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changing perspectives on bonds

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Ashley Goldblatt, Fixed Income Product Director,
L&G Investments, argues that bond markets have
never been more interesting than they are today.
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From 2003-2007, when the financial world seemed a much safer place, bonds produced positive returns as inflation appeared to be a historic problem. Back then interest rates had a downward bias and corporate debt seemed a default-free yield enhancer. With volatility at historic lows it almost became a matter of indifference what vehicle was used to access the bond market segment of choice as performance differences within peer groups were very compressed.

Over the last two years the landscape has changed dramatically as the market has had

to cope in rapid succession with a knowledge crisis (due to the unforeseen and unknowable consequences of the problems that erupted in the sub-prime market), a liquidity crisis, an inflation crisis (especially in the UK, resulting from sharp increases in fuel and food costs) and a credit crisis. Interest rates rose sharply and then fell to a level never seen before. Government bond yields have oscillated and yields on corporate debt, both in absolute terms and relative to government debt, moved from having never been lower to a height many had never seen during their careers.

changing market

As a result there are a number of significant and novel influences on bond markets, including the low level of rates and the period over which they will stay low; the low level of liquidity of markets and the impact that has on creating and managing positions; the strength of the new issue market where volumes are at unprecedented levels; quantitative easing (which is still subject to significant uncertainty as to how it will be implemented); and the dispersion of bond prices away from the norm of those



fixed income expertise

LGIM manages around £130 billion of fixed income assets, with over 45 fixed income investment professionals and an average experience of 10+ years in the industry. This size of business coupled with owning 5% of the equity market give unique advantages including unparalleled access to company management plus consultation and preferential allocation on new bond issuance. These attributes give LGIM a substantial competitive advantage in fixed income management.

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prices being clustered in a narrow range around par.

How does this backdrop translate into perspectives on the major segments that comprise the bond market? Within gilts, the short end of the market offers little in the way of yield. The yield available rises roughly linearly to about 3.75% at 10 years, 4.25% at 15 years, and then starts to plateau. So an advantage over cash rates is available, but only from bonds that exhibit greater volatility. The index-linked market has for some time offered superficially low value with the whole curve offering a real return of less than 1.25% and equivalent value for money across much of it to conventional gilts if inflation is broadly in line with the centre of the MPC's target range. The investment grade market as a whole still offers yields that from a historic perspective more than compensate for the likelihood of defaults, but within the market, different segments have performed in very different ways and will continue to do so. As a general rule, whilst we continue to go through difficult economic times, public sector debt will remain tightly priced and non-cyclical sectors should hold up better than cyclical ones. However, that disguises the very different complexions that individual borrowers display when compared against each other. This is especially the case in high yield, which is displaying the same frothy performance that has recently been seen in equities but with very disparate performance between sectors.

This dispersion of performance in global fixed income markets has forced some difficult investment decisions to be made. Which fixed income product is most suitable for your clients? Which fund group has the resources, experience and ability to exploit this investment opportunity?

effective exposure

Legal & General Investments is one of the UK's largest investors in fixed interest securities offering award winning capabilities.* The range of unit trusts enables access to a variety of global fixed income markets. The investment approach within each fund is carefully designed to provide the most effective exposure to the relevant sub-asset class.

The UK sovereign gilt market and Index linked gilt market are viewed as being some of the most efficient markets in the world. There is subsequently limited ability for an active manager to outperform the prescribed benchmark after fees. One solution is to gain exposure via a sophisticated index tracking approach that ensures tight returns around the index whilst keeping costs to a minimum.

The L&G All Stocks Gilt Index Trust and L&G All Stocks Index linked Gilt Trust employ pragmatic replication to track the relevant FTSE index. This approach keeps trading costs and tracking errors at low levels. With an annual management charge of just 0.20% these index funds typically outperform their peer group.

The approach to corporate bond fund management is different. As described earlier, idiosyncratic risk is something that cannot be ignored. Detailed credit analysis and macroeconomic research supports active fund management in corporate bonds. The L&G Fixed Interest Trust is an actively managed fund offering diversified exposure to the global investment grade market, whilst hedging all foreign currency exposure back to sterling.

strategic approach

If, however, like many advisers, you feel that the asset allocation decision within fixed income markets is a difficult one to make, you may choose a strategic bond approach. Since the IMA sector was formed in September 2008 it is increasingly becoming the default choice for fixed income exposure. The L&G Dynamic Bond Trust was launched in April 2007 to provide investors access to the entire fixed income capabilities of Legal & General Investment Management (LGIM) via a flexible strategic bond product.

While we are faced with an unprecedented investment opportunity in fixed income markets, this is by no means a 'one-way bet'. Advisers must take considerable care when choosing both the right asset manager and the right fund for their clients. ●

*Fixed Interest manager of the year, 2009, UK Professional Pension awards.

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