be there consistently and have a big enough pool of those assets that people can then tap into and invest in and generate some alternative from.

My concern is that you get some of these hedge funds doing it because it is an opportunity at the moment and they don't have depth and breadth and can't manage it properly.

There are opportunities of managing your equity risk as Neil has highlighted around smart beta and over the very long-term those ought to be arbitrated away if markets work properly but for the foreseeable future there seems to be some value in trying to do that type of investment.

Personally I have always been somewhat concerned about market cap as intuitively it seems wrong to me as what you tend to do is when the price of an asset goes up you buy more of it and when the price comes down

you are selling it and I always thought that you bought cheap and sold high.

**James:** What is the potential future demand for yield generating assets be they more traditional fixed income or alternatives? How will that affect capacity for the market to provide these, if you assume that increasingly DB schemes will want LDI strategies that closely correlate to their liabilities, and DC will also get in on the act with more sophisticated accumulation and retirement funds? How much of a demand will there be for different types?

**Neil:** Index linked gilts are obviously in short supply and so there should be more issuance but of course the government doesn't necessarily want to do that so there is an issue around that. If every single pension scheme as they mature moves more money into index linked bonds then it will be an issue, and that is something for the government to address. In terms of alternative assets there are many that pension schemes are looking to move into in order to generate income for liability matching, so for example infrastructure, social housing are asset classes that large schemes have been looking at for some time and have indeed moved into. At the small to medium sized scheme end it is not quite so clear cut as the vehicles aren't necessarily there, and there is also a governance issue in terms of being able to understand these asset classes sufficiently. There is also a supply issue in terms of infrastructure as the NAPF platform is still at the early stages of development in terms of the larger pension schemes committing money to it and indeed finding the projects to invest it - so it hasn't got there yet in terms of a real capacity for these asset classes to provide secure income going forward.

**Mark:** That is the challenge as there are more index linked gilts than there are ground rents and infrastructure debt and social housing debt. Having said that, we are actively looking at long-

term lease yields on property and have a ground rent mandate. For my sins through the 80's and 90's I did vast amounts of social housing debt for Nationwide and it is an area that simply should work very well for pension funds and social housing; if they moved back to their original model which was inflation linked debt. But it doesn't seem to have gained ground or made any push to make it happen. This is the challenge as there are a lot of things there that make sense which although are less liquid but again if the bulk of your portfolio is still in index linked gilts then having 10% of your funds in these other alternatives will be quite helpful because they generate more yield. The problem is access and the quantum just isn't there to replace what is likely to be the demand. The one possibility could be global infrastructure equity, and that is what it is equity risk. I have some concerns around how some people manage that as it is quite volatile. It is not straight forward and even over the long-term you can be upset by the regulator changing things. I have seen gas pipe lines that are heavily regulated look to be quite stable but lose two thirds of their value because the regulators change the charge base. Then what is infrastructure and what isn't infrastructure as you'll look at some funds and they will have car parks and they aren't worth very much now.

You have to be careful when you look at infrastructure and perhaps the most attractive infrastructure to me is the PFI PPP given its actual cash flows, but the problem is that the government has stopped doing them now and doesn't seem to be doing anything at the moment. But long-term those 35 year contractual cash flows are very stable income streams. So government get all of your social housing landlords to fund on an index linked basis because we

**“...there are more index linked gilts than there are ground rents and infrastructure debt and social housing debt.”**

would lap it up and bring back public private partnership for infrastructure debt because we would lap that up as well.

**James:** Thank you both for sharing your insights.

## 2.4 WHITE PAPER

### The future is flexible: why, when, what next?



**Nick Gartside**  
International Chief  
Investment Officer for  
Fixed Income, J.P. Morgan  
Asset Management

**T**he benchmark-relative approach to debt investing has worked well for fixed income investors since the early 1980s. But it's unlikely to work going forward. With yields so low, now is the time to consider how an unconstrained approach can help investors to explore more attractive fixed income opportunities, says Nick Gartside, International Chief Investment Officer for Fixed Income, J.P. Morgan Asset Management.

**"It was the best of times, it was the worst of times."**

*Charles Dickens, A Tale of Two Cities (London: Chapman and Hall, 1859)*

Bond investors have certainly had their fair share of good times. Since the peak in bond yields in September 1981, the five-seven-year US Treasury Index has returned an annualised 8.65%—almost double the 4.8% return from the three-month Treasury Bill Index.

When modern fixed income indices were created back in the mid-1980s, debt levels were low and indices captured the move by central banks to control inflation. As central banks adopted inflation targets, this helped to drive both inflation and interest rates to low levels, providing a duration windfall for fixed income benchmarks.

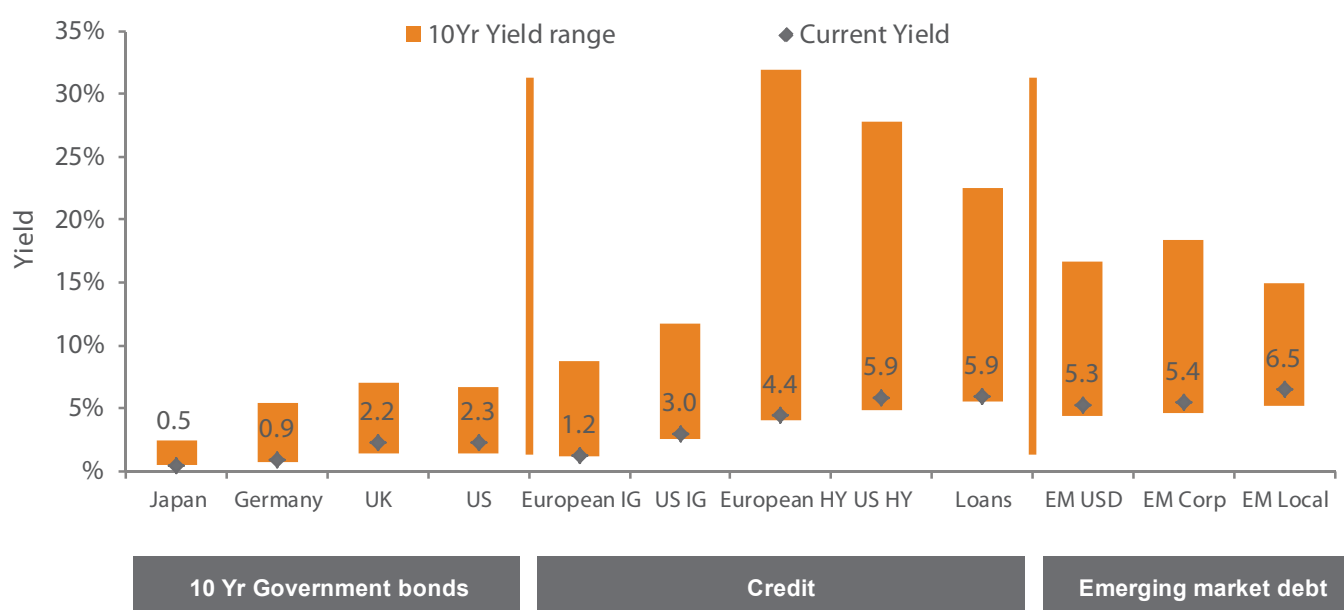
This focus on inflation targeting, along with the advent of cheap money, also facilitated the build-up of huge amounts of debt. But now, with yields at all-time lows and duration risk rising, the best of times are now behind bond investors, and significant challenges lie ahead.

#### Why?

So why do we find ourselves in this position today? Fixed income investors provide an essential social function by allowing individuals, companies and governments to access finance at a reasonable cost of capital that can then be invested. However, current levels of debt are too high.

The problem is that fixed income indices reward 'bad behaviour': those entities that issue the most debt have the

#### Yields are at the lower end of 10-year range across asset classes



Source: J.P. Morgan Asset Management; Bloomberg. Yields are yield to worst. Data as of 27 October 2014.

1. Bank of America Merrill Lynch; returns between 30 September 1981—1 August 2014.

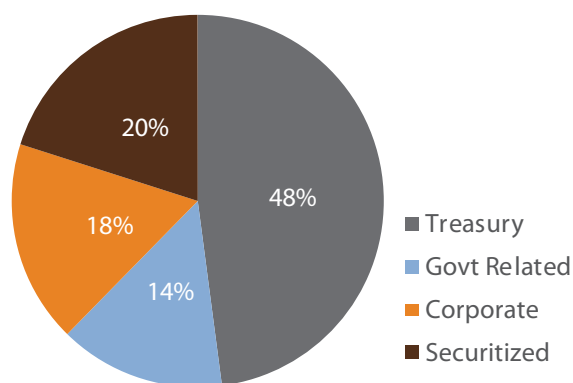


greatest weight in the index. This means that investors with portfolios benchmarked to indices see their exposure to the entities that are the most indebted—and the least able to repay—go up.

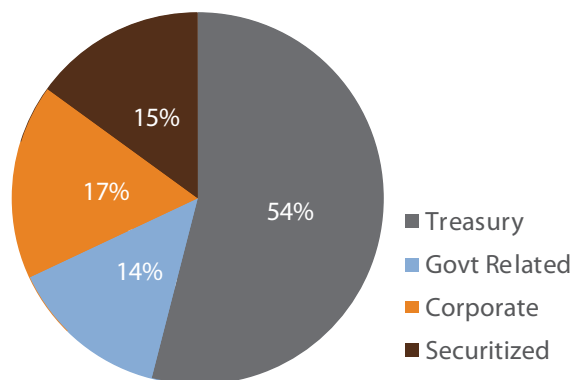
Issue number one is sectoral concentration. The private sector has deleveraged and debt has shifted from the private to public sectors. Exposure to government bonds has gone up, when the compensating yield on government bonds is close to, or at, all-time lows (**Exhibit 1**).

### Exhibit 1: Sector weights in the Barclays Global Aggregate Index

#### Global Aggregate 10 years ago



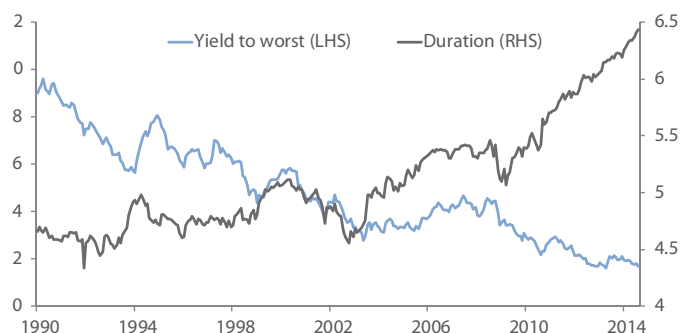
#### Global Aggregate today



Source: J.P. Morgan Asset Management, Bloomberg. Data as of April 2014.

Issue number two is that the basic risk—reward equation has fallen out of sync. Governments have systematically lengthened the duration of their outstanding debts at a time when the yield is close to a record low (**Exhibit 2**).

### Exhibit 2: Barclays Global Aggregate Index Duration and Yield



Source: J.P. Morgan, Bloomberg. Data as of 30 September 2014. Duration is modified duration.

