BNY MELLON

VIEWPOINT

Mandated to own fixed income?

Negative real yields mean that developed government bonds are no longer the natural home for fixed income assets. Where will the search for yield and meaningful returns take those investors who do not want to make a significant shift up the risk spectrum?

Challenges ahead for fixed income investors

Most multi-asset portfolios include a healthy allocation to fixed income to help manage portfolio volatility and provide a degree of protection against interest rate and inflation risk. With the exception of pure growth mandates, private client portfolios are likely to have bond allocations of anything from around 20% for balanced funds up to more than 50% for more conservative mandates (Source: FTSE APCIMS Private Investor Indices Asset Allocation effective 1 June 2012).

Developed government bond redemption yields at record low levels

Source: Datastream as at 20 Feb 2013

Fixed income assets have tended to bring intrinsic benefits to a portfolio: developed market fixed income, notably government bonds, still tends to be seen as a safe haven in times of market turbulence; and pre-defined cash flows help investors to manage income requirements, at least on an absolute basis.

After an extended period of falling yields, and faced with an era of fiscal austerity, potential inflationary pressures and unprecedented policy action by the major central banks, the bond landscape appears to have shifted.

In parallel with a period of strong performance, bond markets have become increasingly diverse on the back of fundamental shifts in capital markets and the shrinking universe of AAA-rated government bonds. According to recent estimates, the pool of pure AAA-rated government debt has fallen from US$10.9 trillion at the start of 2007 to just US$4 trillion in 2013 (Source: FT.com 26 March 2013). As investors have looked beyond traditional fixed income sectors, asset classes once considered esoteric are moving into the mainstream, bringing added choice for investors and greater potential to diversify fixed income exposure.

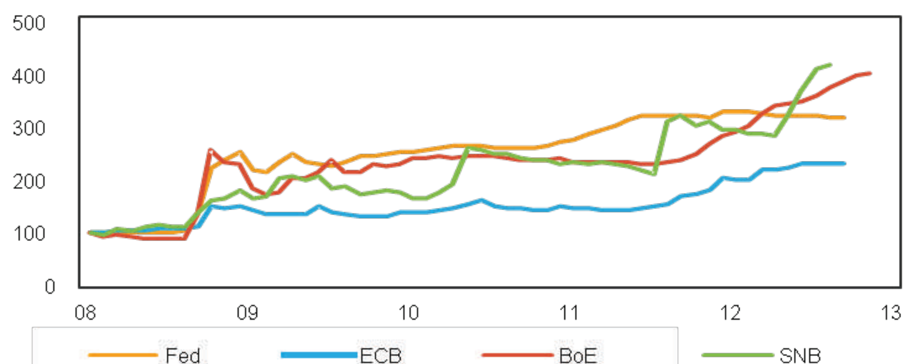
All of this gives rise to a number of questions around the prospects for fixed income markets and presents challenges for those investors who are mandated to own fixed income. How do investors meet these challenges head on?

Where we are today

Still value in government bonds?

Bond markets generally had a good year in 2012 although government bonds lost their shine towards the end of the year. Volatility was also high, with markets vulnerable to newsflow on developed market sovereign debt and economic data, a theme that has continued into the first few months of 2013, with Cyprus the latest chapter in the eurozone saga.

