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Investment Committee: Behind bond bearishness

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Behind the bearishness on bonds

Adam Lewis, committee chairman and associate editor, Fund Strategy

Welcome to the first Fund Strategy Investment Committee. We plan to meet monthly to discuss the merits of the asset classes, regions and sectors that are in the news.

In addition to our regular committee of six who represent the IFA world, discretionaries, wealth managers and multi-managers, we wanted to include each month an independent voice. This month we welcome Schroders' chief economist and strategist, Keith Wade. Keith will be one of a rotating panel of independent commentators who will also include Cazenove's chief investment officer, Richard Jeffrey, and Hermes' chief economist, Neil Williams. The plan is to give you, the reader, a wider range of views than the standard feature offers.

We start with bonds. Headlines have been awash with talk of a "great rotation" from bonds to equities. According to the IMA, in January fixed income asset class saw its first monthly outflow for net retail sales since October 2008, while equity funds had their best month since 2000. Several experts have cast doubt on the fixed income asset class. For example, at the recent Fund Strategy Investment Summit in Kitzbühel, Henderson's director of European equities said there had been an "outrageous party" in fixed income over the past few years and predicted a stealth bear market and a possible collapse in bonds.

Against this backdrop, the questions I pose to our panellists are these: How much exposure should clients have to bonds given the current market outlook? And which type of bonds funds should we be recommending and why?

Mike Deverell, investment manager, Equilibrium Asset Management

"If the global economy continues to improve and if inflation remains high, there will come a time when bonds will be sold off. The difficulty is in knowing when. I do not believe it is quite time to be selling fixed interest yet. However, investors should be selective and should avoid most government bonds where they are guaranteed a negative real return.

In corporate bonds, there is no longer any easy money to be made and so investors should use ultra-flexible strategic bond funds. Small funds like the TwentyFour Dynamic Bond have an advantage in an environment where stock selection is key. I also think investors should hold some inflation-linked bonds, but they must be low duration to reduce interest rate risk. M&G's UK Inflation Linked Corporate Bond fund is a good bet. Another possible solution is to use an absolute return bond fund like Henderson's Credit Alpha.

The 'great rotation' theory has its flaws but, if the key arguments are right, this is not just a good environment for equities but will also become much better for commercial property. Property is a more natural home for money coming out of bonds than equities, as investors search for yield and inflation protection."

Jonathan Davis, managing director, Jonathan Davis Wealth Management

"There is evidence (for example, Commitment of Traders analyses) that far from commercial markets' participants selling government bonds, they are highly net long. In fact, it is the retail investors who are relatively highly net short – probably because of the media hype. Also, we know that insiders (that is, shareholding executives of companies) are selling nine of their companies' shares for every one they are purchasing. That the major equity indices are on multi-year highs is *not* due to major participants buying. On the contrary, they are selling ... to retail, which, as a grouping, is on attitudinal bullish highs and bearish lows. Personally, I would rather take notice of the actions of insiders and commercial participants any day than those of retail investors. Watch what they do, not what they say. Thus, there is no 'great rotation from government bonds to equities'. There may be in the future but it is not happening now.

In January and February we increased our exposures to US Treasuries, long dated to take advantage of rising values and a falling sterling versus the dollar. That way our clients would achieve a double benefit. We will probably hold these until we see yields finally stop falling – our best guess is 12-24 months. With Mark Carney, as Bank of England governor, likely to flood the country with yet more sterling, we prefer US Treasuries to UK Gilts."

James Calder, head of research, City Asset Management

"Given our real return bias, we currently recommend clients have 20 per cent of their portfolio invested in fixed income for a balanced portfolio. We avoid taking a traditional or pedestrian view of this asset class and advocate the use of a mix of strategies. These range from core global sovereign, absolute return and strategic bond funds. These are augmented by tactical positions reflecting a shorter-term view.

Current tactical positions include a weight to index linked bonds in the form of a global inflation-linked bond fund and a high yield corporate bond fund. We have recently cut a tactical position within a long-only corporate bond fund in favour of an asset-backed fund. The asset backed securities (ABS) market's reputation was substantially damaged in the credit crisis of 2008. It had traditionally been seen as a high-quality market with low default rates and considerable protection for investors. The US subprime experience changed that perception, but as the US and European markets have very different characteristics and protections, we favour the European/UK ABS relative to the US market because of their superior characteristics and have chosen a fund that only invests within these markets."