Issue number three is the methodology for including bonds in an index. While this is traditionally determined by the issuer's credit rating, the rating agencies themselves are not always timely in their decisions. This has led to benchmarked-constrained investors owning bonds whose credit dynamics and price have been declining, selling these bonds when they leave indices, and not buying them back until credit rating agencies have upgraded them. Typically, by this stage, the price has already recovered to reflect an improved credit position.

Issue number four is that fixed income benchmarks, as well as concentrating risk in the form of duration and sector risk, fail to fully capture the global fixed income opportunity set. Most investors are benchmarked against aggregate indices, either in their domestic markets or on a global basis.

Nor is the growth of fixed income markets captured in the Global Aggregate Index. The size of newer fixed income markets (such as high yield and emerging markets) is around the entire size of eurozone debt markets. These newer sectors have the additional benefit of a low correlation to traditional aggregate indices and in turn offer the potential for greater reward, albeit with potentially greater risk.

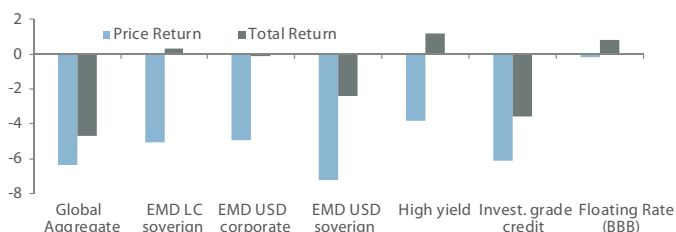
### When?

When will interest rates rise? This is the top concern for any bond investor, and rightly so. During the Great Financial Crisis, central banks around the world adopted policies to fight the twin threats of depression and deflation. But are crisis policies still suitable today, now that the underlying economic environment and outlook is radically different?



The risk is that central banks move policy from emergency low levels to still accommodative levels. Against a backdrop where interest rates and bond yields start to normalise traditional, benchmark-aware strategies, dominated by a high sensitivity to moves in interest rates, will inevitably suffer poor returns (Exhibit 3).

**Exhibit 3: Estimated impact of a 1% rise in local interest rate over one year on selected indices**



Source: Fixed income sectors shown are provided by Barclays Capital and are represented by: Global Aggregate: Barclays Global Aggregate Index; Floating Rate – Barclays US Floating Rate Notes (BBB); IG credit: Barclays Global Aggregate – Corporates Index; High yield: Barclays Global High Yield Index; EMD sovereign (\$): Barclays Emerging Markets – Sovereigns index; EMD corporate (\$): Barclays Emerging Markets – Corporates Index; EMD sovereign (LC): Barclays Emerging Market Local Currency Government Index. Data as of 30 June 2014.

### What next?

How can investors deal with the flaws in the construction of fixed indices, coupled with the turn in the interest rate cycle? One approach is to create indices that reward 'good behaviour'. These can take the form of rules overweighting countries or issuing entities that have low levels of debt, run small deficits or have strong balance sheets. These indices limit the exposure to the most indebted entities. However, they still suffer from a style bias and an inability to radically alter asset allocation.

A more favourable alternative is to remove the fixed income benchmark altogether, measure fixed income portfolios relative to cash and invest in global fixed income markets on an unconstrained basis. This represents a shift to a multi-dimensional approach where managers seek to rotate dynamically through all the different components of global fixed income and currency markets.

In this approach, managers select fixed income markets based on their intrinsic merits and allocate client capital, irrespective of geography and sector, to those parts of the fixed income markets that are expected to appreciate. This dynamic approach gives managers the ability to alter a portfolio's asset allocation to reflect the fact that the best opportunities change over time. It allows investors to manage the risks of rising interest rates and of allocating to deteriorating credits. It is an approach that requires managers to take both long and short positions in markets to target the optimal asset allocation.

In 2013, traditional fixed income indices produced negative returns. Conversely, many unconstrained strategies produced positive returns during this period as they protected portfolios against rising interest rates.

### Checklist for prospective global unconstrained investors

So how should investors select and measure managers? Our nine-point checklist should help prospective global unconstrained investors to weigh up the key issues:

1. Does the manager have a truly global opportunity set? What is the size and location of the global resource? Does the manager have access to all sectors of the global fixed income and currency universe?
2. How does the manager connect all the different teams together? Is there a common investment language?
3. Does the manager use pre-trade tracking error tools to size trades and ensure diversification across portfolios? Does the manager evaluate the correlation and beta of the portfolio on a pre-trade basis with financial market indicators such as equities, gold, commodities, inflation?
4. Does the manager have a quantitative team that can run and maintain proprietary portfolio construction tools?
5. Is the manager's infrastructure robust? Can it cope with collateral management and adapt to ongoing regulatory changes?
6. Every manager knows the portfolio duration, but what about the portfolio's sensitivity to movements in interest rates and government bond yields?
7. Does the manager have the ability to use derivatives and take short positions in markets?
8. Can the manager show evidence of dynamic asset allocation across the global opportunity set, avoiding a style bias?
9. Will the manager commit to a comprehensive communication agenda to keep investors in touch with portfolio changes and dynamics?

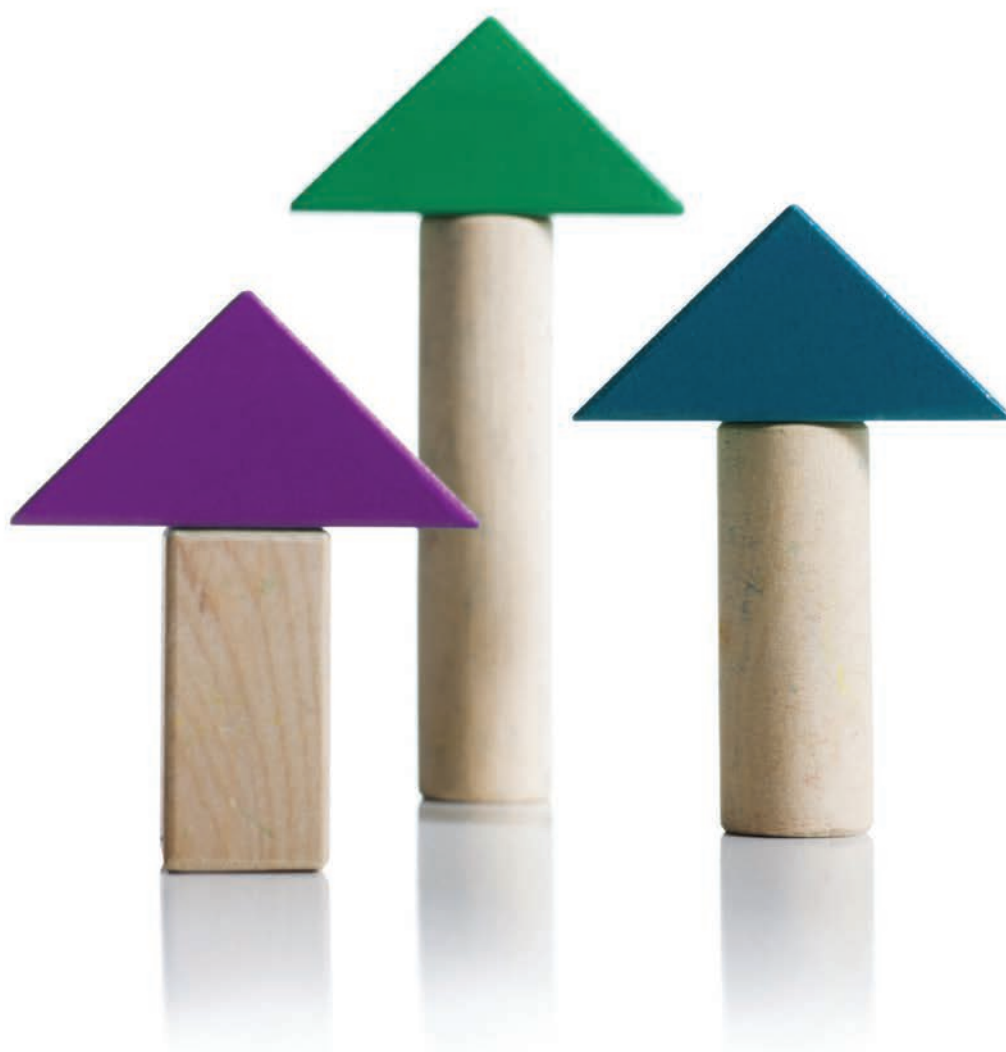
Looking back 30 years, bond indices have served investors well. Fixed income investors have enjoyed very good returns and very good times. With a broader opportunity set and many more ways to access returns beyond a duration trade, it is likely that global unconstrained approaches are likely to provide investors with even better times in the next 30 years.

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## The end of a fixed income bull market... The beginning of diverse opportunities.

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The game has changed when it comes to navigating today's fixed income landscape. J.P. Morgan's deep investment expertise offers compelling and diverse solutions to help institutional investors uncover opportunities in today's market and beyond.



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To learn more about our solutions for today's environment visit:  
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# SECTION 3

## THE SEARCH FOR YIELD

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### 3.1 WHITE PAPER

Why absolute return fixed income strategies are so relevant in the current low yield environment

### 3.2 WHITE PAPER

Multi-asset fixed income – the key to higher yield and lower volatility?

### 3.3 ROUNDTABLE DEBATE

Creating the optimal portfolio – finding the right balance with an expanding inventory of fixed income options

### 3.4 WHITE PAPER

Considering opportunities in non-traditional credit

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## 3.1 WHITE PAPER

# Why absolute return fixed income strategies are so relevant in the current low yield environment



**Andres Sanchez-Balcazar**

*Co-Head of Global Bonds, Pictet Asset Management*

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**I**nvesting in bonds has been a fruitful pursuit over the past two decades, largely thanks to a steady and persistent decline in inflationary pressures. The future looks less promising, however – investors will find it more difficult to secure attractive bond returns over the next five years. This is not only because inflation and interest rates cannot head much lower: there are other reasons to believe bond investing will become a more arduous pursuit.

One is fundamentals. Bond yields are hovering close to their lowest levels on record yet issuers' credit quality has steadily deteriorated in recent years. Since 2005, developed world sovereign borrowers' credit standing has weakened: just nine countries are rated triple-A by Standard & Poor's, down from 16. The picture is similar for corporate bonds. Last year, companies with ratings of BB+ and lower accounted for 21% of total issuance, compared with 10% in 2005.

What is more, traditional benchmarks – and the strategies tied to them – do not help matters. In fact, they often amplify risks.

As such indices are capitalisation or, perhaps more accurately, liability weighted, they expose investors to the governments and corporations that issue the most debt.

This not only leaves participants vulnerable to potentially unfavourable shifts in borrower creditworthiness, it also restricts their access to more attractive investment opportunities elsewhere. Further complicating the plight of the investor is a decline in market liquidity.

The introduction of more stringent financial regulations has forced large investment banks to cut back on fixed income trading. With market-makers in shorter supply, trading conditions in the secondary market are worsening, giving rise to more frequent bouts of volatility.

It would seem then, that the investment climate for fixed income investors is becoming the toughest it has been in a generation.

This presents a dilemma for investors. While their need for capital protection and reliable streams of income remains undiminished, their reliance on the strategies that have delivered success in the past now threatens to introduce unintended risks into their portfolios.

