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THE GOLDEN AGE OF ACTIVE BOND MANAGEMENT

The last 20 years have seen serious upheavals in Europe's financial markets and portfolio construction. The single market still has progress to make as far as goods and services are concerned, but the single currency has significantly broadened the research universe for European investors both in equity and fixed income. Since 2000, it has helped euro-denominated debt attain critical mass and stimulated growth in the corporate bond market.

The 2008 financial crisis reinforced moves towards banking disintermediation, underpinning growth and diversification across all European bond segments. Europe has, in fact, become almost as deep and varied a market as US dollar-denominated debt where very large active mutual funds[1] have been around for some time.

PAST AND FUTURE PERFORMANCE

The disclaimer, "past performance is not a reliable indicator of future returns is both appropriate but also partly inaccurate when applied to bond markets. For example, average returns for the broad € BofAML EMU index since the end of 1998 are 4.4%[2] although the index's average yield has fallen from 3.7% to 0.65%. We can be absolutely certain that average future returns over the next 20 years will be far lower; matching those returns would require the average portfolio yield to fall to inconceivably negative levels. As a result, building a strategic allocation based on past bond index returns would not make much sense.

But, factoring in yield curve levels when buying for the portfolio would give a relatively robust estimate of its average future returns. Expected returns may be broken down into the sum of the risk-free rate and various risk premiums (carry[3] and roll-down[4], interest rate variations, and spread shifts when necessary, etc.). Historic 10-year Treasury data show that changes in the 10-year spread/risk-free rate account for most volatility in returns but any related extra performance is close to zero. Rates have been low for several years, particularly in the eurozone where the risk-free rate is in negative territory, and absolute long bond yields and most credit spreads[5] are still flirting with their all-time lows. As a result, expected bond index returns in coming years are meagre and they might even turn sharply negative were rates to rise. In other words, past performance suggests future returns will be much lower.

Past performance **suggests future returns will be much lower**

We should bear this in mind when considering the essential role of bonds in a multi-asset portfolio. Bonds are generally considered the least risky asset class and they also offer low and even negative correlation with equity returns, the famous flight to quality effect. But these advantages are much less obvious in today's investment environment. We should first remember the behavioural finance motto not to confuse risk with volatility. Historic data and the modus operandi on markets might make us presume that bond market volatility will stay rather low, even if many investors are worried about possible liquidity holes. But volatility does not distinguish between high positive and negative returns even if they are not the same. The real risk for investors is only seeing strong negative returns, i.e. negative skew[6] risk rather than volatility risk. And this factor, as we can see in SCR[7] configurations in Solvency 2, accounts for equity investments being viewed as much riskier. But a bond portfolio's skew varies enormously depending on interest rate levels (see table opposite). With interest rates at 5%, it is close to -1. At 2%, negative asymmetry is similar to an equity index. At 1%, it becomes sharply negative with much more downside[8] should rates rise than upside[9] should rates fall further. And one of the main worries for coming months, as seen during the market turbulence at the beginning of 2018, is that central banks might change gear, triggering interest rate tensions. In such a scenario, risk asset investors would not be able to rely on their traditional bond allocation to allay losses but would instead be hit by one of the rare periods when equities and bonds fall together.

This all means that we should reassess the role of bond investments in an allocation so as to factor in the outlook for lower returns and higher risk. In such an environment, the extra returns from active investing can prove crucial to overall performance. This means checking the techniques available to fixed income managers and seeing if their results indicate increasing use of them in portfolios.

At the Edmond de Rothschild Group, we are convinced that whatever the asset class, active investing is essential if the risk/return profile is to be improved and kept under control over the long term. But here we will focus on bonds so as to identify those fixed income market specifics which warrant an active, rather than passive, approach.

