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ABSOLUTE REWARDS *on offer*

In a challenging era for fixed income investors, more managers and asset owners are finding ***there are benefits to taking an absolute returns approach.***

By Ben Falkenmire

SINCE THE GLOBAL financial crisis, the fixed income market has changed its stripes. Ten years ago, investors were at ease with bonds delivering a decent income stream over an average of three years. High yields meant lower bond prices and a buffer against a downturn in the market.

Today, however, bonds offer a meagre income stream over an average duration of 5.1 years and growing. Bond prices are extremely sensitive to interest rate movements and, at the higher risk end, are behaving like equity, rather than a defensive security. Enticed by more attractive yields, investors have flocked to the credit market, only to squeeze valuations higher.

In response, some fixed income managers are diversifying within the credit market or even taking a hedge fund-style approach. At the more traditionally defensive end, others are consigning themselves to record low returns from a benchmark index.

"If you're a traditional owner of the bond index and are looking to make a return, you are taking a big position that interest rates are going to decline," Franklin Templeton Investments managing director of fixed income, Chris Siniakov, says. "If you're putting all of your eggs into a credit-style strategy, you are adding risk to your portfolio. Unfortunately, this becomes apparent only when times are tough."

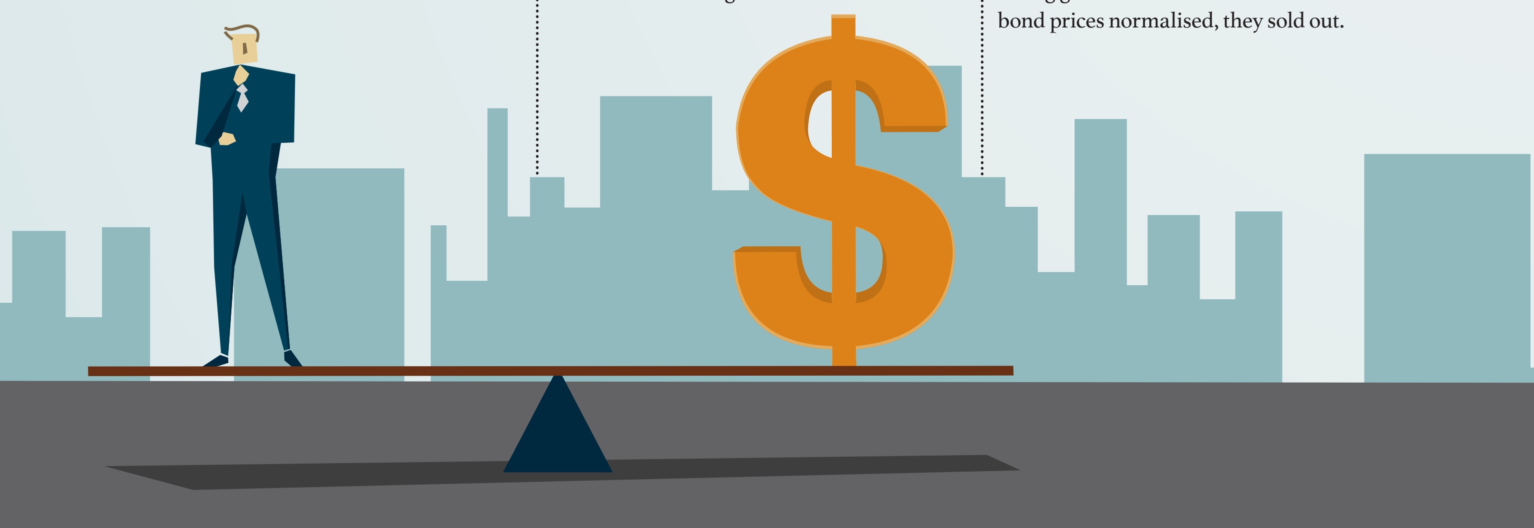
ABSOLUTE FLEXIBILITY

A middle ground for fixed income is an absolute return strategy. Franklin Templeton Investments has been running one for the last two-and-a-half-years with its Franklin Australian Absolute Return Bond strategy (FAARB).

The strategy adopts a flexible approach to handpick government and corporate debt with short durations and diverse yield positions. It targets local and foreign issuers in the domestic market known to Franklin Templeton's 170-person global fixed income team, which collectively manages $400 billion in fixed income assets. The idea is to offer investors the defensive qualities of bonds but with returns of 2 per cent to 3 per cent above the cash rate.