Investors looking to solve this problem have a number of possible solutions to choose from. Strategic bond funds give investment managers the freedom to invest across the broadest possible range of fixed income assets. They typically aim to secure a high running yield and to diversify sources of income.

Unconstrained bond funds meanwhile, are primarily designed to capitalise on macroeconomic trends; the returns of such portfolios, which tend to be highly concentrated, are dependent on the macroeconomic forecasting skills of the investment manager.

A limitation common to these two approaches is that they place insufficient emphasis on what we at Pictet Asset Management regard as the defining features of the new investment landscape – increased market and economic volatility.

A third solution, the one favoured by Pictet AM – is an absolute return strategy. Its distinguishing features are that it deliberately aims to reduce portfolio volatility and seeks to harness structural rather than economic trends.

### Why structural trends matter more than cyclical ones

Many bond investors spend a great deal of time and effort attempting to forecast economic conditions one, two or several years into the future. In doing so, conventional wisdom holds, they arm themselves with the information they need to make shrewd investment decisions.

Yet this approach has a number of drawbacks. Economic forecasts are rarely accurate. Official economic data are often unreliable and prone to revision, while each business cycle is invariably different from the one that preceded it. There is also the knotty problem of distinguishing cause from effect in any statistical analysis of the economic system.

The growing complexity of the investment landscape only adds to these difficulties.

Markets are increasingly influenced by a number of secular trends that have evolved independently of the economic cycle. Examples include the widespread use of unconventional monetary policy, and tighter regulation of the world's banks.

But there are many more.

**Lower rates for longer** – the forces that have conspired to push interest rates to historic lows will be features of the investment landscape for years to come. With developed world governments facing an uphill struggle in their bid to reduce debt to stable levels, austerity and financial repression will remain the policy tools of choice. This should continue to put downward pressure on real interest rates. What is more, banks' reduced desire and capacity to make corporate loans, weak investment demand among advanced economies and excessive capacity in emerging markets will exert a downward force on interest rates across the world.

**Stuttering, protracted reform of the euro zone** – one legacy of the financial crisis is a long, complicated reform of the euro zone, the world's second largest bond market. A banking union and a fiscal transfer mechanism under which the public debts of euro zone members are pooled are essential to safeguard the currency bloc's future. Yet, it will take time for the region to overhaul its economic and fiscal structure – and such a process is certain to result in as many investment opportunities as it does risks.

**A newly-assertive Japan** – under the leadership of prime minister Shinzo Abe, and thanks to the bold moves of its central bank governor, a country long synonymous with recession, deflation, debt and ineffectual government finally appears to be getting to grips with the problems that have plagued it for much of the past 20 years. This will change the country's economic and investment potential.

**An economic transformation in China** – China has begun a long and turbulent journey to economic reform. The country is seeking to reduce its dependence on exports and boost domestic consumption in an effort to sustain a healthy level of economic growth into the future. Capital market liberalisation, the expansion of Chinese bond markets and potentially lower economic growth in China hold out the prospect of fundamental change in global fixed income markets.

We believe investors should look beyond the economic cycle and focus instead on identifying the structural changes occurring within the financial system. By selecting investments that harness these trends, investors can more effectively diversify the sources of risk and return in their portfolios.

### Managing the trade off between volatility and return.

With the discretion to invest across a broad range of fixed income asset classes, it is important to manage the trade-off between risk and return.

For instance, there are a number of options with which to express the conviction that interest rates will remain low for a protracted period. These range from a long position in U.S. Treasuries to an overweight stance in European high-yield bonds.

A distinctive aspect of our investment approach is our ability to identify a security, or combination of securities, that expresses this idea in a way that holds out the prospect of attractive returns but limits the scope for capital loss should the thesis not play out. This process is illustrated in Figures 1 and 2 overleaf. It shows that investing exclusively in U.S. Treasuries would, if our thesis were to play out as expected over a one-year horizon, deliver a positive return of 3.7%. In the worst-case scenario, however, the loss is forecast to be 2.8%. The pay-out ratio of the strategy – dividing prospective return by prospective loss – is 1.31: 1.

Using the same approach, the pay-out ratio of a long position in European high-yield bonds (excluding financials) is 1.34:1. Neither of these pay-out ratios is particularly compelling. But combining a long position in U.S. Treasuries – which typically exhibit lower volatility – with a long position in European high-yield bonds narrows the range of outcomes, producing a more favourable pay-out ratio of 2:1.

### A flexible approach for a more testing times

Bonds have historically provided investors with reliable streams of income and steady capital returns. Yet the profound changes under way in the fixed income market indicate bond returns will be more volatile than they have been over the past two decades. Investors looking to bonds to provide an anchor for their diversified portfolios should consequently modify their approach.

We believe that flexible bond strategies such as Pictet-Absolute Return Fixed Income that ignore the constraints of a benchmark, target absolute rather than relative returns and make capital preservation an explicit investment objective are more likely to prosper than traditional benchmarked strategies in this new environment.

Figure 1

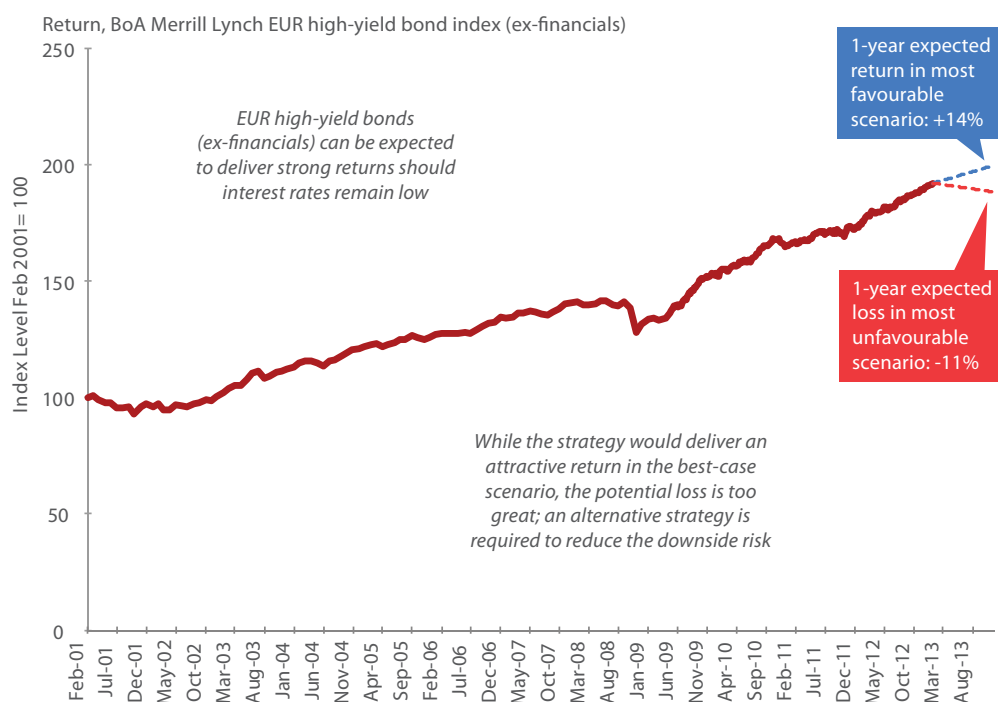
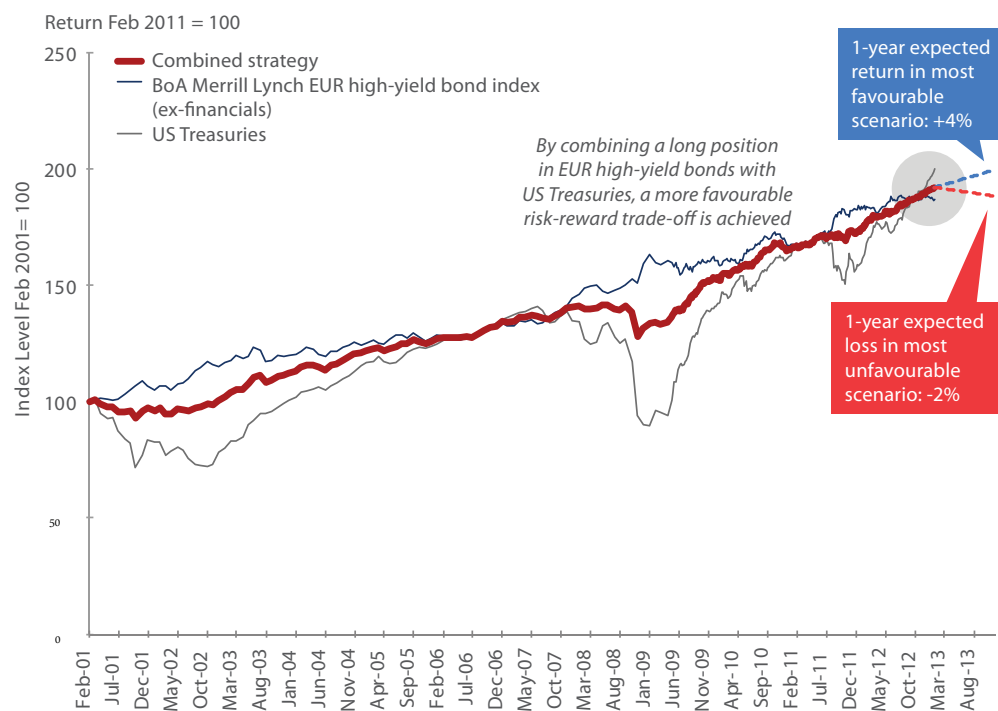


Figure 2





# Every day you change your mind about something. Why not bond investing?

Introducing the Pictet-Absolute Return Fixed Income fund.

*A flexible  
and unconstrained  
approach to  
bond investing*

TARGET RETURN OF

**3-4%**

OVER CASH\* PER ANNUM  
GROSS OF FEES

**3**

*Alpha sources:  
rates, spreads  
and FX*

*Globally diverse  
covering all fixed  
income sectors in  
developed and  
emerging markets*

*\*Over USD Libor or equivalent in share class currency*

In a constantly evolving bond market, investors could profit from abandoning conventional ideas about bond investing.

The **Pictet-Absolute Return Fixed Income fund** offers a flexible and unconstrained approach to bond investing. We aim to construct a diversified portfolio using the broadest possible investment universe.

**Look further afield** Our investment managers have the freedom to invest across a wide range of fixed income asset classes and currencies.

**Look beyond the economic cycle** We use a long term thematic approach and do not rely on economic predictions.

**Diversify risk** We employ diversification throughout the portfolio construction process with the aim to dampen the volatility of returns and to keep risks to a minimum.