WHAT DISTINGUISHES EQUITIES FROM BONDS FOR AN ACTIVE FUND MANAGER

Bond markets are about much more than traditional fixed income managers. The universe has a broad range of players with very different roles. Commercial banks favour bonds which have a positive impact on liquidity ratios, while insurance companies take a buy and hold[10] approach that focuses on the book yield based on the purchase price. Meanwhile central banks, which have been increasingly active on bond markets in recent years, act in line with inflation and growth targets as well as financial stability aims, and not for reasons of profitability. All these investors carry weight on markets; in fact, various sources say they account for around half of global bond holdings.

Moreover, the regulations or constraints to which some investors are subject may have a big influence on the relative value of bond instruments. Basel 1 capital weightings are much lower for financial then corporate issuers, a ruling

that may explain most of the tighter spreads that banks enjoy. And many players can only have limited exposure to securities rated below a certain level. This creates abnormally large default risk premiums for the lowest-rated entities and excessive price shifts when a rating downgrade triggers forced selling. Solvency 2's SCR calculation punishes holders of long-dated corporate bonds compared to shorter-dated bonds and whatever the rating.

These factors create opportunities that a passive fund manager cannot capture. But replicating a bond index has other disadvantages. An issuer's weighting depends in general on his debt stock which may be may be a good proxy in assessing liquidity but is hardly an optimal allocation criterion for a creditor when compared to high-quality credit analysis. Besides, bond index structure varies much more than equity indices due to new issues, diminishing time to maturity, rating changes which may involve serious rebalancing and dealing costs, all of which means complex and costly procedures if a passive fund is to replicate the index.

ACTIVE BOND INVESTMENT DRIVERS

The growth of capital markets and financial instruments has massively broadened the choice of tools for bond managers and European issuers even have their own specifics. Statistically, returns from major bond market benchmarks primarily depend on interest rate variations but more thorough analysis shows that a bond's price may also reflect inflation expectations, real interest rates, yield curve points, swap spreads and credit spreads as well as issuer risk and equity sensitivity for convertible bonds, etc. The ability of an active investment process to harness investment convictions and steer a precise course between exposure to all these factors using, for example, derivatives can significantly reinforce performance and risk control. These factors all depend on analysing subjects like monetary and budget policy, the current stage of the growth and inflation cycles, fund flows and positioning, and financial analysis of corporate issuers, etc.

Reassessing **the role of bond investments** in an allocation

The chart shows that, within a shared trend, major bond sub-segments are prone to very varied performance ranges and that performance hierarchy can shift sharply over a few months. This is largely due to the fact the credit and interest rate cycles are out of step. As a result, being able to make dynamic investments in various bond market segments, including non-benchmark issues if necessary, can leverage outperformance. And an active fund manager can also be tactically under exposed by investing in cash or using hedges.

The possibility of investing in yield curves in a currency other than that of the benchmark can also help improve the risk/return profile. But note that in most cases this must be hedged for exchange rate risk as currency volatility is usually much higher than average bond volatility. Moreover, the synchronised global economic recovery (at least in developed countries) means there is high correlation between a domestic bond index and a global currency-hedged index. As a result, comparing bond yields between currencies only has limited interest: the supplemental yield on US 10-year Treasuries in March 2018 (2.9%) compared to 10-year Bunds (0.6%) more than evaporates after factoring in the annualised 280bp cost of hedging. On the other hand, if the next global recession occurs before the ECB has had the time to seriously begin raising rates, the potential of long US yields to fall back will be greater than on the euro curve. But active strategies are not only restricted to bond allocation managers.

