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A dynamic approach to fixed income

The AB Dynamic Global Fixed Income Fund aims to achieve income and stability with lower risk, the hallmark of any retiree portfolio.

Fixed income products in Australia are commonly run at either end of the risk and return spectrum. Cash, term deposits and governments bonds tend to be low return and low risk, while debt-equity hybrids are seen as high return and high risk.

This scenario, albeit unintentional, creates a gap in the sweet spot for many investors where they seek income and stability. To achieve this balance, one of the biggest challenges is to change the mindset around bond investing and take a fresh look at diversifying fixed income portfolios.

AllianceBernstein (AB) portfolio manager John Taylor[01] says Australian investors should be able to earn a decent and sustainable level of income while doing as much as possible to preserve capital.

"This might not seem a terribly realistic expectation now that government bond yields are so low, but that's only because many investors assume that their fixed-income allocations should consist mainly of government bonds," Taylor says.

"If they're prepared to invest actively in other kinds of fixed-income assets as well, they'll find that it's possible to get a better balance between earning enough income and making their capital last."

The AB Dynamic Global Fixed Income Fund is designed for investors who want to take on a little more risk by investing in a truly active and international multi-sector strategy. The reward is the likelihood that income returns exceed Australian bank bill rates over the long-term.

Taylor points out the last time the Australian bond market was a top performer among developed countries was back in 2009. In 2015 it managed to scrape into only sixth place, he says, further highlighting an investors' need to be globally diversified.

Opportunities naturally arise from the sheer size of the global market, capitalised at more than $68.5 trillion. The Australian market ($1 trillion) offers government bonds, government-related bonds, investment-grade corporates, asset-backed securities and covered bonds. But the global market also offers high-yield corporates and emerging market securities.

Not your traditional fund

The fund differs from the traditional approach to asset allocation because its portfolio managers no longer think of bonds as purely the "safe" part of a diversified portfolio and equities as "growth" – especially with bond yields at historically low levels relative to equity yields.

The portfolio managers believe the sensible thing to do now is to look at bond and equity allocations for what each can provide in terms of both risk mitigation and returns. Taylor says this approach lends itself to casting a wide net in selecting sources of risk and return.

He says investing in fixed income boils down to the following four basic investment principles:

- Go global– invest across all geographies to take advantage of income generating opportunities while also managing risk
- Go multi-sector– invest across all bond market sectors, particularly where it's possible to balance risk and return (for example, by exploiting the interplay between credit and interest rates)
- Be unconstrained– don't be tied to market-weighted bond indices, which are usually highly exposed to the most indebted borrowers and thereby represent a credit risk: As an example, the yield on the Barclays Global Aggregate Bond Index has fallen from 4.5% to less than 1.5% over the past 10 years. What's worrisome is that at the same time, the duration has increased from a little over five years to nearly seven years. In other words, this strategy is now taking on 40% more interest-rate risk than 10 years ago, but with only one third of the yield; and
- Be active– active strategies are better equipped to find income-return opportunities and manage risk, including downside risk, when markets fall.

Balancing risk and reward

As alluded to above, no country or sector can win all the time. AB and Bloomberg Barclays data also shows, on average, a global basket of countries typically beats the Australian market – and with lower volatility. Taylor says the same is true of sectors where, for example, credit or corporate bonds usually do well when interest rates or government bonds are not doing well, and vice-versa.

The key to managing these global shifts is to switch between countries and sectors as they become riskier or less risky, or more attractive or less attractive from a returns perspective.

In a recent whitepaper, Taylor explains the reasons for choosing different sectors can be quite nuanced. In emerging markets, for example, investors can hold local-currency bonds or hard-currency – that is, US-dollar bonds – yet the performance of these subsets can vary markedly.

"Emerging market US-dollar bonds were at the top of the pack in 2012 but fell to the bottom the following year," he says.

The correlation between different sectors can be important, too. For example, emerging market bonds and high-yield securities in developed markets were highly correlated until the "taper tantrum" of 2013. They were less so after this episode and such cyclical variances create opportunities for active investors, Taylor says.

"By actively managing the interplay between these countries and sectors, we can periodically sell the outperformers in one and buy underperformers in the other," Taylor says.

"When this is done properly, the price fluctuations can offset each other, leaving investors with the coupon income. This helps reduce risk while maintaining a steady stream of income, and provides an opportunity to achieve the best results in terms of a balance between risk and reward."

The quote

It's possible to get a better balance between earning enough income and making capital last.

The final tip

Any claim that the Australian bond market is the best place to invest should be treated with caution, Taylor warns.

"Apart from being small and narrowly-based, it can be risky, too," he says.

"Take hybrid debt-equity instruments, for example, which are typically issued by banks and promoted as good income investments. While superficially they might look as though they are offering attractive yields, they do so to compensate for the equity-like risks they pose.

"There may be less certainty about the sustainability of their income payments compared to those of conventional bonds, for instance, or they might at some point be converted into equities rather than income securities.

"When that happens, investors end up holding the very opposite of what they had thought they had bought. There are much better opportunities for income and stability for investors who are willing to be rewarded for taking on a little more risk in a risk-aware global, multi-sector, unconstrained and actively-managed bond strategy." FS

Watch the video on www.fsitv.com