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Fixed Income Investment For Uncertain Times

Simone Westerhuis, 15 April 2019

The author of this article takes a walk around the fixed income terrain to consider how different sectors will fare in uncertain economic times.

The economic clouds are, if you buy the official forecasts, darkening. (Whether they do get darker is, of course, up for debate.) A recent outlook from the International Monetary Fund struck a downbeat tone.

How should investors in the debt market react, given current valuations and yields? To try and answer such questions, this publication shares an article from LGB Investments and written by Simone Westerhuis, the firm's managing director. This news service does not necessarily endorse all views of guest contributors. Email the editor at tom.burroughes@wealthbriefing.com if you wish to respond.

The IMF has just published a rather gloomy World Economic Outlook. It anticipates a slowdown of growth and continued trade tensions. Following equity market volatility in Q4 2018, this prognosis may encourage investors to consider de-risking their portfolios by switching to fixed income investments.

Across fixed income, investors have a wide range of products to consider depending on the scale of their investments. Before making investment decisions investors should identify risks of particular investments. The key risks in fixed income are exposures to movements in interest rates and the credit standing of borrowers. These are assessed in terms of duration and credit spreads respectively.

The duration of a bond is similar to its maturity. More specifically, duration is a measure of the weighted average life in years of a bond's interest and redemption payments. It is useful metric for assessing the risk/return profile of bond funds that contain many securities.

If, for example, a bond fund's portfolio has a duration of five years, a 1 per cent increase in the yields

of bonds with the same duration should result in a 5 per cent decrease in the value of the portfolio. Conversely, a 1 per cent fall in yields will result in a 5 per cent increase in the value of the portfolio. The longer the duration the greater the price movement upon a change in the relevant bond yields.

Credit spreads are measured by the difference between the yield of a corporate bond and the yield of a comparable government bond – the higher the probability of default, the higher this difference will be.

The implication is that a portfolio with an average credit spread of 3 per cent pa will experience an average credit loss rate of 3.00 per cent pa. Investment managers try to construct portfolios that have credit spreads that are higher than the actual rate of credit losses they experience. It should be noted that the credit spreads of large issues that are regularly traded are lower than credit spreads of comparable private placements and aged issues. This is because investors in liquid issues perceive that they will be able to sell their holdings if a credit deteriorates, while the holder of illiquid issues must take a view on a credit for the life of a bond.

By considering both the concepts of duration and credit spreads, investors can assess which fixed income investments meet their investment criteria in particular market and economic circumstances. Broadly speaking, if the economy is growing and interest rates are expected to rise, investors might wish to maintain a relatively short duration in their portfolios while accepting a relatively high level of credit risk. However, if economic growth is slowing and interest rates are expected to fall, investors might wish to lengthen duration while reducing credit risk.

Government bonds - low risk, but low returns

The Sterling yield curve is currently very flat with yields ranging from 0.75 per cent pa to 1.75 per cent pa from three months to 30 years. Investors are not being rewarded for taking duration risk. This is largely because gilts offer pension funds, insurance companies and banks advantages relating to liability matching and capital ratios. These investors do not only consider gross yields. In fact, with UK CPI at 1.8 per cent gilts do not currently offer a real return. Nevertheless, they might be attractive as a safe harbour or for investors anticipating slower economic growth and even deflation.

Corporate bonds

Credit spreads move broadly in line with equity markets because they reflect the financial health of issuers. It is therefore not surprising that at the end of last year we saw credit spreads widen and that they narrowed somewhat in the first quarter of 2019. For example, the yield of bonds in the S&P UK BBB rated UK Corporate Bond Index rose from 2.5 per cent pa to 3.25 per cent pa in 2018 and now stands at 2.9 per cent pa.

High yield bonds below the BBB margin of investment grade offer higher yields of around 5.5 per cent pa, while specialist funds focused on private placements of debt target returns of 10 per cent or more. The private debt market has received substantial additional allocations from pension funds, insurance companies and endowments in the last year or so. At the same time, borrowers have benefited from lending capacity of challenger banks, while perhaps also moderating their funding requirements because of economic and political uncertainties. As a result, many investment managers have struggled to deploy funds.

If the current slowdown in economic growth rates continues in 2019, we can expect to see yield compression and concerns about rising default rates. In these circumstances, investors might be wise not to chase high yields, but to invest in the middle of the credit range. This is the approach we have taken in advising the LGB SME Fund. Launched in 2016, the fund has delivered a steady return of 6.25 per cent pa net of fees. The particular feature of the fund is that it invests in a laddered portfolio of secured loan notes with maturities extending to just three years. In this way it has a steady cash flow and limited exposure to credit spreads as its holdings roll down the curve to maturity.

P2P lending

P2P platforms provide efficient investment mechanisms and access to specialist sectors at the high yield end of the credit spectrum. Interest rates of 4-8 per cent pa are commonly advertised. In 2018 the sector received a boost from the introduction of the Innovative Finance ISA. There was a noticeable switch into these portfolios as equity markets weakened.

The specialism of many platforms is an important consideration. P2P loans to the SME, property and consumer lending sectors might perform very differently as economic conditions change. In this regard, the diversification and management expertise of collective vehicles might add value.

One concern is that the core knowledge of the companies operating P2P platforms is technology rather than credit assessment or dealing with borrowers upon an event of default. Most platforms are untested in a downturn. Last summer the FCA began to consider restrictions on the marketing of P2P products and requirements for greater disclosure of actual default rates and realised investment returns. This initiative appears to be timely.