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## 3.2 WHITE PAPER

# Multi-asset fixed income strategy holds the key to higher yield and lower volatility



**Mark Cernicky**  
*Managing Director, CFA*  
*Senior Product Specialist,*  
*Principal Global Investors*

Since the 2008 global economic crisis, investors have witnessed a global fixed income environment in transition. Extraordinarily accommodative monetary policies from the world's leading central banks have resulted in historically low interest rates and yields. As a result, asset classes traditionally considered high risk have been sought out by investors in their quest for yield in areas of the market that they typically had not invested in before. The end result has been increased correlations between historically disparate asset classes, an investing world dominated by beta. But now, financial markets are at a crossroad; the U.S Federal Reserve has wound down its massive quantitative easing program and it is only a matter of time before short-term interest rates start heading higher. We are moving away from the easy beta world—of all risk assets rising to a more difficult alpha world—where we need to generate returns through macro themes, security selection, and duration positioning.

This is putting traditional fixed income strategies under pressure as investors look for ways to generate yield and still protect themselves from higher rates. As a result, many investors have turned to unconstrained strategies, which may not afford the kind of protection investors are looking for. In fact, unconstrained fixed income strategies may have more risk than traditional fixed income strategies when it comes to protecting a portfolio against market volatility. For these reasons, now is the time for investors to consider an all-weather multi-asset fixed income strategy, which can cope effectively with a rising or falling interest rate environment or when volatility is increasing or decreasing.

### Generating Alpha via Balanced Diversification

Investors often perceive multi-asset fixed income investing as analogous to unconstrained investing and unconstrained investing as analogous to all-weather investing, but that is not necessarily the case. Although multi-asset strategies are not tied to one particular asset class, it does not mean that all are built to withstand an ever-changing market environment. In fact, many unconstrained/multi-asset strategies have underperformed within the last year because of their concentrated duration positioning. When looking for an all-weather strategy, you have to have a happy balance between macro and security risk, or avoid being too concentrated in your macro risk but being too diversified in your security risk.

### Characteristics of an All-Weather Strategy:

- Diversifying Portfolio Risk, More Concentrated Security Positions

An unconstrained fixed income strategy is not necessarily all-weather because it may take concentrated risk positions. For higher yielding strategies to be considered all-weather, they need to diversify the risks within the portfolio. For instance, if an unconstrained strategy is run solely on macro themes and has only one or two concentrated risks in the portfolio, it is not all-weather. Likewise, if managers focus solely on security selection without taking the macro environment into consideration, the strategy is too heavily weighted toward idiosyncratic risks.

A portfolio that is over-diversified in the number of positions may be giving up a source of alpha—security selection—as the investment world moves into a post-quantitative easing phase with potentially higher interest rates and increasing sector and security dispersion. On the other hand, if positions are too concentrated along a few macro themes, such as duration, it dramatically increases portfolio volatility.

Our analysis suggests that a portfolio containing less than 150 positions is the optimal size to retain a sufficient range of returns to generate alpha from security selection. Accordingly, an all-weather multi-asset fixed income portfolio that is built upon focused investments spread across different or multiple macro themes will have better outcomes than fewer concentrated investments.

- Multiple Lines of Defence

How do investors protect their multi-asset, unconstrained portfolios, when they can no longer rely on the benchmark to bail them out? The answer is to build circuit breakers into your portfolio. First your portfolio needs to have multiple sources of protection. There is no fail-safe solution other than hindsight that will protect a portfolio from bouts of systemic risk. As a result, we build in several types of circuit breakers that are designed to trip under periods of ever-increasing volatility. For example, we use a tactical circuit breaker such as the CDX index product to hedge an expected short-term increase in risk. If the risk continues to increase, we use a portfolio stop loss tied to the realised volatility in the portfolio to reduce risk if volatility exceeds a limit. Finally, we use equity volatility to

hedge tail risk during periods of significantly higher volatility to hedge drawdown risks.

- **Pockets of Opportunity – the Benefits of Benchmark Freedom**

In this period of rising interest-rate uncertainty and market volatility, traditional fixed income strategies may not perform well because they are tied to a benchmark that requires certain sector allocations and higher durations. As fixed income sectors move in and out of favour, a strategy that can strategically and tactically adjust allocations will benefit from the ability to move to more favourable parts of the market. For example, hybrid securities are appealing because they are a low-cost way to enhance yield for income-oriented investors and have low correlation to other investments.

A benchmark-agnostic approach can also allow a portfolio to shed some interest-rate risk that has built up in the process of adding duration to gain yield. The way to achieve this is by investing in sectors that have higher yield but lower duration such as the financial sector and high-yield bonds that typically have less interest rate risk or duration than investment grade credit.

Additionally, by moving investment selections to a global portfolio, investors can decrease their interest-rate risk exposure by investing in global yield curves that have less interest rate sensitivity, such as the European yield curve.

Relative value is one of the biggest challenges facing the fixed income asset class with yields too low and spreads too tight. The way to achieve higher returns is to actively select credits in or out of the benchmark that have higher yields and lower duration and volatility that can do well in a rising or falling interest rate environment. When opportunities present themselves, the pockets of opportunity, managers must have the flexibility to be quick in order to capitalise on them. For example, at the end of August 2014, when short-duration bonds and high-yield credits gapped wider, we were able to take advantage of those dislocations, but now that opportunity no longer presents itself. Investors need to find the pockets of opportunity rather than waiting to invest all their eggs in one trade when it comes along, because it may not in a post QE world.

### **Multi-Asset Fixed Income Holds the Key to Future Returns**

Looking ahead, divergence of monetary policy is going to create increased volatility and sector dispersion, in turn, creating pockets of opportunity for active, multi-asset fixed income managers. Global yield curves will offer varying points of attraction. The credit cycle has been extended and balance sheets are strong. The liquidity mismatch and dealer balance sheets will create price advantages.

Placing a greater emphasis on an all-weather multi-asset fixed income strategy brings the importance of active management into focus. Passive investing will leave investors disappointed. In the fixed income space, certain types of investors tend to invest in certain sectors of the market. In turn, this creates dislocation and creates technical opportunities, which active managers can capitalise on to generate alpha. This is certainly true in the investment grade sector, where in high yield, active management adds value by seeking out mis-rated companies that are undervalued. An actively managed all-weather multi-asset fixed income strategy offers the opportunity to benefit from additional yield and enhanced diversification with lower risk.

Principal Global Fixed Income, a specialised investment boutique, offer a range of thematically driven, high conviction credit strategies targeting higher returns with capital preservation.

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# PROBLEM: MARKET UNCERTAINTY SOLUTION: OPPORTUNISTIC MULTI-CREDIT

Today's bond market volatility calls for an "all-weather" global credit strategy that extends beyond traditional fixed income, adapts quickly to changing market conditions, and protects against fluctuating interest rates. That's where Principal Global Fixed Income can help. As a specialist global credit boutique with more than \$US75 billion in assets under management, we offer thematically driven, high-conviction credit strategies to meet your objective of higher returns while minimising volatility with multiple layers of risk protection. Discover how our opportunistic multi-credit strategies can deliver the flexibility and stability to survive whatever the bond market has in store.



For more information contact, Stephen Holt at +44 (0)207 710 0255, [holt.stephen@principal.com](mailto:holt.stephen@principal.com)  
or Oreste Gallo at +44 (0)207 710 0234, [gallo.oreste@principal.com](mailto:gallo.oreste@principal.com)

For more information, visit [www.principalglobal.com](http://www.principalglobal.com).

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## 3.3 ROUNDTABLE

### Creating the optimal portfolio – finding the right balance with an expanding inventory of fixed income options

#### Moderator



**Andrew Smith**  
*Independent Consultant and Commentator, and Former Chief Economist UK, KPMG*

#### Panellists



**Skip McMullan**  
*Chairman, Bank of America Trustees and Independent Trustee, Pi Consulting*



**Giles Payne**  
*Director, HR Trustees*



**Ian Eggleston**  
*Scheme Manager, PS Independent Trustees Limited*



**Alan Cauberghs**  
*CFA – Investment Director, Schroders*

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**Andrew Smith:** Asset owners are increasingly diversifying their investment portfolios away from traditional fixed income strategies, but why should they now consider new options for their fixed income portfolio?

**Alan Cauberghs:** For once this is a change that is not being driven by the asset management industry but one that is being imposed upon by the asset owners and the market. This is because we are going to go through a very different period over the next 10 years compared to the last 25 to 30 years.

If you look at the fixed income markets in general we have seen a significant rally in bonds. Yields have been declining substantially over the past 25 years, credit spreads have been collapsing, interest rate volatility is collapsing as well, and even currency volatility is markedly lower than it used to be prior to 2008. The entire economic environment within the financial market has changed. Central banks are doing a lot of things that they weren't supposed to do. Bankers were brought up with the idea that they would set the interest rate and that would have an impact on the economy – end of story. Right now if you look at the responsibilities of the Bank of England they are

even responsible for the housing market. All this has implications for financial markets, portfolios and more specifically fixed income portfolios. If you want to continue to manage fixed income in the way that you have managed your income allocations over the last 20 to 25 years, it isn't going to work anymore. This isn't just because the next two years are going to be more volatile when interest rates start to normalise, we are going through an entirely different era. The role of investment banks and central banks has changed which has a profound impact on fixed income portfolios. That is what is driving the need to have a different approach in running fixed income portfolios.

**Skip McMullan:** There are quite a lot of trustees here today and my view is quite simple and bares no importance to whether you are a DC or DB owner. It is a black box and I have got to make sure that it pays the pensions over the long term so really what is in the black box is a secondary issue to being satisfied that the pensions can be paid. If you are a DB scheme and are aligned with the covenant then I have got certainty that I am going to be able to pay the pensions and if it is DC then it's the other way around but I still want to be able to give my members certainty that they know what they are going to get when they retire.

Being cynical, asset managers are a breed who have to come up with another name for a mousetrap every time something happens where they run out of momentum on what they are currently doing. Trustees have got to better understand what is going on so that they can pick and choose their strategy to suit what their black box is supposed to be producing throughout its life. It is a very Warren Buffet long term view of the world as I am not interested in the next quarter or five years, more so 15 to 20 years down the road to see what the portfolio is going to be doing. Rather than looking at it on an asset manager by asset manager approach but trying to understand what that will do with the liabilities that I have to have to fund over the long term.

What is also important is that I have got to have the cash every month to make sure that I can pay the pensions and that is what really matters in the short term. As schemes become increasingly mature on the DB side you are getting far less cash contributions coming in so you've got to find other ways to produce the cash. With DC it is different as you are getting the cash and just needing to make sure that it is invested correctly, but it is a different governance issue.



**Andrew:** Do you feel that with fund managers there is a lot of attention paid to quarterly performance and perhaps is there enough freedom to be counter cyclical?

**Skip:** I am not a great believer in benchmarks per se, I'm more interested in something that is more akin to an absolute return because I have to know that I can pay those pensions out in the future. You do obviously need something on a quarter by quarter basis to understand that the managers are performing in the way that you would like but I am much more interested in what is happening long term with regards to the absolute return that I am going to get out of that investment philosophy.

**Andrew:** It is good to know that there are some long term investors left.

**Skip:** Very much so, and you are now starting to get the bond managers starting to think long term about what the funds will produce just as much as some of the equity fund managers. You can still pick active equity fund managers who do deliver over the long term, so despite the fact that LGPS have been told that they are going to go passive, at the LPFA we are not a buyer of that argument and we are still looking to find some active management and are taking a very sizeable portfolio in house and are creating a long only equity fund ourselves.

