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Fixed income, flexible investing

Neuberger Berman presents a case for taking fixed income allocations offshore in pursuit of higher yields.

As we're all aware, an inverted yield curve – where short-term bond yields are higher than longer term bonds – has long been considered a reliable indicator of whether an economy is going to enter a recession.

In the US, historic examples include a 13-month inversion in the lead up to the Global Financial Crisis, and the 254-day inversion that led to the implosion of the dot-com bubble in 2000.

While in June of this year Australia's yield curve inverted for the first time since the Global Financial Crisis, the current US yield curve inversion is now hovering around the 12-month mark, making it one of the longest inversions since 1980.

While it's often said that records are made to be broken – could we have done without this one?

Well, it depends on who you ask.

For instance, Neuberger Berman senior portfolio manager, fixed income Adam Grotzinger says a lengthy inverted yield curve presents attractive opportunities for bond investors.

"We're definitely longer in the tooth of this cycle, but I think that's to be expected given it's taken so long to get inflation under control and growth is still reasonable," he says.

"So, a longer cycle this time around but these don't happen often, and they present interesting opportunities for investors as and when they come around."

In fact, the yield curve has only inverted five times since 1980. When it does, Grotzinger says that's the time financial advisers should look to add more duration to clients' bond portfolios.

And there's two reasons for this.

The first, he says, is if you're investing to generate a stable income.

"Adding duration during an inverted yield curve environment historically has enabled you to maintain that level of income because as and when the central bank cuts rates, that cash rate or deposit rate will decrease while longer duration opportunities will hold their yield, so you have an element of yield maintenance by extending duration," Grotzinger explains.

But there's also the additional aspect of total return for investors.

"In addition to maintaining yield, when yields drop you have that additional power of generating positive total return to your bond portfolio," he says.

"It's a good thing to start thinking about because it lets you maintain yield and potentially add total return to your bond portfolio by extending duration."

And this makes sense, he says, because the toing and froing of inflation is going to be a major theme for fixed income investors over the coming 12-24 months.

While it may not necessarily be true for the US, global inflation is on the right trajectory, being that we're moving to a disinflationary environment, which is a stark contrast to where we've been over the last year or so.

"[We're moving in] a direction of getting inflation back to the levels that central banks really want to see towards the end of 2024," Grotzinger says.

"The implications of that are pretty positive for bond investors, being that we're getting much closer to the end of the hiking cycle as inflation targets are expected to meet their medium-term objectives, and that should bring a stabilisation to interest rates."

And that's a good thing for bond investors in that there's potential for not only high income out there in the markets but equally positive total returns over the forward-looking environment, he notes.

As such, Grotzinger says now is prime time for local investors to look at opportunities in fixed income – and they shouldn't be afraid to take their allocations abroad, namely the US.

This is because the Federal Reserve has raised interest rates higher than the Reserve Bank of Australia (RBA), with the Fed Funds Rate now sitting at a 22-year high of 5.25%-5.5%, but with an expectation of hitting 5.6% before the year is out. In comparison, the RBA cash rate is currently 4.1%. While inflation is expected to improve throughout the remainder of the year and 2024, it won't be returning to pre-pandemic levels any time soon.

"It's a higher yielding environment in the US market. So, clients thinking about additional income opportunities outside of Australia, there is a rationale for going abroad, particularly to the US market, to have that yield in your portfolio," Grotzinger explains.

The other reason for looking offshore is one we all know very well, often touted as the only free lunch in investing: diversification.

"Investing outside of Australia brings additional opportunities and diversification to a domestic-heavy portfolio. Australia's representation in the global fixed income markets is pretty small, and it's relatively concentrated with a lot of banking exposure and a lot of commodities, so the US markets provide additional diversification and yield opportunities relative to Australia," Grotzinger says.

A simple way for investors looking to increase or switch up their fixed income allocations and to access all these benefits is through the Neuberger Berman Strategic Income Fund, the fund manager's flagship, multi-sector offering.

"The Neuberger Berman Strategic Income Fund is focused on maximising returns and delivering high levels of current income for a volatility that looks like an investment-grade bond portfolio," Grotzinger explains.

"So, we have thresholds on the amount of risk we want to take; it's really about maximising the return we can achieve for that level of risk tolerance for our clients."

The fund, which is Recommended by both Lonsec and Zenith, is well diversified and generating an attractive level of current income, which is distributed to investors monthly, he adds.

"Through a single vehicle, you can attain that diversification you're after, you can exhibit higher levels of income, and you can further increase your diversification through exposures," Grotzinger says.

With US$168 billion invested in fixed income, and as a 100% employee-owned private partnership, the Neuberger Berman team also has skin in the game, so you can rest assured their values and objectives are aligned to investors'.

"It's really just us and the clients, focusing on achieving objectives with no corporate parent or other businesses competing in terms of what we do with those clients," Grotzinger says.

"That's a fairly unique culture for a fund manager." **FS**

The quote

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Watch the video on www.fsitv.com

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