

# It's all about absolute return

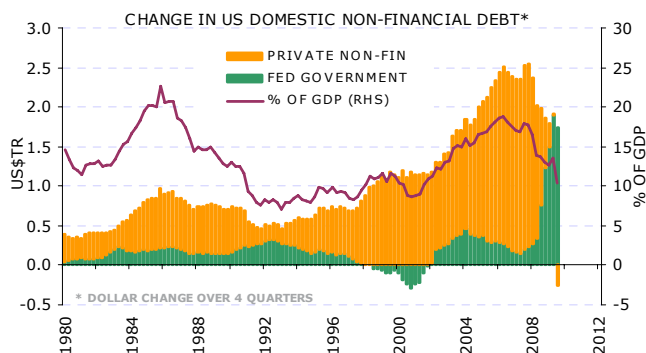
## Investing in bonds in a rising rate environment

The Global Financial Crisis has caused greater dislocations than originally thought. What was once a consumer (sub-prime, mortgage, and housing) problem shifted quickly to the financial sector (leverage, financial engineering, cheap credit, poor underwriting standards) and eventually ended up on government balance sheets. As institutions became too big to fail and threatened to bring the entire system down, the government was forced to become the lender of last resort.

### Yields are near historical lows

As the private sector has begun to reduce leverage, the public sector has significantly increased its leverage (Chart 1). Governments were forced to pick up the pieces left behind by private sector.

**Chart 1 – Non-financial deleveraging is yet to start**



Source: Federal Reserve; Morgan Stanley Research. As at 31 January 2010.

Governments have expanded their balance sheets, causing yields to fall to historical lows. This can be partly attributed to:

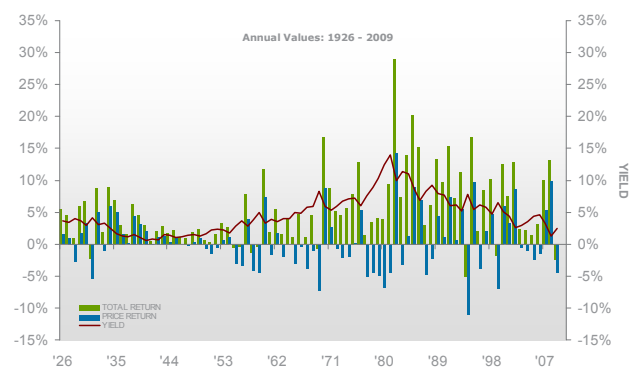
- **Risk aversion** (i.e. more people holding risk-free government assets).
- **Quantitative easing.** As governments issue debt, central banks buy the debt and print currency.
- **Central bank rate cuts,** which lower the overall level of funding.

If governments do not restore fiscal policy to more sustainable levels, investors will start to demand additional returns. Investors will do this by increasing the risk premium on the debt of those countries with the worst fiscal positions. This leads to expectations of higher interest rates over the short run and investors will start to question the appropriateness of bonds in their portfolios.

There is no doubt that rising rates are negative for bond funds. The interest or coupon income that is generated from fixed income assets generally minimises the capital loss. However, if the rise in rates is large enough, it can wipe out an investor's coupon income and produce negative returns. This is extremely poignant for investors with duration in their portfolios. As investors move out of the maturity curve, the sensitivity to rate changes rises. Should rates rise materially, this could magnify negative returns.

Wells Fargo recently published a study on the returns on an intermediate government bond index returns from 1926 – 2009. During this period, there were 10 instances when the fall in capital price more than offset the return of coupon income. The biggest loss came in 1994, when yields dramatically rose 250bps. This resulted in a total return of -5.1%. In 2009, yields rose 120bps resulting in a -2.4% return.

**Chart 2 – Intermediate-term government bonds**



Source: Morningstar. As at 31 December 2009.

## How to manage bond portfolios in a rising rate environment

If bond portfolios are held to maturity, then rising rates do not matter (if you do not count mark-to-market). The holder gets the return of the coupon and total return as long as the assets are held to maturity. However, most bond investors do not fall into this camp and are therefore subject to the daily fluctuations in market pricing.

As we know, no two economic cycles are ever the same. Rates are near historical lows, government balance sheets seem beyond repair, central banks are attempting to exit liquidity facilities from the financial crisis, and inflationary pressures are starting to build.

Few things are certain in life, except death and taxes! However, in the aforementioned environment a certainty for bond investors is rising interest rates (and the possibility of negative bond returns).

Bear markets can be devastating. Not only do they delay wealth accumulation for young investors but also they destroy savings for older investors who rely on them for income. As shown below, it can take an extraordinary time to recoup an investment after recording a substantial negative return.

**Table 1 – It takes time to re-coup an investment after a negative return**

		Magnitude of loss on investment			
		-5%	-10%	-25%	-50%
Return on investment	2%	2.50 yrs	5.25yrs	14.50yrs	35.00yrs
	4%	1.25yrs	2.75yrs	7.25yrs	17.75yrs
	6%	1.00 yrs	1.75yrs	5.00yrs	12.00yrs
	8%	0.75yrs	1.25yrs	3.75yrs	9.00yrs
	10%	0.50yrs	1.00yrs	3.00yrs	7.25yrs

The above assumes monthly compounding. Recovery periods are rounded to the nearest quarter of a year.