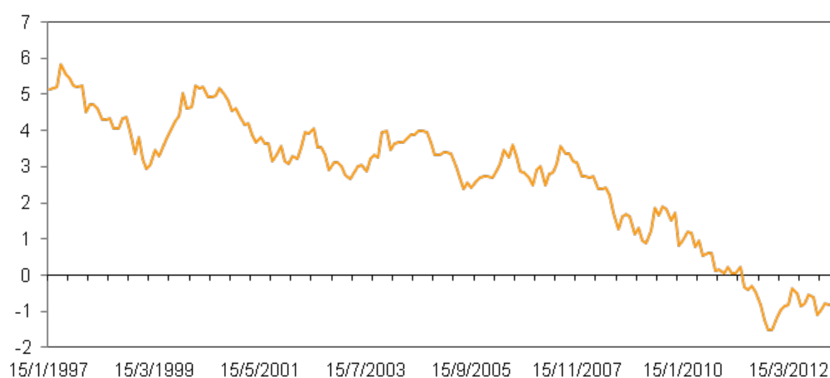
Central bank assets, January 2008 = 100



Source: Meriten Investment Management, Ecowin, 12/2012

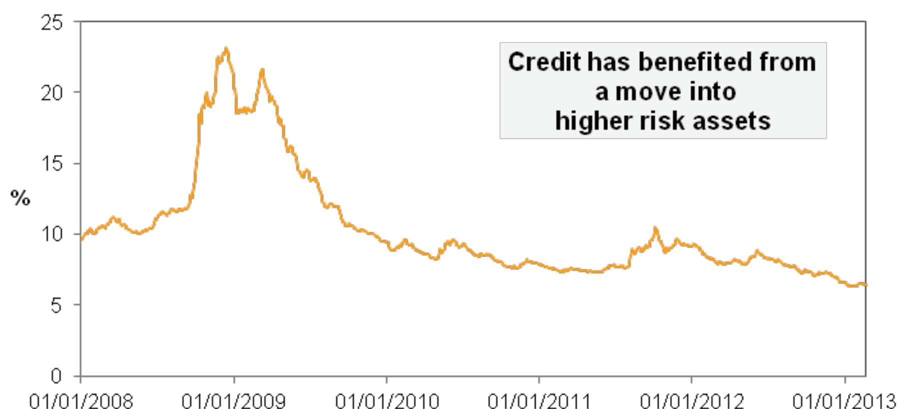
As part of the effort to keep interest rates low, the world's leading central banks have engaged in wide-scale quantitative easing. Extensive bond-buying programmes have seen central bank balance sheets expand sharply (see chart above) and led to artificially-low yields on government bonds. The rally in riskier assets from late summer 2012 onwards was the result of this unprecedented policy action, which drove investors to move up the risk spectrum in search of greater potential returns. Corporate bonds and high yield, in particular, saw marked spread compression.

Real Yields—UK 10-year benchmark bond



Source: Datastream 15/1/1997 to 15/2/2013, UK benchmark bond 10 year redemption yield minus UK CPI ex commodities & energy yoy % change. Past performance is not a guide to future performance.

Bank of America Merrill Lynch Global High Yield Index (redemption yield)



Source: Datastream as at 25 Feb 2013 in euro. Past performance is not a guide to future performance.

With developed market bond yields at record low levels, real yields have dropped into negative territory as inflation has remained persistently high in spite of the low-to-no growth economic backdrop. A further consequence of the fall in yields has been a steady rise in market duration, leaving bonds highly vulnerable to any tightening in monetary policy — whether in the form of higher official interest rates or the withdrawal of liquidity.

High yield bonds reclaimed from the ‘junk’ yard?

Spreads on high yield have come in a long way since the immediate aftermath of the Lehman Brothers collapse. At the end of 2008, global high yield spreads stood at 1731 basis points (bps) over US Treasuries. They finished 2012 at 561 bps over Treasuries after another strong year when spreads came in by nearly 200 basis points – all the more remarkable given the record level of new issuance which extended right through to year end. The J P Morgan Global High Yield Index was up by 16.21% in US dollar terms (Source: J P Morgan, High Yield Market Monitor 2 Jan 2013). Where does this leave markets looking forward? Is the continued appetite for corporate issuance in evidence so far in 2013 misguided given recent strong performance?

A healthier corporate sector post credit crunch

The aftermath of the global credit crisis has had some important effects in the credit space. With notable exceptions, and in sharp contrast to record levels of public sector debt, the corporate sector is generally enjoying a period of financial health. After

concerted efforts at deleveraging since 2009, company balance sheets are generally much stronger now than they were and liquidity is much improved. Companies are also more cautious about taking on debt to fund acquisitions.

