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Losing momentum

What's ailing the developing economies? | 24

The Fund Strategy Investment Committee looks at new bank products that act like equities | 36

Ed Lam

The Somerset Emerging Markets Dividend Growth fund manager says he is going for gold

FUNDS | 16

Julian Ide

Old Mutual Global Investors' CEO discusses taking on the industry heavyweights

PROFILE | 32

FIRST FOR INVESTMENT STRATEGIES

EQUITIES IN **DISGUISE?**

COMMITTEE CHAIRMAN

Adam Lewis
EDITOR
FUND STRATEGY

A member of the Fund Strategy Investment Committee recently pointed out to me that it had been a long time since we had looked at the fixed income space, and he was right. It was back in March last year, which was actually the first ever investment committee, when the panel convened to discuss the seemingly bearish sentiment around the asset class amid much talk of an upcoming 'great rotation' from bonds to equities.

Keen to address this, I was seeking out possible subjects to debate when I stumbled across a note from Kames's head of fixed income, David Roberts, which I thought the panel could explore and give its views on.

Essentially, his argument is that investors are in danger of repeating the mistakes they made before the financial crisis, with many new types of bank instruments being offered, such as hybrid securities, additional tier-one debt and contingent capital notes.

Roberts argues that in some cases these instruments act much like equities, performing well under strong market conditions and entailing significant downside risk when it is not. Under 2008/09 conditions, he says, many of these instruments would be written off, with little probability of recovering any money. Happy to expand upon this argument, Roberts is this month's independent commentator.

So the question for the committee can be split into a few parts. First, do you agree that investors are set to repeat past mistakes with some of these new, higher yielding fixed income instruments that Roberts mentions? Secondly, with FE data suggesting that the average high yield fund is becoming increasingly correlated with the FTSE All-Share, are you worried that this asset class is not providing the necessary diversification? Lastly, with these first two points in mind, where are you investing on the fixed interest spectrum at present, based on your views of the market?

Mike Deverell
INVESTMENT MANAGER, EQUILIBRIUM ASSET MANAGEMENT

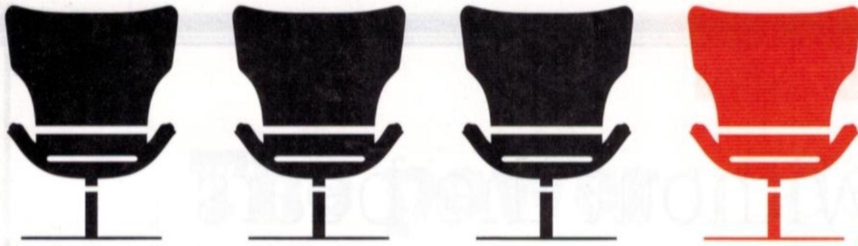
"As with any asset class, investing in bonds is about weighing up risk and reward. There are two major types of risk in corporate bonds: default risk and interest rate risk. Quite rightly, investors are focused on interest rate risk right now. With rates likely to go up in the next couple of years, many investors have gone low duration, meaning their portfolio has low sensitivity to changes in yield. In our view this is sensible, but we should not forget about default risk. In an economic recovery, this risk reduces, but with yields very low relative to history the potential upside is low as well. We like strategic bond funds that can manage both interest rate and credit risk, moving from higher risk and higher yield to safer bonds when required. We especially like the TwentyFour Dynamic bond fund. We balance this with an investment in the M&G UK Inflation Linked Corporate Bond fund. This invests in high-quality bonds and should provide protection if inflation increases from the current lows. We have also moved underweight bonds and increased our allocation to commercial property.

Jonathan Davis
MANAGING DIRECTOR, JONATHAN DAVIS WEALTH MANAGEMENT

"As inflationary cycles mature, naturally, global investors sell off the growth stocks first, as well as high yield bonds, then the growth large caps and commodities associated with higher growths. In their place they normally buy stocks with high dividends, for example, utilities and big oil, as well as government bonds. These are generally safe in times of falling inflation or even outright deflation. And guess what, that has been happening since the start of 2014. Why fight the tape? For now, buy long duration government bonds, as global growth slows and we experience disinflation (and in a few cases record low inflation). Reduce exposure to high yield. Why be the guy picking up pennies in front of a potential steamroller? 2014 is not 2013, when the idea was 'Buy The Dip' every time, and it worked. What if it does not work this year? There are increasingly strong indications of stocks being sold off and government bonds bought. The inflationary cycle is over five years old. It is old.