BOND PORTFOLIO SKEW

	Largest 3-month gain	Largest 3-month loss	Skew[6]
10-year bond with 5% rates	9.3%	-9.0%	-1.0
10-year bond with 3% rates	5.5%	-6.2%	-1.1
10-year bond with 2% rates	6.8%	-8.6%	-1.3
10-year bond with 1% rates	4.3%	-10.6%	-2.5
Eurostoxx 50	32.0%	-42.5%	-1.3

Source: Bank Credit Analyst

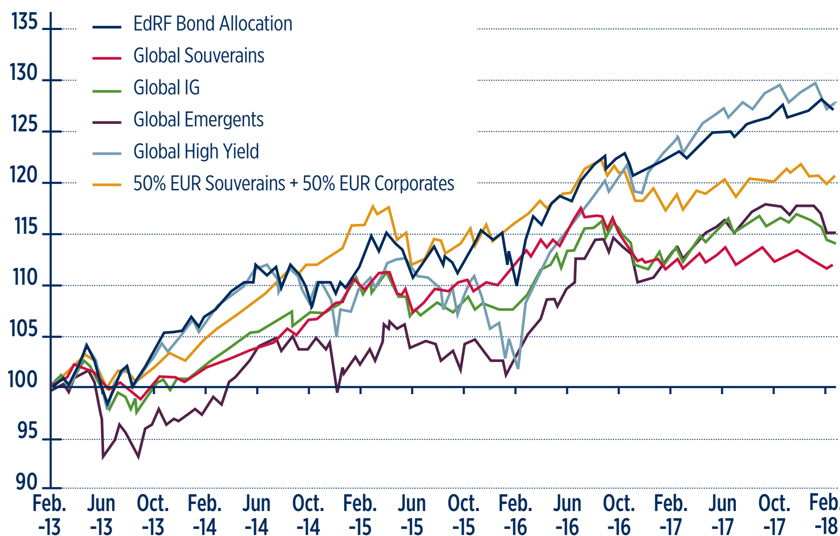
1. A fund managed by an investment company which raises money from various investors who become shareholders of the fund.
2. Source: Bloomberg.
3. Carry is the gain from holding a bond whose yield is higher than the risk-free rate.
4. A strategy which seeks to benefit from positive yield curve formations.
5. The gap between a bond's actuarial yield and that of a risk-free bond with the same maturity.
6. Defined as the ratio between maximum drawdown and strongest gain.
7. Solvency Capital Requirement.
8. Downside is an asset's potential loss.
9. Upside is an asset's potential gain.

The eurozone stands out for having several sovereign states with the same currency. Even if the ECB has succeeded since 2012 in restoring the single currency's credibility, the Greek crisis has convinced buyers of European government debt to set peripheral countries like Greece, Italy, Spain and Portugal apart, be more sensitive to risk aversion and pay more attention to political risk like France's 2017 elections and more recent polls in Italy.

The extra returns from **active investing** can prove **crucial to overall performance**

This means a euro-denominated bond portfolio invested in government debt has some leeway over and above duration, slope or curve choices. At the same time, Europe's reinforced and complex financial regulations, combined with country-specific banking systems, have spawned a wide variety of issues (senior, Additional Tier 1, Lower Tier 2, CoCos, etc.). And credit spreads have shifted to take factors like subordination categories and idiosyncratic elements into account, resulting in broad dispersion and creating a vast field of opportunities for active investment specialists.

BOND SUB-SEGMENT RETURNS



ACTIVE BOND MANAGEMENT IN EUROPE HAS A BRIGHT FUTURE

Historic US mutual fund data show that, over the long term, average returns from active bond managers are higher than passive investing in many categories. The development and increasing complexity of fixed income instruments in Europe over the last 20 years has created a favourable framework for the same to happen in Europe. And as returns on major bond benchmarks are expected to be very low and even negative, due to the historically low yields offered by most issuers, there is every chance that this trend will see even faster growth. **As a result, the alpha[11] that an active fund manager might generate, either through rigorous selection of the risks investors are exposed to, or through diversification into non-benchmark allocations, should represent a growing and crucial proportion of a bond portfolio's returns.**

10. The buy-and-hold strategy consists of holding a position for a relatively long period, the opposite of a short-term trading approach.

11. Alpha is the percentage of a fund manager's performance in excess of market returns.

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