**Andrew:** Which alternative fixed income strategies are most capturing investors' attentions?

**Giles Payne:** There is an enormously wide range of opportunities out there and each manager will couch it in slightly different terms and be slightly differently nuanced. As a trustee it raises the issue of who is in the best position to make decisions about which particular strategy is appropriate for which time. As you increase complexity the likelihood of a trustee board having that skill reduces. The key here is that

if you are going to pick a manager that you are picking one who can use a range of those strategies in a cohesive way and have a planned volatility and risk control so they have a good chance of getting the returns available. Try to ask a trustee whether asset backed security or infrastructure debt or senior secured loans offer the best opportunity and you will lose most of them fairly quickly. They are all fairly good opportunities at different times and will undoubtedly have places in portfolios but it is really up to the asset managers to use their skills to blend those assets into a portfolio. With the majority of trustees as you get to the very big schemes where you have real in house skill and a governance structure which allows for those decisions to be made more effectively than trying to select those individual opportunities becomes more relevant but for your average pension scheme the real way to do it is to delegate that sort of diversification to a manager.

**Ian Eggleden:** Yes Giles is right and as a trustee of a £5 billion scheme where as you rightly say all of the advice comes from all sorts of experts, the trustees are usually outnumbered by the amount of people around the table who have far greater skills in the investment world than they do. We do have to make judgements on that.

For all of my other clients who are probably in the average to small category, the trustees can become bamboozled by the science of all of this and it is very tricky to expect them to move quickly up the scale and understand everything that is put in front of them. As an independent professional trustee you feel that it is your role to try and bring that to the table and get them to the point where they do understand this and can take

**“...what the trustees would like to do is not necessarily what the company wants to do...”**

an informed decision on what is put in front of them.

There is a whole range of things out there not to mention the question of covenant, and what the trustees would like to do is not necessarily what the company wants to do. I have one scheme where the trustees have the power to implement the investment strategy and merely have to consult with the sponsor. You get to a very difficult point when you are trying to implement a strategy where you want to take the risk off the table but if the sponsor isn't going to go along with it, at what point do you decide to press the button where you may lose the support of the sponsor? That is a very difficult decision.

When you are talking about fixed income strategies, this is exactly where you tend to move in different directions to the way that the sponsor wants to move, particularly when he is thinking about his P&L account.

Having said that, what I have seen happening more recently is trustees feeling more able to move into some form of multi asset credit strategy which seems to provide some good diversification. Although it is a bit illiquid as long as you are capable of finding the cash to pay the pensions without worrying about it then it is probably a good strategy.

It is relatively higher risk in the fixed income world but it has taken on quite a head of steam in the last year or so.



**“...if you can find the right products and manager then you have got the opportunity to make your fixed income portfolio perform...”**

On top of that, there is private debt and absolute return which is something that we have talked about and is becoming very popular. I can see that moving further into the arena as we move down the track.

**Skip:** In my experience there are very few trustee boards where you can honestly say that the trustees have the skills, knowledge and capability and even time to focus on a lot of these issues. So you are going to get boards with different levels of skill looking at solutions which work for them but not for others which isn't to say that one solution is better than another just that they feel more comfortable in dealing with it.

**Andrew:** Why is it important to now focus on bond alpha as opposed to beta?

**Ian:** What we have seen happening is the across the board low yield environment. When you think of the traditional fixed income market, the cost of investing in that market is usually fairly small. That is probably not too bad if we are paying say 0.3% on investments which are yielding something like 5% as they were in the good old days but if you are now paying 0.3% and you are only getting 2- 2.5% then that is getting quite expensive.

Looking at the beta world is making people wonder whether they can do better than that and so if you can find the right products and manager then you have got the opportunity to make your fixed income portfolio perform

better than it would have done otherwise and hopefully at a reasonable cost.

The key to this is actually finding the right manager which is easier said than done.

**Alan:** If you look at the beta versus the alpha debate the short answer is that beta has worked very well in the past but it is no longer going to work going forward. The reason is that yields are so low. If you look at a global benchmark then 20% of that benchmark is Japan. Do you want to allocate 20% of your money to a country that has monstrous levels of debt and where the central bank is actively trying to create inflation to push down currency? I wouldn't think so. It doesn't make any sense.

Again if you look at a global or UK benchmark, the yields have fallen significantly. Interest rate risk has historically worked tremendously. Do you really still want to take that interest rate risk now? You won't be very well compensated for it.

If you look at the way that beta and benchmarks are constructed, you put most of your money in those countries and companies which carry the highest levels of debt. Again it doesn't make sense.

If you want to have an acceptable level of return coming from fixed income investments, if you want fixed income to continue to perform the same role in your portfolio bringing diversification and reducing risk then you have to do things differently.

I don't think that we do have to come up with very innovative solutions in terms of fixed income. I feel that we should continue to do what we were doing in the past but now just do it differently. This leads to the debate on investment guidelines. If you look

at how these are put together most investment guidelines that I see are exactly the same as 20 years ago when consultants first thought about them. Back then they made absolute sense but today they don't.

Beta isn't going to work anymore but I don't feel that we have to push out the risk envelope. With fixed income the asset class isn't designed to generate very juicy returns and really it should be boring. It should be there to diversify your portfolio and reduce the risk of your portfolio. If you continue investing in fixed income the way that we all have in the past then it isn't going to perform that role anymore. This is why we should embrace some wider investment guidelines rather than asking ourselves the questions of whether we should go into private debt or emerging market high yield companies. These aren't the right questions to be asking.

**Andrew:** Do you agree that investors are demanding a broader spectrum of fixed income products to try and diversify?

**Ian:** I believe this is partly driven by the investment consultants who are constantly coming up with new ideas to tackle the problems that exist.

**Skip:** They are very helpful in explaining the different style characteristics in the same way that we've had that in spades on the equity side and you are now getting that much more on the bond space of why this fund is slightly different to another although it is all in fixed income. A little bit of help in explaining would be helpful although it does come back to considering the background to some of these funds and whether they are constructed purely with local ideas or with global ideas and where do you search to get those ideas from and you do need some help to walk your team through that.

**Andrew:** What extra investment strategies can be employed in fixed income portfolios?

Ian: It is all about diversification. I was looking at a Mercer survey the other day which showed that in 2004 the split of the pension funds that they surveyed was 64% in equities, 34% in bonds and 2% in other whereas ten years later in 2014 it is 37% equities, 47% in bonds and 16% in other. This demonstrates a significant shift particularly into the fixed interest and the alternatives part of it. If you drill down into the 2014 fixed interest allocation it is 14% in fixed interest gilts, 29% in index linked gilts, 42% in corporate bonds and 15% in other matching assets within the fixed income portfolios.

I would guess if we were sitting here in ten years' time we would see an even more diverse picture that we might not believe if we were to see it today.

It is about the appetite that we have for risk and if you are going for liability matching portfolios you are still going to be investing in gilts. If you are a trustee you will want to invest in cash flow generating assets and perhaps even things like infrastructure debt if you get the right opportunities as it should be relatively low risk if you pick the right ones.

If you want to go low risk and defensive then you have to look at things like the buy and maintain credit which we've already mentioned and I like it as an opportunity.

**Giles:** Part of what is happening with pensions is the maturity of schemes and increasing requirement for cash flow and potentially moving to a point where they are cash flow negative. One of the emphases that need to be pulled out of this type of multi-asset investment is a generation of income to be paid out to the pension schemes to allow them to pay pensions. Cash generation is going to become more and more important and buy and hold

is one way of doing this.

I have a situation where we have various assets which are producing quite lumpy cash flows and so we are looking at buy and hold to effectively fill in those cash flows and create a smoother cash flow profile to enable us to actually pay out benefits.

In terms of moving to a more global environment, diversification is the key as there are opportunities elsewhere in the world. A great deal of attention is paid to these opportunities by the investment managers and I would expect most of them will be aware of the best of these.

With the emerging markets or less developed economies there will be more opportunities and perhaps less developed financial systems which will throw out opportunities for people to invest in. Typically they will provide higher yields as well. So going back to this point of generating cash through which to pay benefits, diversifying your portfolio globally is important as well.

**Skip:** In terms of the proportions that Ian mentioned, if you think about DB only and came back in ten years' time then you would have more liability driven assets but if you take the market overall because of the growth in DC you might find that there are quite a lot more growth assets that are still in play. In fact, with the changes in the budget this year there are good grounds for arguing that the default fund is going to have to continue with growth assets for quite some time as most people will be looking to go to 65 at least and then there will be quite a long time to carry on for any retirement funds.

As a trustee board and all the ones I work with we don't feel that we are constrained to look at UK only ideas,

**“...diversification is the key as there are opportunities elsewhere in the world.”**

but if we do get ideas that come from somewhere else we need to understand the origin of those ideas and it doesn't necessarily mean that a fixed income manager gets a bigger or smaller tick in the box but they have to be able to explain where those ideas come from. If it is a global idea which may involve currency or something similar then we need to understand that there are risks coming with that which we might not have if we were looking at a purely UK portfolio.

We would certainly treat any of these things on an unconstrained basis and if someone has a good idea we don't discount or ignore it just because it is outside the UK.

The flip side is that if someone is coming with an unconstrained idea what resources do they have to promote and sustain it. We are talking about things which are long term and I don't feel that any of us want to get involved with something that seems like a great idea but then becomes a covenant issue when it goes away because you have your investment managers saying that was a great idea but as they are out of it now then you've burned your bridges.

**Andrew:** Is it important to find fixed income managers with low correlations to markets?

**Alan:** It is going to be increasingly important to pay attention to correlation. If we look at the world today the UK is not just a market in isolation. Financial markets are interconnected and perhaps more

so than the markets in goods and services. This means that whatever else happens on the planet it will have a direct impact on the UK. For instance the most important trading partner of the UK is the Eurozone. This means that the UK right now is importing deflation from the Eurozone and by having a UK only focus doesn't mean that this problem goes away. You still have to deal with that.

From this perspective it is best to have a more global approach. Looking at the world today we can see a growing divergence between the Anglo Saxon, European, Japanese and Asian economies. The UK and the U.S. have very solid rates of growth. Inflation is modest and employment seems to be improving. On the other hand there is the Eurozone which is very weak with deflationary pressures, no growth to speak of and high unemployment. Japan is somewhere in between and Asia is different as well so there is this growing divergence.

We then have the central banks where most have cut interest rates to zero, or close to zero. This means that they can no longer use interest rates to set their monetary policies, so they are now using currencies. Currencies trade in pairs so there are going to be 50% winners and 50% losers.

What is important is to embrace the global opportunity set but to understand that volatility is also going to increase significantly. As soon as one of the central banks starts to normalise interest rates it doesn't just mean that interest rates are going to rise, but also that volatility in the equity markets will go up. That will mean that credit spreads will widen and currencies will become more volatile. It is then very important to monitor the volatility between all the different pockets that you have in your portfolio. From this perspective correlation between equity markets and credit markets, which is already high, will increase. What you may want in your portfolio at this point is some currency risk.