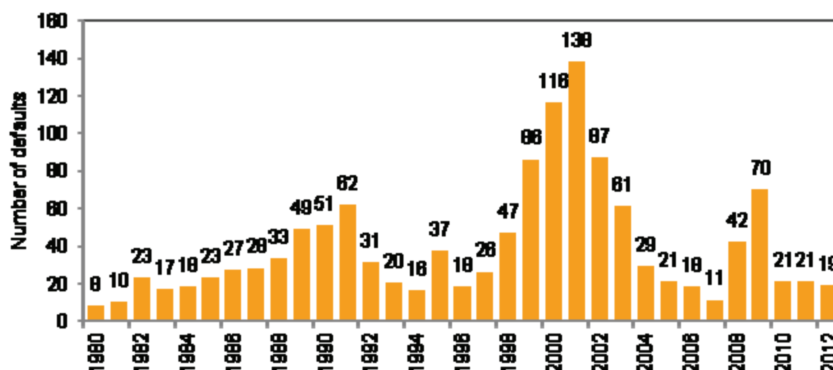
All of this has left companies in much better shape to face prolonged economic weakness. Despite the low-to-no-growth backdrop, defaults globally are relatively low and, with lending standards easier in both the US and Europe, this should remain the case. The global high yield universe saw the par-weighted default rate drop to 1.14% overall in 2012, and the number of defaults has also been consistently low over the last three years as the chart below illustrates (Source: JPM High Yield Market Monitor 2/1/13).

"Financing available since the credit crisis has been characterised by wider spreads, less leverage and stricter security terms for borrowers, particularly in Europe. The most recent vintage of financing is therefore better protected against the risk of default."

Paul Hatfield,

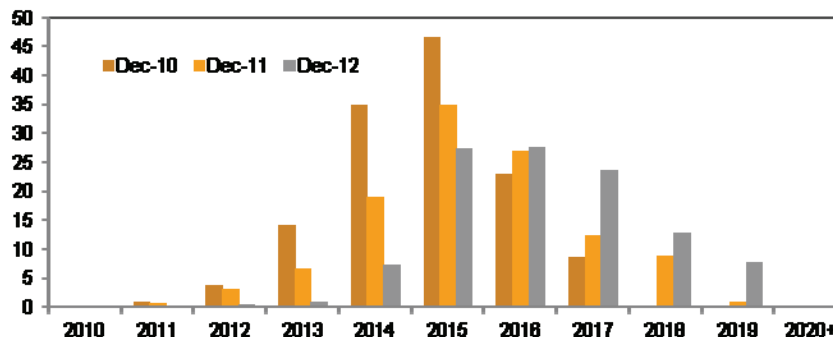
Chief Investment Officer, Alcentra

Low level of defaults reflects health of corporate finances and easier lending



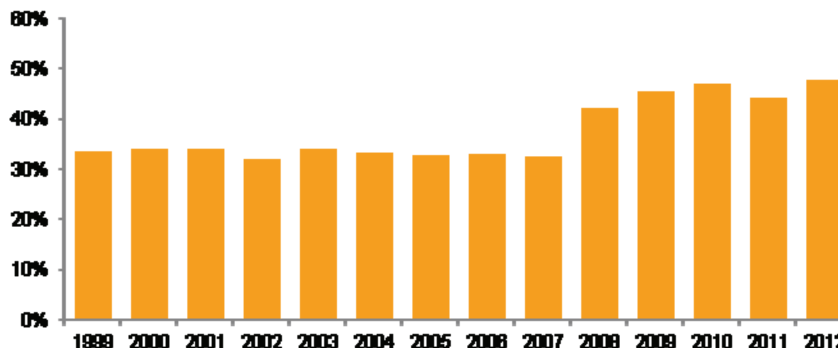
Source: J.P. Morgan; Moody's Investor Service

European Loans Maturity Profile (€ billions of facilities in the S&P ELLI)