"We start with no duration and add it only where it's rewarded with compelling valuations and yields in the right part of the curve. We then realise a profit when the bond moves back to a fuller valuation," Franklin Templeton Investments director of fixed income, Andrew Canobi, says. "In credit, we keep the average rating around the single A range. When we dip our toes into more interesting ideas, we'll look for an undervalued bond and when we are happy to buy, we look for a profit and then move out."

As an example, Canobi cites the March quarter 2016, when energy prices collapsed and the market feared the worst. High-quality issuers – like Rio Tinto, Origin Energy and Woodside – were experiencing substantial pressure on their bonds. Franklin Templeton Investments was able to buy in at attractive prices with 5 per cent to 6 per cent yields from strong global diversified miners. When those bond prices normalised, they sold out.



In the last 12 months, the $55 million FAARB has returned 4.24 per cent according to Morningstar, placing it in the first quartile for performance. As at June 2017, the portfolio yield is 3.2 per cent with a duration of one year, compared with the Bloomberg AusBond Composite Index's yield of 2.3 per cent and 5.1 years. These figures suggest an absolute return strategy has merit.

Colonial First State has been using absolute return bonds for about eight years, since before they became popular. Senior investment manager George Lin says there are pros and cons to using them but the ultimate advantage is that they give portfolio managers the opportunity to buy the best priced bonds.

"A lot of bonds sit outside the traditional bond benchmark universe. We feel that some of those – like high yield, securitised and emerging debt – can be underpriced at times," Lin explains. "These higher yielding type bonds tend to correlate with equity, so we do not necessarily want a structural allocation to them but prefer to give our managers the chance to pursue an active return strategy."

GOING LONG ON INFLATION

One risk factor that has Franklin Templeton's attention is inflation. Inflation-linked bonds give protection against rising interest rates but durations are typically long and if interest rates move too much, the benefits can quickly evaporate. This is where Siniakov and Canobi surgically target bonds.

"We consider inflation a bit of a sleeper in the longer term. We don't expect the market will turn anytime soon in the developed world towards a disinflation or deflation outlook. The downside of owning exposure in inflation is limited, so we're happy to leave that in the portfolio at the longer-term end," Siniakov says.

According to Danica Hampton, head of investment specialists at Citi, global growth is moderately strong and is pushing inflation higher, with forecasts of 2.3 per cent and 2.2 per cent for 2017 and 2018. But she is quick to point out the world is heavily leveraged and a key indicator for inflation, wage growth, remains stagnant.

"The big question is what happens when these unprecedented monetary policies from governments around the world are unwound," Hampton says. "Global wage growth is still relatively benign and a piece of the puzzle we need to keep our eyes on. When wages increase, that will spark global domestic demand, and in turn inflation."

Siniakov says that if the US and global economies continue to grow, wage growth will come on and move the world into an inflationary environment. But with some mixed signals in the market, he is erring on the side of caution, with preservation of capital front of mind.

"The US has reduced its unemployment rate significantly in the last three years. Traditional relationships will tell you that we should start to see more significant wage pressures but that hasn't come through in the data and everyone is trying to understand why," Siniakov says.

GOING SHORT ON AUSTRALIA

While the US and Europe crawl forward, Australia appears to be inching closer to a slide in growth. Lin says when you take into account the downside risk to the Australian economy, the country's bonds are not a bad prospect.

"We are still one of the only developing countries to offer bonds with relatively higher yields. What will be interesting to see is any change in the short-term interest rate differential between Australia and the US. If the differential declines further, hedging US bonds into Australian dollars becomes less attractive," Lin says.

For 2018 and 2019, Siniakov is predicting Australian interest rates will be eased rather than increased, listing household consumption as a catalyst.

"Household consumption is almost 60 per cent of GDP but households are burdened by record levels of debt and low income growth. And now we have a central bank and regulators implementing policies to cool down housing market prices and activity. If they are successful, the flow-on effects could be significant," Siniakov says.

In response, Franklin Templeton Investments is positioning itself at the short end of the yield curve. This means it is closely anchored to the cash rate. If that rate is moved down by the Reserve Bank, yields decline and bond prices rise, translating to a better return for their investors. Their long-term inflation position is there to pick up any growth in the market that will eventually come. It's an absolute return strategy in action. ✕