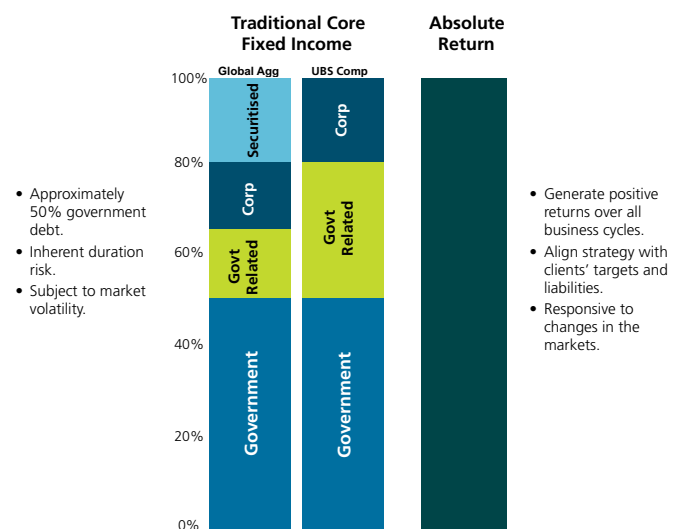
Therefore, managing a bond portfolio with an absolute return objective is vital. Simply holding a bond benchmark with an average of 5 years duration (traditional bond fund management) can be disastrous. Dynamic hedging of duration risk becomes essential because as yields rise and prices decline, hedging the interest rate risk can offset any capital losses.

Traditional bond fund management exposes investors to market volatility, periods of negative performance and limits alignment with investors' objectives. By adopting an absolute return approach, investors can achieve a positive return over all business cycles. Rather than suffering through the ups and downs of the market, this dynamic process changes in response to market conditions and has the potential for superior risk-adjusted results.

## The problem with traditional portfolio management

As with traditional bond fund management, managers are constrained to invest in the sectors and securities of a particular benchmark. The bias lies with the issuers because typically the larger the borrower, the greater component of the index it becomes. This becomes clear upon closer examination of the Barclays Global Aggregate Index and UBS Composite below.

**Chart 3 – Barclays Global Aggregate Index and UBS Composite**



Government and government-related debt now comprises approximately 65 – 80% of these two major debt benchmarks. With fiscal balance sheets so poor, investors are now exposed to a much greater level of sovereign debt than ever before and therefore subject to elevated risk.

In Kapstream's March 2009 Viewpoint, we addressed the problems associated with benchmarks. [Click here to view.](#)

In bear markets, a traditional bond fund manager may outperform its benchmark yet still register a negative return. This is because in most cases, managers typically do not deviate largely from the components within the benchmark.

However, with an absolute return objective, managers have greater flexibility, seeking to out-value across sectors and geographies, and identify strategies priced for the best return potential in the current market environment. Additionally, this involves taking advantage of unique opportunities within countries and sectors that are often overlooked or under-represented in market indices. The result is a dynamic portfolio managed to the total portfolio risk (as opposed to index risk), with numerous uncorrelated positions across all specialty areas for the purpose of achieving consistent returns.

Another attractive feature of an absolute return objective is the ability to reduce risk by hedging against market declines. In this current market environment, this can involve multiple options:

- 1. Sell fixed rate assets:** Most bond portfolios hold fixed rate assets. The traditional method of reducing duration is to sell the bonds and move the funds to cash. Timing is critical for this exercise and can be costly, as yields need to rise quickly. On average, the duration of bond benchmarks is approximately five years. That means that for every 1% rise in rates, the benchmark will have a capital loss of 5% (not including coupon income).
- 2. Hedge interest rate risk with derivatives:** Reducing the duration of the portfolio (or even having negative duration) during this period can be invaluable for the investor and protect the portfolio from capital losses. Rather than sell the existing holdings, the portfolio managers can reduce the portfolio's duration with futures, options or swaps.
- 3. Own floating rate assets:** Favouring floating rate debt over fixed rate debt reduces the overall duration risk of the portfolio. As rates rise, floating rate assets refix the coupon at a higher rate (usually monthly or quarterly).

- 4. Yield curve management:** Just as reducing the portfolio's duration is critical, it also becomes extremely important to manage the yield curve and spread exposure of bond portfolios in a rising rate environment.
- 5. Reinvesting at higher rates:** As bonds mature and more cash is held in the portfolio, investors are given an opportunity to invest at higher interest rates, thereby providing better future returns.
- 6. Various business cycles:** Countries' interest rate cycles differ. Investors should avoid the fixed rate debt of countries with a tightening bias and invest in those with normal to easing biases.

## Conclusion

- Current yields in government and sovereign portfolios are extremely low compared to historical levels.
- Government debt supply is increasing while private sector balance sheets are contracting.
- We fully expect rates to rise in the coming years as the economy recovers and inflation becomes more evident.
- Higher rates do not necessarily mean negative bond returns if managed properly.
- A well diversified, flexible, absolute return approach helps reduce the volatility of returns and the negative effects of rising rates.