Duration
Friend or Foe?

With the global economy at an economic cross road, many investors are questioning the role of fixed income in their portfolio. Yields are near historic lows, and the memory of 1994 still haunts many investors.

At this juncture, Altius believes one of two scenarios could play out — the green shoots turn out to be weeds, and yields push lower; or the global economy continues to recover and yields normalise, resulting in capital losses within traditionally managed fixed income portfolios.

Scenario 01
The green shoots are weeds and yields decline – duration is a friend

Duration plays an important diversifying role in a portfolio. Holding bonds of long duration is the best way to cushion portfolio losses when there is a downturn in equity markets, typically driven by a poor economic outlook.

If the economic green shoots we are seeing become weeds, duration will again play an important role in a portfolio despite current valuation levels.

Inadequate or poorly timed policy adjustments are the largest threat to the global growth recovery. Global inventory levels have largely been replenished, and arguably the post crises gains are behind us. If strong secular drivers of growth remain elusive (US housing being the expected sole saviour), then further stimulus will be required. Given the debt constraints of most global economies, monetary policy has been left to do all the heavy lifting. Global rates are at historically low levels and there is a risk that monetary policy will become increasingly ineffective, hampering the recovery process.

The other risk factor to watch is an untimely tightening of fiscal policy in either the US or China, which could also be negative for global growth.

Despite yields being near all-time lows, a negative outlook for growth could see a flight to quality further suppress yields. In such instances, investors will look to duration over running yield as this is its cue to play an all-important diversifying role in a portfolio.

Scenario 02
Global economic recovery – duration is a foe

China and the US, in general terms, have seen improved economic performance year on year since 2010. While March 2013 data releases have mostly been weak, it is likely this is a temporary soft patch due to the US sequestration and seasonal factors (second quarter data has been weak for the past three years).

The United States

Housing construction has played an important role in past US recoveries, and most economists are predicting it will do so again this time. The chart below shows that building permits and housing appear to be in the early stages of a more sustained growth trajectory. The overhang of unsold properties has fallen to a 13-year low, while the average interest rate on new mortgages has also fallen to an all-time low thanks to interventions by the US Federal Reserve. House prices have also turned the corner.

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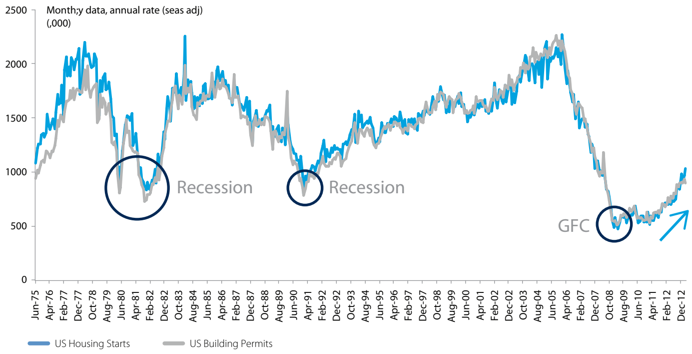
US Housing Starts and Building Permits



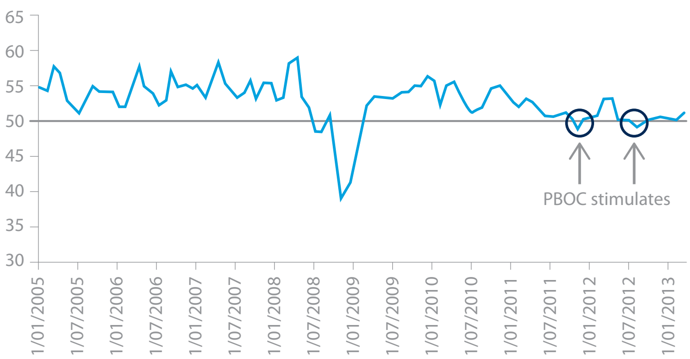
Source: Bloomberg, Altius Asset Management

The US Fed continues to provide conventional and non-conventional support, committing to keep rates low and undergoing a bond buying scheme (in the order of $85 billion a month) until unemployment falls to 6.5 percent—assuming inflation stays in check. Given the current lack of an inflation pulse, short term rates are expected to stay low for longer. This is supportive for economic growth.

China

Conditions in China are also supportive for a recovery in global growth. While in general the outlook for China is a more moderate level of growth (circa 7-8 percent), there is still further capacity for monetary and fiscal stimulus. As shown in the chart below, the People's Bank Of China (PBOC) stimulus has been effective in influencing the economy to date.

