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Some golden rules on fixed income are just not meant for today's markets. Take the case of the Brexit-induced market shock, the oil price collapse and the Chinese currency devaluation in recent times.

On all three occasions, bond managers who did not break their benchmark-based rules would have suffered losses.

By contrast, those who did would have fared better and even made some quick gains.

In this edition, we invited T. Rowe Price to walk us through the rationale behind the Dynamic Global Bond Fund and why it pays to be nimble and flexible when the unexpected happens.

We invite you to read this article to find out more.

Michelle Baltazar
Director of Media & Publishing

Protecting against volatility through unconstrained bond investing

As the challenges facing bond investors keep coming, it is becoming increasingly difficult gain smooth, consistent returns from bond portfolios. Over the past 12 months, the slump in commodity prices, China's slowdown and intense speculation about central bank actions have made for a highly volatile and uncertain period for the global economy. Then last month, the UK unexpectedly voted to leave the European Union, sending markets worldwide into a short-term tailspin until order was restored.

Events like these are only adding to the pressures felt by fixed income investors already dealing with the impact of a major deleveraging cycle that began following the 2008 Financial Crisis. Yields are at record lows: at the end of June, the total amount of government bonds with negative yields reached USD $11.7 trillion[1]. Australian bond yields are currently comfortably above those of most of the rest of the developed world, but could fall as the Reserve Bank of Australia is expected to cut interest rates further.

A different approach to bond investing

In times like these, when yields are low, markets are volatile and the prospects for the economy are uncertain, traditional benchmark-based approaches to bond investing are no longer as effective. That's why many investors are adopting a more unconstrained approach to - one that considers the full spectrum of the fixed income universe, including government bonds and credit instruments, and countries that are less correlated to major markets.

The good news is that fixed income investors today have more choice than ever before. In countries where interest rates are rising, for example, steepening yield curves can offer income opportunities, while rising volatility on foreign exchange markets can lead to currency opportunities. Emerging markets can offer the higher yields that investors look for but may come with added risk, while lower-yielding, less risky securities still offer benefits in a period of highly volatile equity markets.

The bad news is that greater choice does not necessarily make the job of fixed income investors any easier - with more options comes the need for more research, due diligence, and risk management. However, investors who actively embrace this wider opportunity set are ultimately likely to find their efforts rewarded, while those who do not seek access to different country bond markets could miss potential performance enhancement and diversification.

And the opportunity set continues to expand and evolve. Since the 2008 financial crisis, more companies in Europe are accessing the public debt markets for their financing needs, which is fueling the growth of the euro high yield asset class. Similar trends are occurring among companies in the emerging markets—indeed, the Emerging Markets corporate debt market is the fastest-growing fixed income asset class.

Investors with access to a broad range of markets can derive returns by taking positions in countries at differing stages of the interest rate cycle. Figure 1 illustrates a hypothetical interest rate cycle between a selected number of developed and emerging markets. It shows how an investor can take advantage of relative country exposures in markets where interest rates are falling or stable versus countries where interest rates are rising. This enables investors to not only exploit interest rate differentials between countries, but also adjust duration (price sensitivity to changes in interest rates) and yield curve exposures within individual countries.

Protecting against downside risk

Let's see how an unconstrained approach works in practice. Over the past year in our Dynamic Global Bond Fund, we have faced three major tests of our ability to protect clients' assets in highly volatile markets. The first came in August last year, when equity markets plummeted following the People's Bank of China's decision to devalue the renminbi. In response, we quickly exited a number of long positions in Asian currencies such as the Korean won and the Malaysian ringgit. We had previously felt that these countries were relatively immune to a rise in volatility, but in reality the situation in China put pressure on local bond markets. Subsequently, we adopted short positions in a number of Asia ex-China currencies, which proved beneficial for performance during the autumn.

The second test came in January 2016, when equities slumped again on the back of renewed fears over China and the spectacular collapse in the oil price (Figure 1). However, we had begun the year with a strong defensive stance, having added a number of hedges to the strategy during November and December. These included short positions in credit derivative instruments, long duration positioning in high quality government bond markets and short positions in specific emerging market currencies versus the US dollar. Most of these defensive positions paid off in January.

Then came the Brexit vote. In the month running up to the UK's referendum on European Union membership on 23 June, it became clear that volatility would rise and that the cost of insurance against that volatility was fairly cheap. While we did not necessarily predict a Leave vote, we saw the outcome as asymmetric: the potential downside impact of a Leave vote on the financial markets would be much greater than the upside response to a Remain. Our positioning therefore reflected this asymmetry so that in the end we benefited from the outcome.

Going unconstrained does not mean sacrificing quality

It is important to stress that adopting an unconstrained approach need not come at the expense of quality or bring additional transaction costs - it is possible to retain a high-quality, liquid profile while still being agile enough to manage risks. A fixed income strategy that is not constrained by a benchmark, but still contains the best investment ideas, should fulfill fixed income's role as a diversifier and a provider of sustainable income and capital preservation. Ultimately, the goal is balance: how to find the right mix between duration, country allocation, bottom-up security selection, and currency preservation to achieve optimal returns while effectively managing risk and protecting the portfolio. FS

[1]Fitch Ratings

Watch the video on www.fsitv.com

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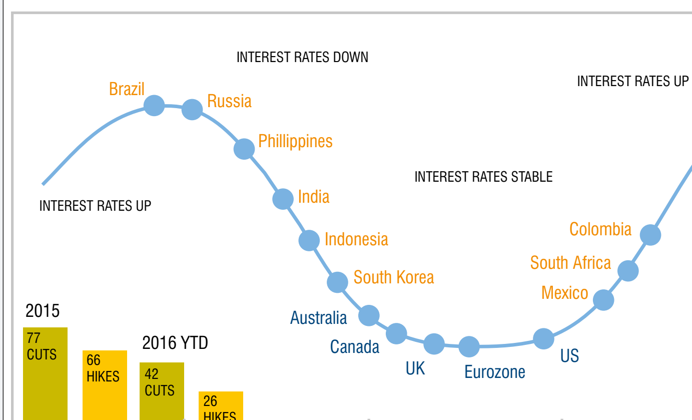
Figure 1. Illustrative interest rate cycle



The two columns of cuts versus hikes are the actual cutes and hikes that have happened across countries worldwide. As of June 30, 2016.
Sources: CRB Rates and T. Rowe Price