**Skip:** Up until recently, say before 2008, the Federal Reserve and Bank of England tended to do things in lock step and would move the same way simultaneously. Now because of the difference in performance from these major economic blocks they can't move in quite the same way. It is likely that the Fed will move next year although there is still a huge amount of uncertainty about the timing. In the U.K you could be looking at the back end of next year before you see anything in this country because it is unknown and in Europe all I can do is wish them luck as it is a very uncertain case.

Previously you could think of these things in a much more linked fashion now they are almost totally unlinked and so you have to choose your markets. This goes back to the global question that when somebody brings you an idea you have to think where has it come from and what is the parent idea about, because it is so different to what it was like in the past.

**Andrew:** If we were faced with a period of sustained deflation what would that do to pension funds and could they deal with it?

**Ian:** The problems that we have in our pension funds today are pretty dire so if the situation gets worse I'm not sure that we are in a position to be able to deal with it.

**Skip:** You could take a shallow view in that at the level of the individual pensioner it would be a massive problem but for the overall pension scheme not so much as it has a life time to carry on and can work things out.

**Andrew:** Thank you all for your insights.

**“The UK and U.S have very solid rates of growth.”**

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## 3.4 WHITE PAPER

### Considering opportunities in non-traditional credit



**Alex Veroude**  
*Head of Credit,  
Insight Investment*

**I**n this low yield world, investors are faced with three choices if they want to generate adequate income: sacrificing liquidity; leveraging exposures; or, reducing credit quality. Of those options, given the yields currently available in credit markets, we believe that giving up some liquidity may offer the best risk-reward trade-off. Within the more illiquid subset of credit markets there are a range of opportunities. Of particular interest is the senior loan market and within that asset class, loans to finance commercial real estate in Europe.

Loans have a history as long as money; they are arguably the oldest financial product. A loan is an agreement between a lender and a borrower to lend some money for an agreed term at an agreed rate, with some conditions attached. Today's loan market can be divided in two. There are consumer loans including mortgages, credit cards and the financing many people use to buy a new car. The corporate loan market, as the name suggests, has an incorporated entity behind it rather than an individual.

There are three big categories of corporate loans: loans to a company; loans to a real estate entity such as a building or shopping mall, which are typically incorporated as standalone vehicles; and loans to infrastructure projects. If you add up these three categories, the corporate loan market in Europe is worth €3.6 trillion. That is significantly larger than the investment grade and high yield bond markets combined.

#### T&Cs to suit

Corporate loans have always been customised transactions, originated in most cases by banks. Because banks pay floating rates to their depositors, loans have also typically been floating rates. This provides a natural interest rate hedge. Senior loans get their name because their holders take precedence over bondholders and other unsecured creditors in the event of default. In addition, they are secured on the assets of the company, again aiding recovery levels in the event of a default.

The customised nature of loans means that lenders can attach tough terms and conditions in the event of non-payment. These are called covenants in the loan market. A lender will also expect to see detailed financial information in far more granular detail than typically would be publicly disclosed in the prospectus for a bond, in order to make a better credit

assessment of the borrower. Most companies other than very small firms in industries with little requirement for capital expenditure will make use of loans at some time.

Larger firms will typically have a revolving credit facility in place to smooth over fluctuations in working capital. But as firms get bigger, the world of corporate funding splits into two. Some companies are large enough to tap the capital markets; they will issue debt in the form of bonds. But many companies will never want to go to the trouble and expense of accessing capital markets. It is very time consuming and expensive to hire investment banks to underwrite the bond, lawyers to provide due diligence on a prospectus, go on the road to promote the deal, comply with regulatory reporting requirements and fund an investor relations team.

Figure 1 offers a simplified comparison of bonds and loans. The first big difference is that loans typically pay a floating interest rate benchmarked to market rates such as Libor (the London Interbank Offered Rate) with regular resets. With bond yields at historic lows the risks are now asymmetric: it is more likely that yields will rise and prices fall, rather than vice versa. If interest rates rise, loans will suffer far less, because the floating interest rate will go up. There is a natural interest rate hedge. If rates do fall further, loans will typically have floors written into the covenants which means that the interest rate cannot go below a specified level.

In terms of covenant protection, due diligence and information, loans have higher standards than bonds. The documentation provided on a bond is the prospectus. A document covering perhaps a couple of hundred pages is the information you evaluate when making an investment of perhaps U.S.\$50 million. That information is public. For regulatory reasons it has to be disclosed to everybody at the same time. Loan documentation is far more extensive and is private. One of the key terms of a loan agreement are the covenants: in return for the loan, the protection for investors can be extensive. Lenders also see information that is never disclosed to the public, right up to the level of management accounts. The private nature of that information has a practical implication, there is no public rating.

But, if you have the necessary skills the depth of the information provided by the borrower will allow you to make your own assessment of the rating. The crux of the story is if you

compare bonds and loans is that there is a lower probability of a loan going wrong and that is reflected by the implied rating. If things do go wrong and the loan defaults, loan holders have a much higher recovery rate than bondholders, which is a reflection of their seniority in the capital structure.

That should be worth something to a rational investor. A rational investor should be happy to receive a lower interest rate for a loan than for a similarly rated bond. Over the last 15 years that has been the case, with a substantial difference in the yield that you get paid on loans versus bonds - except for the last 18 months, when spreads on high yield bonds have dropped below those available on loans (Figure 2). In short, we believe the loan market is priced irrationally, at least for now. The entry point for loan investing has been very attractive at several points in the past, but it typically does not persist. This is potentially one of those entry points.

### Commercial real estate

For comparative purposes, Figure 3 shows the characteristics of different corporate loans and suggests that European commercial real estate currently offer an attractive risk-reward profile relative to other types of loans: low default rates, high recovery rates for those loans that do default combined with attractive yield levels. The reason for commercial real estate loans offering higher yield levels compared to infrastructure loans or investment grade corporate bonds is bank deleveraging. Many banks have been forced, for regulatory and other reasons, to withdraw from the commercial real estate lending market.

While not all banks have pulled out of real estate lending, but according to KPMG the debt funding gap, the difference

between loans needing to be refinanced and the amount of capital available, is several hundred billion euros. That sounds like a huge risk to the commercial real estate market, but it is also an opportunity. Firms that do have capital to deploy and an understanding of credit fundamentals can make loans at potentially very attractive rates because demand is outstripping supply.

So the spreads available in European commercial real estate loans do not reflect a structural risk problem in these markets. Spreads are not wide because they are a bad investment: wide spreads on European commercial real estate loans reflect the wider context of the European economy.

This situation is likely to be a catalyst for the profound reshaping of the market. In the United States, a fifth of commercial real estate lending comes directly from institutional investors, including fund managers, insurance companies and pension funds. In Europe, the institutional loan market is very small, but it is beginning to grow. Once institutional investors own, say, 20% of the commercial real estate loan market in Europe, it will go a long way to closing the funding gap.

### A better risk/reward

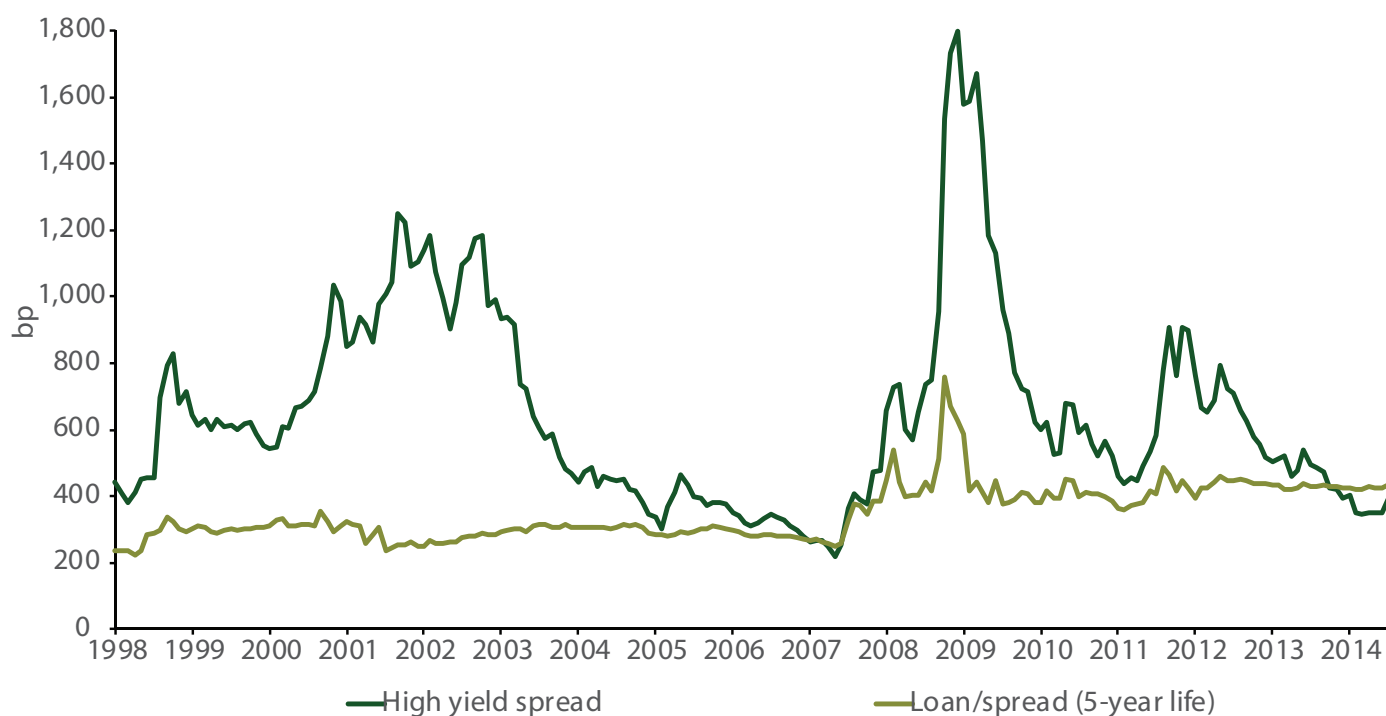
Investing in illiquid credit opportunities is not suitable for all institutional investors. The relative illiquidity, as well as the research and analysis required for these types of assets, not to mention having access to the market in the first place, demands specialist asset management skills. However, for those investors who are prepared to put the time and effort into it, then the opportunities to be found by going down the route of lower liquidity may offer a better balance of risk and reward.

**Fig 1: A comparison of high yield bonds and loans**

	Loans	Bonds
Yield	4.6%	3.6%
Interest Rate	Floating	Fixed
Covenant protection	Strong	Weak
Due diligence package	Comprehensive	Limited
Information	Mostly private	Public only
Security position	Secured	Unsecured
Capital structure	Typically senior	Typically subordinated
Rating	Not available/private	Public
Default risk	BB	BBB
Recovery upon default	70% average	30% average

Source: Credit Suisse as at September 2014. Index. Past performance is no guarantee of future results. It is not possible to invest directly in an index.

