fund strategy

INVESTMENT INSIGHT FOR FUND SELECTORS

November 2015 | £3.95
fundstrategy.co.uk

Hunting for treasure

Which asset managers are winning in the race for pension freedoms assets? – 28

Group Profile
Neptune emerges from the shadows after a tough spell of underperformance – 38

Investment Committee
The Fund Strategy Investment Committee looks at whether bond liquidity fears are warranted – 36

Patrick Collinson
Jeremy Lang at Ardevora steers clear of biases that might skew his view of stocks – 34

MORE INSIDE
- Regulation
- Sector Focus: Prop
- News Analysis

Could bonds be left high and dry?

Liquidity is a growing concern for many bond investors as interest rate rises loom. *Fund Strategy*'s experts consider whether the worries are warranted

COMMITTEE CHAIRMAN

Laura Suter
Editor,
Fund Strategy

Bond liquidity is top of many investors' minds as fears about the market reaction to an interest rate rise spark concern about a drying-up of liquidity in bonds.

Increased regulation has meant there are fewer participants in the bond market and has led to banks holding lower inventories, particularly in the corporate bond space. The fears about liquidity in the market even prompted the Bank of England to publish a blog post warning that this increased regulation may have destabilised the bond market.

While there are few immediate worries on liquidity, the concern is that when the Federal Reserve raises interest rates in the US there will be a rush for the exit, sparking liquidity problems.

In light of this, concerns have been raised about the largest bond funds' ability to liquidate assets in time to meet a mass exit. Fund selectors warn that they are hunting for smaller, more nimble bond funds and are asking managers hard questions about liquidation times.

But bond fund managers are caught in a Catch 22. The 'safest', most liquid assets are those returning virtually nothing, harming fund returns. It is the same for large cash holdings held to boost liquidity. Some managers wanting to meet targets are moving up the risk spectrum into high-yield debt and other vehicles likely to be hit hardest by liquidity dry-ups.

Man GLG Strategic Bond fund's Jon Mawby reckons liquidity problems are being masked by the continuing inflows into the bond space. But when this turns around and net outflows begin, the tide is likely to go out and leave many bond fund managers high and dry.

Tim Cockerill

Investment director
Rowan Dartington

Liquidity has become the buzzword. In bond markets, liquidity has reduced as the increased regulatory requirement for capital has changed their nature, leading to the exit of many bond traders.

While markets are calm, liquidity seems manageable, but the indication from managers is this could change quickly. If this is a concern, fixed interest holdings should be skewed towards the most liquid, which in the UK would be the gilt market. But this creates a dilemma as the outlook for fixed interest is poor because of the belief that interest rates are going to rise. Gilts look expensive, and one reason for this is their liquidity profile, so it's a case of 'you can't have your cake (higher yield) and eat it (liquidity)'.

If there was a liquidity crisis, bond prices would dive, spreads would widen and screen prices would not be indicative of what you'd get from a buyer. The flip side is that yields would spike and there would be bargains.

There are potential alternatives to fixed interest, such as commercial property, but this is less liquid still.

Lee Robertson

Chief executive
Investment Quorum

Bond market liquidity has been much talked about over the past 12 to 18 months.

The eye of the liquidity storm was probably mid crisis back in 2008. The FCA has since requested that the largest bond funds stress test their portfolios against the risk of a bond crisis or 'tantrum'. Both Fed chairwoman Janet Yellen and her predecessor, Ben Bernanke, have sparked concerns in the bond markets when talking about monetary tightening but both times bond prices have recovered fairly quickly.

When interest rates do begin to rise, long bonds are at a greater risk, alongside high-yield bonds; therefore investors should be wary of capital erosion as prices fall and yields rise.

But with central banks remaining supportive amid the global slowdown, interest rates are likely to rise only slowly in the US and UK, while in Europe and Japan QE will suppress yields.

Given that the new norm for interest rates will probably be much lower than in the past, investors are likely to remain engaged in this asset class as a haven from volatility in the equity markets.

John Husselbee

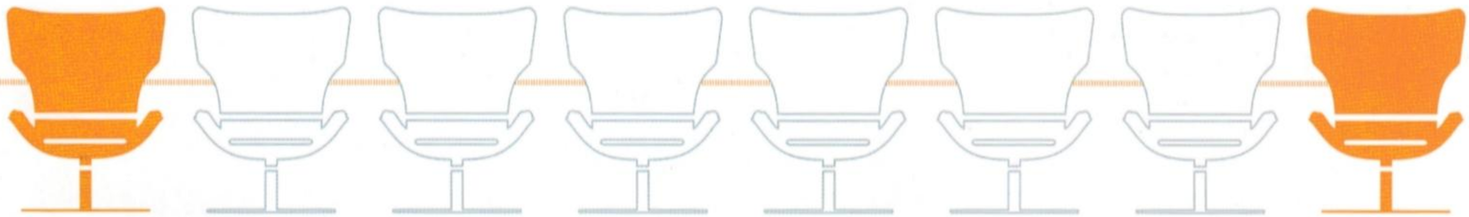
Head of multi-asset
Liontrust Asset Management

As a result of extraordinary monetary policy since the global financial crisis there is certainly an excess of liquidity in the markets today. How this will all be unwound by bank authorities and regulators remains one of the biggest known unknowns.

