a strategic approach

March 2010

Stewart Cowley explains how to navigate the challenges that lie ahead in fixed interest markets.

You know things are reaching a critical point when, as a bond manager, friends and family start asking you about bond issuance patterns in Greece.

It's just not the sort of thing you expect to be quizzed on. At the same time, it highlights how difficult it is to explain such things and more to the point, if you are an adviser, how you pick your way through the bewildering array of funds on offer.

Some bond funds have very narrow remits (for example investing solely in the UK), whereas others are very broad and can invest globally, using all the levers available, including country and currency allocation, government bonds and corporate bonds. What's right in a portfolio context for a client is therefore down to individual circumstances. Some like to have a range of funds that they can move money between (such as a UK gilt fund, a corporate bond fund and a global portfolio), whereas others like to have everything in one place, in a wide ranging 'go anywhere' fund.

Whatever the preference, bond fund managers have important choices to make in the next year. As a global bond manager working within the total return, go-anywhere area of the market, there are issues to deal with in the global markets that are both opportunities and threats.

corporate bonds

In terms of corporate bonds, the extraordinary opportunity to buy the debt of perfectly good companies at astonishingly low prices (high yields) has passed. In both absolute terms and in terms of yields relative to government bonds, the market has settled down to something like the pre-crisis levels we saw in the first three months of 2009. In that sense, the easy money has been made, and although there will always be a place in any portfolio for corporate bonds, you now have to think harder about the type of companies you include. The astonishing flow of money into high grade corporate bonds in 2009 may mean a move lower down the credit quality scale in order to find the gems. This takes more work and careful consideration when picking potential survivors.

government bonds

Then there are the issues associated with government bonds. Looking at the basic economics of, in particular, the US, Europe and the UK, you can understand why, come the summer, we expect 'double dip deflation' as economies falter and inflation falls away. Under normal conditions, this would be the perfect environment for bond yields to fall because in the topsy-turvy world of bond mathematics, falling yields equate to rising prices. But, as we have seen with Greece, Spain and Ireland, the markets are very worried about the amount of bond supply coming from governments because of high budget deficits. In the UK and US we have not escaped the same criticism, but the markets haven't really focused on us yet as they have done with Greece. It remains to be seen if we can say and do the right things to bring our budget deficits down and maintain the confidence of the markets. Only then will natural forces take over and allow yields to decline to levels that will be tending towards Japanese-style borrowing rates.

currency markets

And then there are the currency markets. If we say and do the right things in the coming months, sterling could be the surprise package this year. We have taken some tough measures early on, such as banking reform and

quantitative easing, but the focus must now be on budget deficit reform. Without it, it is likely that the pound will fall this year. And we shouldn't expect that the US dollar will forever remain a 'safe haven currency'. The $1.6 trillion budget deficit hasn't received as much attention so far as it should have. If the euro, US dollar and British pound are the potential losers this year, then the potential winners will be currencies more closely associated with the expansion of China, such as the Japanese yen and Australian dollar. The inclusion of these in a global bond portfolio could be a useful counterweight to bond price movements.

challenges ahead

Although there are some very big challenges to be faced in the next 12-18 months, you have to believe that one day we will overcome them. That in turn will create its own challenges. How do we manage the exit strategy? Let's imagine for a moment that western bond yields have declined to historically low levels. The normalisation of interest rate policy and the removal of quantitative easing will send bond yields higher. As yields rise and prices fall, bond portfolios could experience considerable declines in their capital values. In those circumstances bond managers are going to have to act fast to protect clients' money. The only place to hide will be in cash, by selling bonds. Alternatively, if the fund operates within UCITS III legislation, it is going to have to use the full extent of its powers to protect the portfolio or even benefit from rising yields. This involves selling 'short' in the market through exchange traded derivatives to benefit from price declines.

Because we live in an inter-connected world, it's difficult to argue that what happens in one place, such as Greece for instance, isn't going to have an effect on a domestic portfolio. Following all this through, you will see there are a wide range of opportunities and threats heading towards us. Some of them are domestic, but many of them are international. To cope with them, as professional investors, it may be wise to have as many tools in your tool box as you can possibly muster.

Stewart Cowley is manager of the Old Mutual Global Strategic Bond Fund.

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