**Fig 2: Loan spreads vs high yield spreads – as at end July 2014**



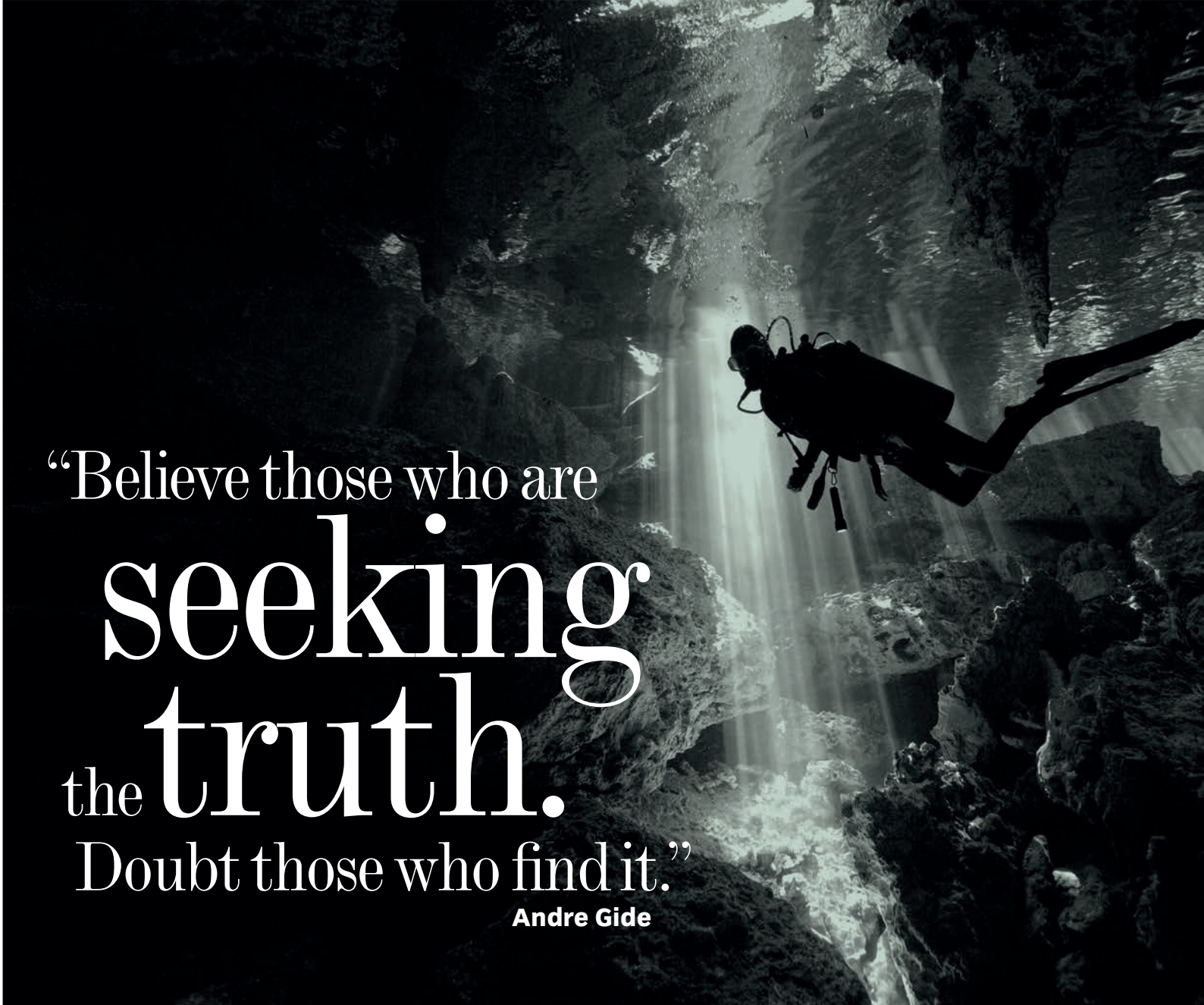
Source: Credit Suisse Western European Institutional Leveraged Loan Index, as at July 2014.

**Fig 2: Corporate loan risk/reward characteristics**

	Rating	Yield	Annual default	Recovery	Net loans	Coverage
CRE loans	A+	3.0	0.07	90%	<0.01	>100x
Infrastructure loans	BBB-	2.0	0.61	80%	0.12	17x
Investment grade corporate	A	0.9	0.12	40%	0.07	13x
High yield bonds	BB-	3.6	1.77	30%	1.24	3x

Source: Barclays, JP Morgan, Credit Suisse and Deutsche Bank, as at September 2014





“Believe those who are  
seeking  
the truth.  
Doubt those who find it.”

**Andre Gide**

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# SECTION 4

## SOVEREIGN AND CORPORATE DEBT

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### 4.1 ROUNDTABLE

Emerging versus developed market fixed income: examining the established and still establishing markets

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## 4.1 ROUNDTABLE

### Emerging versus developed market fixed income: examining the established and still establishing markets

#### Moderator



**Chiara Albanese**  
*Reporter, Wall Street Journal*

#### Panellists



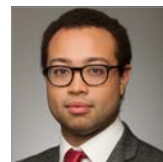
**Tony Charlwood**  
*Investment Officer,  
The Pensions Trust*



**Monique Wong**  
*Strategic Investment  
Adviser, Coutts*



**James Bevan**  
*Chief Investment Officer,  
CCLA Investment  
Management*



**Anthony Simond**  
*CFA – Investment  
Director, Schroders*

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**Chiara Albanese:** Asset owners have been accused of being too hasty by shying away from Emerging Markets (EM) especially after the taper tantrum discussions started. How can investors get the right exposure and the right selection?

**James Bevan:** First and foremost you need to have a robust and rigorous perspective on how you're going to do analysis and what you're going to look for. When one thinks about the interface of growth, balance sheets and yield, there are some outstanding opportunities such as India and Indonesia. Right now there are some quite interesting tactical and strategic trades that can be contemplated but in an environment where developed market bonds have been held at outrageously low levels through financial repression, it does seem to me that emerging market debt represents an opportunity to derive attractive real yields with the very legitimate expectation that default risk is very modest.

**Tony Charlwood:** I am broadly in agreement there. One has to accept that emerging market debt and indeed equities are more volatile than their developed market counterparts and you can see that in the stats on standard deviation. But I would make two points here, for long-term investors like pension funds who can

ride out the volatility, if you want to try and time your entry into these asset classes then you can get good performance in the short-term and benefit from the volatility because longer-term the higher risk is rewarded by the higher returns. I would certainly agree that emerging market debt opportunities are spread across a wide range of assets within the overall class, you've got hard currency sovereign debt, local currency debt, corporate debt; so there's a great diversity available both by types of debt and by the individual countries you can invest in. That diversification dampens the impact on performance of problems in single countries or companies. I also agree at the present time the valuations look very attractive. On local currency debt you can get a yield of about 6.75% - you do carry the currency risk there of course - and on hard currency debt probably anything from between 4 and 5% so there's certainly an attractive pick-up in yield compared to developed debt.

**Monique Wong:** In terms of the broader assets classes I do think that valuations are attractive. When we look at emerging market debt and we make the qualification between local currency debt and hard currency debt, local currency debt obviously carries with it quite a lot more volatility on the currency side especially now when you have a more entrenched

view about U.S dollar strength. The magnitude of that is even higher. If you look at the JP Morgan Emerging Market Currency Index, it's down about 7.25% this year, it was down about 7.5% last year and it's down about 25% from its peak 3 and a half years ago. You do have to be selective in the local currency space especially when you look at countries that have low growth and high inflation. It's uneconomic even to hedge out the currency risk. On the other hand when you look at hard currency emerging market debt, broadly the yields are 5 to 5.5% I'd probably like it higher than 5 and I don't like it at the 4.75 to 5% space but there is a lot of dispersion in between. With hard currency debt, if you look at it in dollars or sterling or euro, it's largely dollar credit or sterling credit or euro credit and therefore it's been the beneficiary of that reach for yield in the zero interest rate environment that we've been experiencing. We try not to be seduced by yield and we're not always immune to it and we assess each investment on its merit.

Because we are multi-asset managers, we don't have expertise in everything, we do use funds, ETFs and we do buy single bonds as well.

**Anthony Simond:** The taper tantrum was mentioned, people leaving emerging market debt; there was a lot of media coverage about that last



year. That was actually more on the retail fund side of the equation than on the institutional side. What we saw and I don't think we were alone in that, is that a lot of pension funds, insurance companies, sovereign wealth funds, around August to October, were actually looking to put money to work in emerging market debt because those yield levels were looking more attractive. So on a net basis, the asset class would have actually had positive in-flows in 2013 despite what you may have read in the broader press.

**Chiara:** What are the perceived risks associated with emerging market fixed income, and are they all justified or is there a danger of overshadowing the benefits of investing in this asset class? How do you minimise those risks and how does each regional cluster differentiate in that space?

**Anthony:** In terms of the risks, some of the misconceptions are associated with the fundamentals of some of these countries on aggregate. Debt levels have come down significantly over the last 10 years. In terms of external balances, reserve levels have also increased significantly and so you're being compensated for lower debt, higher growth, and you're getting those better yields than in the developed world. Just as an example, Mexico is one of our core conviction over weight positions. In the local market it's yielding about 6%, its debt level is about 48%, if you compare that with the U.S, debt levels are over 100% of GDP, you're getting less than 2.5% on your U.S 10 year treasury.. What are the risks? We did mention currency earlier, currencies are now used as the asset where a negative view is really expressed but it has allowed some of these fragile 5 economies to really adjust, India, Indonesia, Turkey, their current account deficits which were a problem last year have really adjusted in 2014. FX depreciation may be over but in the long-run can actually be a positive. Geopolitical risk is another big one, we've seen that in Russia and Ukraine in the Middle East, even in

China and Japan, that is something that an active manager would look to be fully up to speed with when making investments.

**Tony:** Specifically on emerging market debt, we gave our manager the mandate to run a local currency debt portfolio but with the discretion to have up to 25% in hard currency debt, so there was a clear view there that we like the outlook in the long-term for emerging market currencies but for more shorter-term tactical asset allocation they have the ability to switch. We are talking about currency risk but there is a risk for any country, not just an emerging market country, issuing debt off-shore in U.S dollars and as Anthony said you do have to look at the strength of their external accounts very closely. As he also mentioned, the fragile 5's external accounts have improved but I've been around long enough to remember the Asian debt crisis in 1997 and the various Latin American crises before and after that. There is a fundamental mismatch so just buying hard currency debt still leaves you with a sovereign risk.

**Monique:** I agree, I didn't point that out previously, but obviously just buying hard currency debt doesn't completely protect you from the currency volatility because it depends on whether the country or the sovereign has the ability to be able to pay foreign currency denominated debt. Some of that can be mitigated by buying emerging market corporate bonds, because a lot of emerging market corporates are global multi-national companies with revenue streams that come from various currency lines and you are somewhat protected there. In this low interest rate environment, apart from the reach for yield that you've had from investors, you also have the other side of the coin which is that corporate and

**“...emerging market debt and indeed equities are more volatile than their developed market counterparts...”**

sovereign issuers are looking to come to the market to borrow money for as long as possible and as at lower rates as possible. You do have issuers that have been able to come to the market at prices that I think we wouldn't have seen previously. I might have to defer to Anthony on this. Earlier this year, in the summer, Ecuador for example issued a 10 year U.S dollar bond at just under 8% and this is a country that 5 years ago defaulted entirely on their debt. In order to pave the way for bringing this bond to the market they bought back 80% of their defaulted debt which means that in effect there was a selective payment of defaulted bonds going on. If you ask me, 8% was not the right price, more than a few years ago that would have been somewhere in the double digits I would suggest.