China's Purchasing Managers' Index (PMI)



Source: Bloomberg, Altius Asset Management

While the working age population in China is falling, productivity growth continues to benefit from catch-up industrialisation and modernisation. We believe China will have a lower but more durable growth profile going forward, and it's important to note this more durable growth profile will still be a significant contributor to global growth. Given the current size of the Chinese economy, the current level of economic output generated by a growth rate of 7.7 percent is the equivalent of approximately 8.8 percent growth only two years ago. In other words, China currently has the same 'global contribution' at a lower rate of growth.

Europe

While Europe remains the world's economic basket case, and will be for some time, the market appears to have largely discounted its contribution (or lackthereof). While Europe will continue to provide a key source of event risk, it is unlikely to impact the overall global recovery which will largely be driven by the US and China.

1994 may not repeat, but it could rhyme

The path to global recovery will not be smooth. Whether you are an advocate for recovery or believe economic conditions will deteriorate further, having some exposure to duration is important regardless of what happens.

Unfortunately, most investors' portfolios tend to be underweight in fixed income. While this is a widely accepted shortcoming, the reality is that most investors are understandably nervous at the prospect of increasing their exposure when yields are at historic lows.

While duration might be a foe at times, fixed income doesn't need to be. As mentioned earlier, many investors are still haunted by the bond market experience of 1994. In that year, aggressive monetary policy (a 2.5 percent rise in rates by the US Federal Reserve and a 2.75 percent rise by the RBA in a matter of months) saw large losses in the bond market. We don't expect the magnitude and velocity of interest rate hikes to be as aggressive as that, given economic growth is more fragile and needs continued support. However, investors should expect bond yields to normalise in the medium term, which will result in capital losses on long rates duration assets.

The prospect of rising rates does not need to spook investors. There are many tools and techniques available to active fixed interest managers which allow them to effectively manage their portfolios when interest rates begin to rise. Investors who choose to take their exposures passively, via index funds, do not have this luxury. They remain at the mercy of an index which reflects capital market borrowing requirements, and therefore tends to be more heavily invested in the most indebted borrowers. Today that constitutes Commonwealth Government securities, which are long dated and therefore more exposed to capital losses as rates rise. Similarly, staying invested in intermediate term deposits means investors will also miss out on the ability to reinvest at higher levels of yield.

Active fixed interest managers add value in a rising rate environment by:

- investing in short dated bonds which have a lower duration and are therefore less sensitive to interest rate changes. Short dated corporate bonds that have a yield above the cash rate benefit from capital gains (in addition to accrued income) as the yield falls toward the cash rate over the life of the security.
- Investing in floating rate notes (FRNs). FRNs pay a fixed margin above an agreed level such as the bank bill swap rate, and avoid the downside of rising interest rates by giving up some of the potential upside if rates fall. In a rising interest rate environment, spread compression can lead to capital gains in FRNs.
- Using interest rate swaps to swap fixed rates for floating.

There is a tendency for investors to lump all fixed income into the one bucket. However, sector positioning is critical in a rising rate environment—that is, it is important to distinguish between rates duration and credit duration. A portfolio heavily weighted to credit duration can deliver positive returns in rising rate markets. Corporate securities pay a spread above government bonds, reflecting the level of credit risk of the corporate. Typically credit spreads tighten during times of economic strength, providing an opportunity to capture positive returns from the capital appreciation.

Using these strategies, it is possible for an active fixed interest manager to deliver positive returns in sustained rising rate environments. However, benchmark relative strategies, including some constrained active managers and index funds, are limited in their ability to implement these strategies effectively. Therefore 1994 may rhyme for some.

Altius' central view and outlook

Altius believes the global recovery will continue, led by the US and China, noting the March 2013 quarter highlights the inconsistency of that recovery and the tendency for the rate of recovery to wax and wane.

Domestically, a two-speed economy remains and the transition is unlikely to be smooth or perfectly timed. With inflation tracking at the mid-point of the inflation objective, the RBA is able to provide further stimulus if required. Overall Altius believes the short end of the Australian yield curve will be underpinned by RBA easing, while upside surprises on global growth will put pressure on longer dated bond yields.

In summary

It is important to have a duration exposure in a broader portfolio context. The purpose of duration is to act as a counter to equity markets. However, in rising rate environments fixed income does not need to be the enemy. For instance, switching into credit strategies and floating rate notes can allow managers to deliver positive returns. Unfortunately, traditionally managed fixed income portfolios and index funds do not provide this flexibility for investors.

We are currently at risk of losing a generation of possible fixed income investors who become disillusioned with relative returns. At Altius we have designed our process to be flexible and to meet investors' expectations and requirements ofa defensive asset class. We aim to outperform the UBS Composite Bond index by 1.5 percent as well as the RBA cash rate, providing the best of both worlds.

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