Source: S&P Global Leveraged Lending Review, Q4 2010, Q4 2011 & Q4 2012

Average Equity Contribution to Leveraged by-outs



Source: Standard & Poor's LCD, "European Leveraged Lending Review", Q4 2012

Some concerns remain, not least about the ‘wall of debt maturities’ that needs re-financing following a boom in leveraged buyout financing between 2004 and 2007. However, many companies have been pro-active in tackling this through a range of measures — for example, pre-emptive re-financing, issuing senior secured high yield bonds to pay off loans, or extending maturities on existing issues. This process has also helped by filtering out the weaker companies that were unable to re-finance through the debt markets. Furthermore, stricter lending criteria have led to new deals exhibiting higher equity contributions and lower debt to cash flow ratios (see previous page).

Is there more to come from credit?

Against this backdrop, how much more do credit markets, both in the US and elsewhere, have to give? Although speculation has already begun over when and how abruptly the US Federal Reserve’s (Fed) bond buying programme will come to an end, central bank policy remains supportive for high yield markets for the time being. So what is likely to drive a widening of spreads? Equity market volatility could be a factor in determining how well credit performs through 2013. Short duration credit tends to be more resilient, but there is a close relationship between the level of the VIX and returns in the credit market overall, notably in high yield (see below). A small increase in the default rate and a spike in equity volatility could mean significantly wider spreads.

“There is no question that the macro environment for companies will remain uncertain especially in Europe. The tough fiscal backdrop in much of the developed world is likely to see growth struggling to rebound sharply. Broadly speaking, however, credit tends to do relatively well in low-growth environments as cash flow rather than earnings momentum is the crucial factor in determining performance.”

Alexis Renault,

Head of High Yield, Meriten

JPM 2 Factor Regression Model

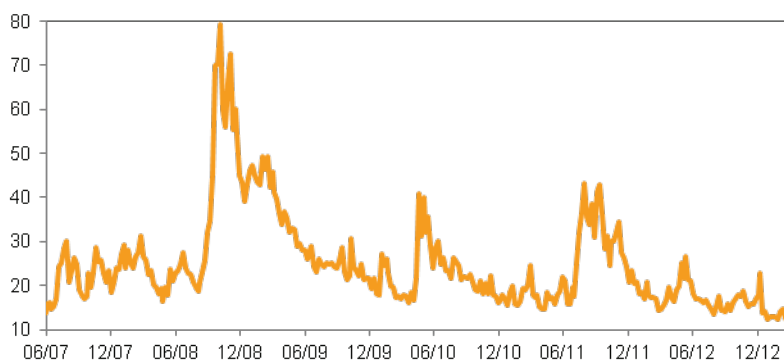
Index: BofA ML Euro High Yield Fixed Floating Rate Constrained Index - HEAC

Performance on a one year horizon

Default Rate \ VIX	10%	15%	20%	25%	30%	35%	40%	45%	50%	55%
1%	13.3	11.1	8.9	6.7	4.5	2.2	0.0	-2.2	-4.4	-6.6
2%	12.2	9.9	7.7	5.5	3.3	1.1	-1.1	-3.4	-5.6	-7.8
3%	11.0	8.8	6.6	4.4	2.1	-0.1	-2.3	-4.5	-6.7	-8.9
4%	9.8	7.6	5.4	3.2	1,.	-1.2	-3.5	-5.7	-7.9	-10.1
5%	8.7	6.5	4.2	2.0	-0.2	-2.4	-4.6	-6.8	-9.1	-11.3
6%	7.5	5.3	3.1	0.9	-1.4	-3.6	-5.8	-8.0	-10.2	-12.4
7%	6.3	4.1	1.9	-0.3	-2.5	-4.7	-7.0	-9.2	-11.4	-13.6
8%	5.2	3.0	0.7	-1.5	-3.7	-5.9	-8.1	-10.3	-12.5	-14.8
9%	4.0	1.8	-0.4	-2.6	-4.8	-7.1	-9.3	-11.5	-13.7	-15.9
10%	2.9	0.6	-1.6	-3.8	-6.0	-8.2	-10.4	-12.7	-14.9	-17.1

Past performance is not a guide to future performance.