**Anthony:** We actually bought that bond in December! For us, things have changed in the last 5 years. It's not that surprising they managed to get that deal away. The market does have quite short memories after all. They actually didn't default on their whole debt stock, interestingly when President Correa who is still in power, when he was first elected he chose what debt he deemed legitimate and what he deemed illegitimate so at the moment it seems now that he's in power, everything is now legitimate debt. We actually did sell it about a month later because it got to levels we thought were a bit too rich. We are seeing more issuers from these more frontier markets, countries like Rwanda issued in 2012, 20 years after they were in civil war, we're seeing issuance from

the likes of Honduras which has one of the highest murder rates in the world. These are some of the things the media would like to play up but actually if you dig a little bit deeper, these countries are actually fundamentally very strong and that's why you have to go beyond that first level when doing analysis.

**Chiara:** James, when you see those African countries issuing, do you get excited or scared? What's your reaction?

**James:** I get interested. The first thing one has to ask, is how comfortable will I be that money sums will be paid per the contract, what is the strength of the covenant? What I find very interesting is the extent to which some economies have woken up to the reality of international finance, and very often they will give you a lien over particular assets. Take Tanzania, for example, where it's quite easy now to lend money against agri-projects where they are underwritten by the availability of rights over land and this is a really important development in terms of the long-term access to capital. In contrast, I look at an economy like Jamaica which has still not addressed its historic debt problems and I think it is going to find it very difficult to come back to the international markets to borrow sensibly. For me it's all about what the contract is, and what the probability of being paid the figure that is on the table is.

**Chiara:** Anthony, you said the markets have a short memory but how short is it? To be honest the sell-off in emerging markets that we had when the tapering discussions started a year ago or so was quite significant. How much to an extent are we still bruised from this experience and what will happen when rates start to be hiked for real?

**Anthony:** We think of it as a dress rehearsal of something to come so hopefully the market has really priced in those Federal Reserve hikes. You said it was a bad period of risk aversion, I'm not saying it wasn't but from peak to trough the hard currency index fell about 11.5% last year. If you compare that to the Russia crisis and Lehman crisis where it fell 30%. Looking at it on a relative basis it really wasn't as bad as all that. As I said the fragile 5 is last year's story, rate rises likely in the price, and in general the market is quite surprised how well emerging markets have done this year. If you look at the beginning of 2014, most of the big investment banks are expecting another negative year at least in the hard currency side. We're likely to have a positive year and local currency should be flat to minor positive as well so for us we're not as worried as maybe we would have been last year.

**James:** Can I pin you down on this issue and see whether you share my perspective on whether the market believes that the Fed is tightening because there is real growth in the system. If I go back to 2004-2007, we know that emerging market debt saw spreads narrow in that period despite the fact the Fed was raising rates. Indeed emerging market debt outperformed U.S debt because people were much more confident that the economic backcloth was benign and that's what I

suspect we will see repeated if we are confident that the Fed will only raise rates when growth is much more visible.

**Anthony:** I don't disagree with that.

**Monique:** If you think about the taper tantrum and that's still quite fresh in our minds from last year, I'm going to say that broadly all income and yield asset classes are going to be vulnerable in a taper tantrum. How vulnerable they are and how interest rate sensitive they are is going to depend on a series of variables, one of which could be where you are in the yield, and how sensitive you are to interest rate rises. A couple of other things are quite important as well. One is positioning and to the question with regards to emerging markets versus high yield, maybe this reveals something about the way our book is positioned. I would have thought that right now high yield is a more populated trade than emerging market debt.

The other point I want to make is liquidity. I agree with you with regards to it depends on how global growth looks but I remember back to 1994 when the Fed was raising rates from 3% to 6%, so a 300 basis point rise. Sweden is not a big developed market but it's on the edge, and people could not get out of the Swedish bond market, Swedish rates rose 300 basis points just like the Fed. U.S 10 year yields rose something of the order of 300 basis points, Swedish 10 year yields rose 500 basis points because people couldn't get out and a lot of emerging markets are magnitudes smaller than that.

**James:** I'm only assuming that U.S 10 year yields rise 100 basis points. That's my assumption. I agree it's game over if we were to see 300 basis points more bond yield next year.

**Anthony:** The liquidity point is a very good one. Maybe not just emerging markets but generally fixed income. What you have seen is that asset manager Assets under Management

**"...emerging market debt outperformed U.S debt..."**

(AUM) now dwarfs the side of the street so the big investment banks don't really have the resource or they're not putting aside the money now for fixed income and what they can warehouse on their own balance sheet and that does provide a risk for fixed income in general.

**Chiara:** Tony, from a pension manager perspective, how do you tackle this liquidity risk that we clearly saw last year and is likely to emerge again?

**Tony:** It sounds a bit flippant but in a way we sidestep it. Our asset allocation to the emerging market debt is unlikely to change really so we can ride through the effect of drying up of liquidity in the short-term. Not to say we're complacent about how the asset class will perform in the short-term. We've recently commissioned some research on looking at the equity betas of our alternative asset classes and certainly emerging market debt has quite a surprisingly high beta, but of course it's a classic risk-on-risk-off asset class. When the perceived risk rises people get out of more risky assets and sell down equities; they would probably also sell down emerging market debt if they can and high yield debt. That is a concern in the short-term but as I say, we try and stick to the longer-term perspective.

**Chiara:** Based on your experience what were recovery rates from emerging sovereign debt? How does it compare with high-yield from developed countries and what are the benefits?

**James:** In purely statistical terms, emerging market sovereign debt default rates are remarkably low. Statistically, interestingly, U.S. high yield default rates are currently low but I would argue that is an accident waiting to happen and we are projecting default rates next year of between 1 and 3%, because the enormity of new issuance in the last couple of years looks to be wholly at odds with the financial strength of the underlying

delivery. EM debt is materially less risky than conventional high-yield credit debt particularly in current market conditions.

**Anthony:** Just in terms of recovery rates in EM debt, it's probably on average between 20 and 40 cents on the dollar on a sovereign default. For every U.S.\$100 of debt it's 20 to 40 range.

**James:** The global average for credit high yield is 40 but the default rate in sovereign is much lower which is an important point.

**Chiara:** within EM, Eastern Europe is now struggling with other issues. What are the opportunities and risks with Asia and Latin America?

**James:** I think there are three distinct areas. One to be avoided is low yield in Asia, so I would be looking to be out of if not already out of Malaysia and Thailand where I think future returns look small compared with the scale of risk. Secondly, there are markets that are benefitting from attractive supply and demand dynamics in this group I would plonk Singapore and Hong Kong, if you are prepared to stretch the definition of what is 'emerging'. There are then some very attractive high-yield opportunities and I would consider India and Indonesia. From a technical angle, the area where I have the greatest uncertainty is those markets that have benefitted most from positive fund inflows and it's not at all clear how investors are going to behave in the event that there is more turbulence in the market. Malaysia is an obvious risk and I look at Mexico as a potential risk on that front, and this is obviously not the same view as Anthony at all.

**Anthony:** I agree with your Asia call. We are overweight in India and Indonesia

**"In purely statistical terms, emerging market sovereign debt default rates are remarkably low."**

as well; we don't like Malaysia and Thailand. We do like some of the more frontier names like Mongolia and Vietnam. I was recently in Bangladesh and there are interesting opportunities there as well but that's really frontier. In terms of Mexico it is a very over-owned market, we don't see that as too much of a risk, the fundamentals continue to be strong and that reform story which is one of the main investment drivers going into India and Indonesia is still very strong in Mexico and we think that will continue going forward.

**Monique:** I'm going to compound that by saying we own the Mexico sterling 100 year bond. We like the equity but we think that equity valuations were too expensive so it was a bit like taking equity but with lower beta. If you are in a 100 year bond we think that bond yields are not going to go up very much in the U.K., we have the ability to withstand a certain amount of volatility in the portfolio and it's an economy that's almost a U.S. growth play.

**Tony:** We are very overweight in Brazil. I know the President Dilma Rousseff has just been narrowly re-elected and she's a socialist obviously with a lot of socialist rhetoric in her election campaign, but as was expected by our manager, she's already implementing a number of policies which were really her opponent's, the pro-business candidate. The central bank has already increased interest rates to try and bring inflation under control because it's approaching almost 7% and there's sufficient leeway in terms of debt levels for improving infrastructure through public spending programmes so they



feel there's an opportunity there which isn't recognised in the market yet.

**Chiara:** A path less trailed is emerging market credit. What do you see the prospects of this particular class to be?

**James:** From my point of view, very interesting. I am projecting that sovereigns will outperform credit but what I find interesting about the work that is required to analyse a credit debt opportunity is there is a lot less risk than there is with equity. Not only is it higher in the ladder, but it is also less exposed than equities to how boards will behave. We tend to have westernised perspectives of the priorities of shareholders in the minds of the board. That isn't always the case as we know in emerging economies. With debt, you have real tangible evidence as to what the instrument will give you, in contrast to the uncertainties in equity.

**Anthony:** We're positive on EM corporates; we were surprised last year how well they held up given what else is going on. Again the fundamental picture is pretty strong, less levered than their developed world counterparties, high yielding, it is an investment grade asset class. It was mentioned that there is a risk that they're issuing in U.S dollars but their revenues might not also be in hard currency. Actually if you dig deeper, most of the issuance has come from financials and from oil and gas companies who do have natural U.S dollar earnings so maybe less of a risk there than you might have expected.

**Chiara:** Will we be in an environment in the future in which emerging markets weight will reach 50% of the fixed income portfolio or not, and how long will it take?

**James:** I think the weighting to emerging market debt will rise inexorably because everyone knows that financial repression means that the pricing of developed market debt

is rigged and it's not 'open and honest' and if one is thinking about genuine diversification benefits and opportunities, at the same time focusing on the premise that one would like to get some reasonable rate of return, to me emerging markets wins hands down and therefore will end up having a much larger slab of portfolios. That said, in liability driven situations EM debt instruments are clearly inappropriate for DM investors.

**Monique:** Over time the proportions that we allocate towards emerging market debt will increase and largely because this is a growing market, it's also a market which is maturing in the economic cycle and especially where we have benchmark funds and these become an even bigger part of the benchmark it will do so too.

**Anthony:** I wouldn't say that EMD should be 50% of your fixed income allocation but the last survey we saw of pension fund allocation was about 5% to EMD. We probably would expect it to grow to 10 or 15% is probably a reasonable amount and that's a lot of money. We think there's a big structural backstop for the asset class that's going to occur over the medium term.

**Tony:** Pension funds are increasingly liability aware and so the commitment to liability driven investments is increasing, and that is developed market debt rather than emerging market debt, certainly for us. On the growth asset side we've now got a very diversified portfolio and I don't think within that we've got any plans to increase the proportion in emerging market debt.

**Chiara:** Thank you all for your insights into this subject.

**"Pension funds are increasingly liability aware..."**

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