Money printing has driven government bond yields to historic lows and asset prices to historic highs. The hunt for yield has been and remains a major challenge to investors wanting to maintain the risk-reward balance.We have looked to alternative strategies to assist, both in bonds and with equities.

Strategic bond funds, the so-called jugglers of bonds, have grown rapidly; not surprising when they offer the potential to hedge both credit and duration risk. Some funds are far too large for any part of the investment cycle, and we, as investors, rather than speculators, prefer the smaller funds where there is more flexibility.

As the regulatory environment tightens there are obvious fears of a short-term liquidity crisis, but long-term investors can accept shorter-term volatility on the way to a long-term objective.



James Calder

Head of research
City Asset Management

Predicting rate rises has been a mug's game over the past three years. But the start of the next cycle appears to be around the corner. Economic conditions have improved to the point where the decision not to raise rates would leave the market aghast.

The Fed is under pressure to raise rates soon, owing to the fact that 2016 is an election year and it will be loath to be seen to be playing politics or – even worse – behind the curve, which could lead to aggressive tightening further down the road.

We continue to be at the bottom end of our allowable fixed income weight per risk mandate. In fact, we have been creative with the structure. This has led to a mix of strategies, including floating rate notes, which should help weather rate rises.

The NB Global Floating Rate Income fund is our core holding here. The remainder is a mix of credit long-short through Muzinich. We have some strategic bond managers with an absolute bent, in particular Nomura, and we have added TCW, a manager that is holding cash in the expectation that it will provide liquidity to the market.

Mike Deverell

Investment manager
Equilibrium Asset Mgmt

We are a lot more optimistic about fixed interest than we have been for some time.

For a while we've been very underweight in favour of property. However, while 10-year gilt yields remain low at around 1.8 per cent per annum, corporate bond yields have crept higher. The yield on the Iboxx Sterling Corporate Bond index has gone up to almost 4 per cent, after being around 3 per cent not that long ago. High-yield bonds have seen a similar move and look much more attractive than they did.

The average corporate bond fund has lost nearly 4 per cent since February. Any rate rise is unlikely to hit corporate bonds as much as government bonds as this is perhaps partially factored into prices already.

Liquidity is an issue, and until there is a period of market stress we won't know how big this issue is. We find fund managers have often been trying to add to holdings on market dips, and have been unable to buy what they wanted as others did not want to sell. Ultimately, while lack of liquidity may exacerbate volatility, provided there is no default, your return on a bond is known when you buy it.

Jonathan Davis

Managing director
Jonathan Davis Wealth Mgmt

First, I should disclose my position: The Fed, and therefore the Bank of England, will raise rates sustainably when Hell freezes over. Each monthly decision is a coin toss now, but any raise will come right back down again.

Corporate bonds are unattractive to us at these extremely low yields, which are much like 2007 as I see it. Government bonds, however, remain wholly attractive as rates are low but are likely to go lower on a medium-term view. This is because we are in an era of disinflation and possibly deflation.

There are trillions of US Treasuries and Gilts and Bunds etc, so there is no liquidity concern. There are many mutual funds and ETFs allowing access to government bonds, which we prefer. I prefer US Treasuries as I am bullish on the medium to long-term outlook for the US dollar, which ties in with my bullish view of deflation and government bonds.

Over the longer term, a strengthening US Dollar would likely be negative for most commodities and probably emerging markets. However, it is weakening now and this is positive for them now.

INDEPENDENT VIEW

Mike Bell

Global market strategist
JP Morgan Asset Management

We would argue that concerns over a potential liquidity crisis are overstated.

Reduced liquidity can lead to wider spreads during periods of market volatility, but we think investors should look through the volatility and focus on whether company fundamentals remain intact. If the probability of default has not increased we would expect the volatility to be short-lived.

An increase in interest rates by the Federal Reserve would signal that the US economy is strong enough to no longer require "extraordinary" support. This should be consistent with spreads tightening as the economy continues to improve and monetary policy remains highly accommodative.

We see opportunities in global high-yield credit in particular, where valuations are pricing in a high probability of recession relative to our expectations for continued economic expansion. Even government bonds – despite their low yields by historic standards – do not look likely to suffer a large sell-off.

Fed tightening could lead to a stronger dollar, further dampening inflation and allowing for a gradual pace of rate increases in which real rates remain low. In this environment we would expect 10-year Treasury yields to be below 2.5 per cent. With the European Central Bank on track to increase its stimulus measures, this should provide support for credit spreads as the hunt for yield continues.

Investors should expect more volatility from here. Reduced liquidity could exacerbate it, but we do not expect a crisis and see opportunities in markets where valuations are too pessimistic.