VIX: Chicago Board Options Exchange Volatility Index
Significant decrease recently



Source: Bloomberg, Meriten Investment Management; 29/03/2013.

For the time being, however, default rates remain low, equity volatility is relatively low, and from a technical point of view, demand is still strong. Nevertheless, issuer selection will be critical and those companies that can demonstrate strong cash flow are likely to benefit.

Emerging market debt matures

Alongside other historically high-yielding asset classes, emerging market debt has also benefited from the hunt for yield. The convergence of this and a number of other factors has fostered a growing interest in emerging market debt and seen it take its place as a fully-fledged asset class. With relative stability in many emerging economies and improving fundamentals, there has been considerable growth in investment-grade emerging market debt over the last decade – from both sovereign and corporate issuers. In the early 1990s, high quality, investment-grade bonds – those rated BBB and above by Standard & Poor's – accounted for about 3% of the emerging market bond universe, all of it US dollar-denominated. Today, they account for over 60% of the total universe and in the first nine months of 2012 almost 80% of sovereign and corporate new issuance was investment grade (Source: JPM Emerging Markets Research Aug 2012).

Access to emerging market debt has also improved, with greater liquidity and an investment universe that has grown significantly over the past 25 years to include more than 50 sovereign issuers. The total size of outstanding emerging market debt stock, including sovereigns, corporates and local currency issues, is approaching US$8 trillion. The investable universe covered by J P Morgan indices stands at over US$2.5 trillion (Source: JPM August 2012). Will emerging market debt continue to see the flow of funds that has driven this growth? And what will that mean for yields?

"We believe that emerging market debt is still attractive compared to developed market equivalents, but the days of collecting coupons of 7% are over – investors will need to adopt an increasingly selective approach."

Colm McDonagh,

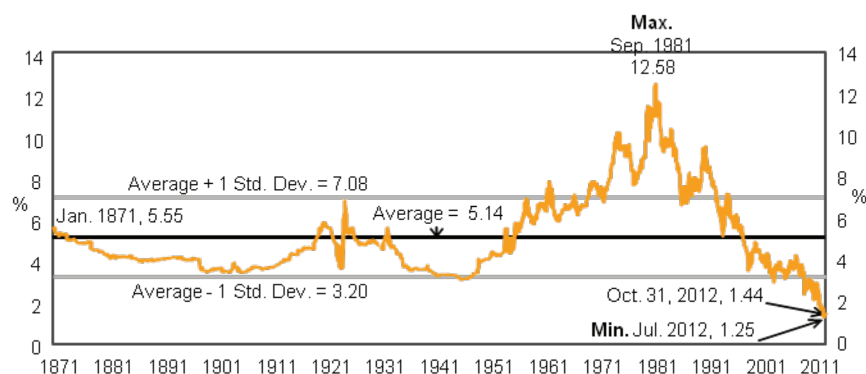
Head of Emerging Market Debt, Insight

Beyond infinity?

The challenge that fixed income investors face is how to mitigate risks around inflation and interest rates, but at the same time deliver meaningful capital appreciation. It has also become increasingly difficult to determine what 'normal' bond yields look like.

In the short term, it seems likely that policy and politics will continue to outweigh fundamentals in driving bond yields. Over the longer term, the concern must be what happens to government bond yields once the global economy starts to recover. In many cases, bonds now offer low to negative real returns with inflation an increasing concern given the pressure on commodity prices, including soft commodity prices that feed directly into consumer price inflation.