James Calder
HEAD OF RESEARCH, CITY ASSET MANAGEMENT

"Investing across a spectrum of fixed interest strategies is always prudent, especially when this mix can be tailored to the prevailing economic circumstances. Our current exposure is expressed through strategic, absolute return, floating rate and high yield funds. The common thread is short duration, owing to our belief that for the UK and the US the interest rate cycle will at some point start tightening. We consider our high yield exposure to be tactical as opposed to strategic. The high yield market has grown as corporates have turned to it when banks have been unwilling to lend. This has created a greater choice of issuers. Corporates yields are lower than historically, reflecting the higher demand, but are still more attractive than on gilts and investment grade, plus there is scope for capital growth. The duration of high yield also tends to be lower than for investment grade debt, making the bonds less interest rate sensitive. Although high yield is more closely correlated with equities than other fixed income assets, we do not find this a cause for concern.



Are investors repeating pre-crisis mistakes through new bank products that act like equities? Our committee considers the risks

This year marks my first decade with Kames Capital, an event that coincides with the 10th birthday of the Kames Strategic Bond fund, and I have been in a reflective mood. This has inevitably led me to the question: what have we learned from the great financial crisis?

Although a lot has been learnt, it does appear that people are looking for new ways to make old mistakes.

A great example of this is the new types of bank instruments being offered, such as hybrid securities, additional tier-one debt and contingent capital notes.

Most additional tier-one and hybrid securities sit near the bottom of the capital structure. Many offer materially less protection than ordinary equity. They are often structured in such a way as to afford a reasonable, single-digit annual upside in the good times with the possibility of 100 per cent losses in the bad.

What has changed in the past six years? Subordinate debt issued before the crisis tended to leave investors quite well positioned. In most cases ordinary equity value needed to be wiped out before investors could be forced to accept actual (as opposed to mark-to-market) losses. In recent years companies have manufactured structures that protect equity investors by creating the ability to wipe out subordinated debt investors long before the equity value reaches zero.

Bond funds that held subordinated debt in 2008 saw massive asset price recovery in 2009 and 2010 as the impact of mark to market was unwound. Had the same funds held instruments where the worth was wiped out by default, there would have been no possibility of recovery. We do not dismiss these out of hand. But tell me we will never see another crisis, never see another bout of volatility and I will shut my eyes, hold my nose and jump right in.

THE INDEPENDENT VIEW

David Roberts

HEAD OF FIXED INCOME, KAMES CAPITAL

Tim Cockerill

HEAD OF COLLECTIVES RESEARCH, ROWAN DARTINGTON

"The dark days of the financial crisis seem a long way off, and although things may not have normalised – and indeed a new norm is yet to be established – financial risks seem to have receded in the minds of most investors. The difference between the 10-year yield on benchmark UK Gilts and Italian government bonds is 30 basis points and compared with Portugal government bonds the UK yields 10 bps more. Something does not seem quite right here. But it reflects, I think, the search for yield and a disregard for risk and valuation assessment that we have seen before. The investment banking system is first class at inventing new products. The concern, as David Roberts points out, is that these carry risk akin to that on equities and need strong markets to perform well in. If we see a reversal of strong markets, then buyer beware! At present the European bond markets appear to be expecting QE, which is one reason bonds have been performing well, but with tapering underway in the US and the UK unlikely to undertake more QE, this support may be an illusion.

John Husselbee

HEAD OF MULTI-ASSET, LIONTRUST ASSET MANAGEMENT

"Fixed income assets have been the ballast in a balanced portfolio for the whole of my investment career – back to the mid-1980s – not always producing a healthy income stream, but usually providing diversification and capital preservation. Today, unusually, equities are yielding more than government bonds, with the return from the latter fairly unattractive as higher inflation looms. Investors mandated to gather income from fixed interest assets have had to take on more risk. In this territory, capital preservation characteristics begin to erode, but there is no cause for panic. Those who can receive their income from equities have found them more attractive, with clients more willing to accept a total return approach and settle for regular fixed withdrawals. Our income in the model portfolio service is mainly being sourced from equity, allowing us to preserve capital via strategic bond funds, which do not necessarily provide a consistent yield. Furthermore, these managers have the knowledge and experience to assess the new issuance in the fixed income market.

Lee Robertson

CHIEF EXECUTIVE OFFICER, INVESTMENT QUORUM

"By the end of last year, asset allocators were becoming concerned about the future course of fixed income. Equities became better value than bonds. Investors became bullish and equity markets rallied. US tapering was about to start and it appeared that rates might rise soon. All this acted as a negative for fixed income assets. Over the past few years, corporate and high yield bonds have been bought aggressively as central banks became accommodative through QE and interest rate cuts. This led to a bull market in bonds and a fall in bond yields. This has been the backdrop to the issuance of many hybrid fixed interest securities that are more correlated to equity-type asset classes and which, therefore, are higher risk. While some of these might default, the balance sheets of many companies are much stronger than a few years ago and default rates seem to reflect this. We have been underweight bonds for the past 12 to 15 months in favour of equities. However, with central banks still doveish on rate rises, bonds still offer attractions over the short term.