Introducing the Fund Strategy Investment Committee, which aims to offer a broad range of expert views on assets of all kinds. This week: the 'great rotation' from fixed income

THE INDEPENDENT VIEW

Keith Wade, chief economist and Strategist, Schroders

"There has been much talk of a great rotation out of bonds and into equities, but until recently it has been hard to detect in the flows. Investors have been seeking more risk but have been reluctant to part with their bonds. Instead, surveys suggest that equity flows have been funded out of cash. That seems to be changing, with institutional investors now selling US Treasuries, according to State Street. Flows into equity are picking up as investors recognise that the need for safety has been reduced following the policy moves of last year. Central banks are distancing themselves from inflation targets and are increasingly focused on growth; the US Federal Reserve is directly targeting unemployment, for example.

Overall we are tilted toward equities and away from bonds. Central banks are still buying bonds and will aim to keep a lid on yields, but such a shift in their objectives means investors need to be wary of the safe haven sovereigns (primarily the US, UK, Japan, Germany and Switzerland). As a result our Multi Asset portfolios tend to be short duration in these markets. Instead, our bond exposure is focused on the credit markets, where we believe the carry is still attractive relative to the yields on other assets. Fundamentals are better in the US than Europe, particularly in the banking sector, but we have begun to increase our exposure to the latter region given the premium available. Longer term, there is a case for inflation-linked bonds, although they are expensive at present. Emerging markets are near the end of the rate-cutting cycle, so debt in these regions has become less attractive."

Ryan Hughes, portfolio manager, Skandia, part of Old Mutual Wealth

"In today's world of risk profiling it is hard to give a single number when talking about exposures as every case is different, but assuming the average investor, then I would currently consider 40 per cent in fixed interest. This may seem high to some, given yields are at record lows, but my thinking reflects that the global economy remains a challenging and potentially volatile place.

Given the challenges that exist, I would look at investing in bond funds that have significant flexibility to take advantage (or shelter) from whatever situations emerge in the next couple of years. While I am attracted to the view that the world will recover and equities will perform strongly given their current valuations, I cannot help but fear that we have not seen the end of this long-running financial crisis. In essence, my thinking becomes a mental battle between hope of recovery, therefore wanting to own lots of lower-quality investment grade and high yield, and fear of further turmoil, pushing me towards high-quality corporates and, dare I say it, even some government bonds. Needless to say, given the differing expected outcomes, flexibility to adjust becomes critical and the best place for me is with truly strategic bond funds."

Tim Cockerill, head of collectives research, Rowan Dartington

"The level of bond exposure is going to depend on the client's objective and risk profile. However, bonds have always been a key component of income-oriented strategies and in a world of low interest rates it is tough right now to build portfolios with a high level of income, knowing that bonds are expensive and there is very likely to be a sell-off (various reasons could trigger this) and at some stage a rotation into equities. Our exposure ranges from 10-30 per cent in bonds depending on the income level required and risk budgets.

We are presently looking to change our bond exposure to include more global bonds (unhedged) because we think sterling will weaken, and to add funds with short-dated mandates to protect against rising yields. In addition, we believe the pressure is upwards on inflation and we will be adding inflation-linked bonds to the mix. As part of this we have switched some of the bond allocation into more flexible funds which allow the managers the option of quite short duration.

We are, however, aware that best-laid plans do not always work out and so in addition to these tilts we like a broad base to our bond exposure because events may not unfold as we expect or in the time frame we expect. This may look as though we are sitting on the fence, but experience tells me to be diversified, especially with lower-risk profiles where income is concerned."

Lee Robertson, chief executive, Investment Quorum

"Much has been written about the 'great rotation' out of bonds and into equities, and compared with fund sales in 2012, when bond funds dominated European fund sales, it does seem that this year has been a different story as investors began to evaluate their reasons for holding bonds – especially when taking into account inflation and the possibility that central bankers might change their policy stance on quantitative easing and interest rates.

While it is quite apparent that investors currently favour equities over fixed income assets, given that many sentiment indicators appear to be turning more positive, they are still investing – albeit to a lesser degree – in bonds, particularly with a real return strategy in mind. While we believe that global equities do not look particularly expensive against bonds, we do feel the valuation case needs to be supported by better profit margins.

Looking at fixed interest, traditional western government bonds look unattractive. The corporate bonds sector has looming liquidity issues and high yield looks expensive, so we are advocating strategic bond funds for broad-base asset allocation de-risking. My suggested funds are Artemis High Income, Invesco Perpetual Monthly Income, Henderson Strategic Bond and Old Mutual Global Strategic Bond."