Lowest Interest Rates in 142 Years:



*Germany, Japan, U.K., and U.S.
Source: BNY Mellon using data from Global Financial Data and Bloomberg

The Fed has gone on record committing to the continuation of quantitative easing (dubbed 'QE infinity' by some commentators) until employment in the US is back on an even keel — its stated target is to see unemployment drop below 6.5% from its current level of 7.7%. Once this happens, there will be more questions to answer: how quickly will the liquidity tap be turned off in bond markets and how quickly will yields rise as a

result? And will official short-term rates rise in tandem, particularly if this coincides with a build-up in inflationary pressure?

There is little debate about the fact that rates are almost bound to rise at some point from their current 140-year lows (Source: BNY Mellon, Global Financial Data, Bloomberg). There is much greater debate about whether or not the bond bubble will burst or the Fed will manage to deflate it gently.

For those investors looking for ways to protect their portfolio from interest rate risk, it could be time to re-think bond strategy and investigate a wider range of fixed income investment opportunities.

A range of opportunities open to investors

There are a number of approaches that investors can take to mitigate interest rate risk and a range of strategies available that offer routes to implementation depending on the overall aims and risk/return profile of each portfolio. For example, using derivatives-based strategies to partially or fully protect against falling bond markets; or by diversifying into fixed income and credit sectors that display less interest-rate sensitive characteristics or that tend to outperform in low-growth environments.

"Drawing on an expanded investment pool and, therefore, a more nuanced global universe provides investors with greater opportunities to diversify interest rate, credit and currency risk. Our current focus, for example, is on those markets we feel are best supported by quantitative easing, but still have control over their fiscal position — and therefore retain the ability to cut interest rates."

Paul Brain,

Leader of Fixed Income, Newton

Below we examine a number of options an investor might consider. Depending on the combination of assets and the degree of re-allocation, and the resultant risk/return profile, diversification benefits for portfolios can include: lower portfolio duration, a higher yield for relatively little additional risk and greater potential for capital appreciation.

A dynamic approach to bond investing

A number of global bond strategies have the flexibility to invest in a broad-based universe and take tactical asset allocation decisions that extend beyond developed government bond markets, offering a well-diversified portfolio but still with a eye on controlling risk. Many of these strategies have the freedom to invest in credit markets as well as sovereign issues, and with no geographical or sector limits.

This allows managers the freedom to manage exposure to macroeconomic themes, either through bond or currency positions, as well as seeking out relative value across fixed income markets and sectors. Investing beyond what were traditional safe-haven markets does not necessarily mean a significant increase in risk. Emerging market debt is a case in point. Many emerging markets are now on a sounder financial footing than their developed counterparts – they enjoy low levels of government and personal debt, low pension liabilities and healthy fiscal positions. Including investment-grade developing markets can provide considerable diversification benefits. There are also a number of smaller developed markets that have very small weightings in global bond indices but offer liquidity and a sizeable share in world GDP.

A focus on absolute returns

Derivative-based approaches also offer diversification benefits. Using long/short strategies can limit draw-downs at times of market stress. Absolute return-style investing aims to generate a positive return regardless of market conditions and many absolute return-style strategies are permitted to take negative duration positions, allowing them to benefit from rising yields.

Emerging market debt no longer a single asset class

There are undoubtedly opportunities for long-term investors from both a yield and capital growth perspective, as emerging market debt (EMD) moves to a more mature and sophisticated phase of its development. However, as the EMD universe has expanded it has also become more complex and can no longer be viewed as a homogeneous

"With market uncertainty showing no sign of dissipating, investors are recognising the value of a true multi-strategy approach to fixed income management. No matter where we are in a market cycle, there are opportunities to be had, whether on a long or a short basis."

Peter Bentley,

Head of UK and Global Credit, Insight

market. Government issuance is no longer confined to 'hard' currencies like the US dollar. Local issuance is on the increase and demands a more in-depth understanding of country-specific drivers. Issuance from the corporate sector is also on the increase, supported by relatively strong economic growth compared to the developed world. Diverse issuance is leading to divergent returns – currency and issuer selection within emerging market debt are becoming increasingly important.

Credit including high yield and specialist sectors

Credit strategies are an established part of many fixed income portfolios, but growing corporate issuance has seen the development of a more nuanced and sophisticated universe. This has given rise to a wide array of investment opportunities covering a range of maturities across the quality spectrum, from investment grade credit to high yield and distressed debt. Whether investors include investment grade and high yield in portfolios or choose a more narrowly-defined universe, analysis into credit quality and robust issuer selection are key success factors in this space.

Depending on how much risk investors are prepared to take on in order to capture potential returns, there may also be opportunities in the 'distressed' area of the credit market.

Looking beyond mainstream credit investing

There are a number of specialist areas of the market that could be worth consideration, depending on the degree of risk that investors are happy to take. Though we by no means capture every strategy available, a number of examples are included below:

Keeping it short

Investing in shorter-dated paper and keeping portfolio duration low can limit interest-rate risk and limit a portfolio's sensitivity to widening spreads. A short investment horizon also means that credit analysis has a greater chance of uncovering any potential problems over the lifetime of the bond.

"Secondary market prices in loans have rallied but still offer attractive margins, while attractive terms are available on primary issues. We are also seeing the prudent use of leverage. Defaults and downgrades tend to be concentrated in the older vintage credits."

Paul Hatfield,

Chief Investment Officer, Alcentra

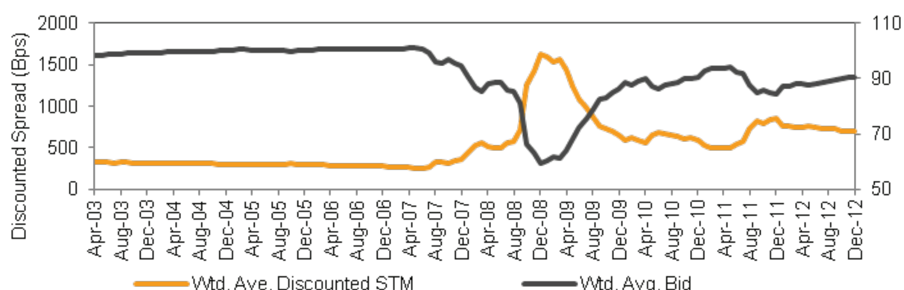
Loan investing

A highly specialist investment area, secured loans are sub-investment grade corporate debt instruments that are secured against the assets of the borrower. Given the intrinsic nature of the notes, secured loans can benefit from a higher recovery rate in the event of default than unsecured obligations like high yield bonds.

Furthermore, loan investors often receive the benefit of extensive legal covenants that provide control over borrowers in the event of weaker performance. Due to their position in the capital structure, secured loans also display lower secondary market price volatility than high-yield bonds.

'Secured' high yield

Discounted Spreads-to-Maturity vs. Weighted Average Bid



Source: Standard & Poor's "LCD European Weekly Secondary Report", 17 January 2013

“We think we are likely to see opportunities to pick up distressed credit below fair value from forced sellers as they sell debt to clear out their balance sheets. We also expect to be able to pick up mis-priced credits that provide arbitrage opportunities around event risk and capital structure.”

Paul Hatfield,

Chief Investment Officer, Alcentra

Senior ‘secured’ high yield bonds have gained in popularity in recent y ears. A senior secured high yield bond shares in the same security pool as a senior secured loan and for that reason is expected to achieve similar levels of recovery. Some of these bonds have been structured to pay a floating rate of interest.

Fixed income is a diverse asset class encompassing a wide range of investment opportunities that bring distinctive characteristics to portfolios and offer excellent diversification benefits – regardless of the stage of the interest rate cycle. Looking beyond traditional fixed income sectors can provide investors with the tools to diversify portfolio risks around duration, and mitigate the impact of both continued market volatility and the potential for a rising interest rate environment.

BNY Mellon offers a range of fixed income and other debt market solutions through our multi-boutique model which encompasses the capabilities of hand-picked world class specialist investment managers - each one a leader in its field with its own unique investment philosophy and proprietary investment process.

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