The View from the Bridge by Clive Hale

My name is Bond

Bond has been on my mind a lot of late but, unlike many people, it is not the Daniel Craig film but the horror movie – or perhaps the comedy of errors – that is the fixed income sector I have been watching through my fingers. This world is not full of fast cars and vodka martinis – well, perhaps for a few of the fund managers it might be – but the rather more mundane considerations of duration, liquidity and the direction and timing of interest moves.

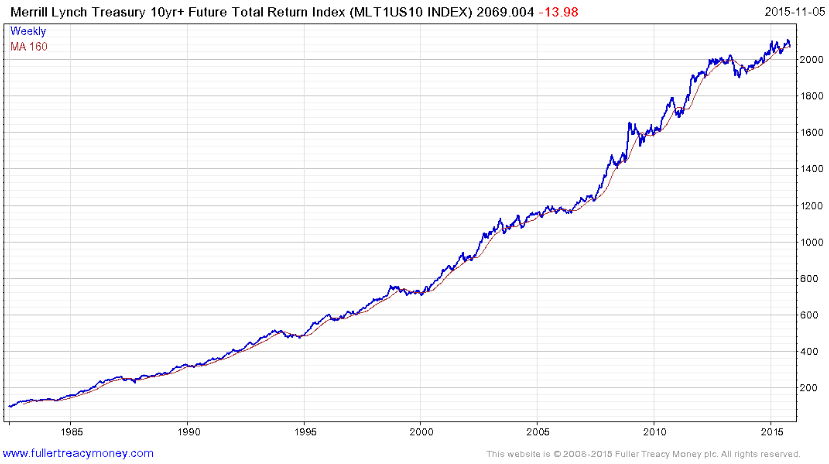
The numbers of actors who have played 007 on-screen may be growing but it has nothing on the fixed income cast-list. In the three most popular Investment Association bond sectors – Sterling Corporate Bond, Sterling Strategic Bond and Global Bonds – the listed funds align themselves to a total of 70 different indices and benchmarks, with more than a few declining to follow any benchmark at all.

The huge range of strategies on offer even within those three fund groupings makes it very difficult to say who has done a decent job. Such is the variety of ways to make – and lose – money in bonds, many investors have settled on using 'strategic' funds on the heroic assumption their managers will know what is going on at the ECB, BoE, BoJ, SNB and others and position their portfolios accordingly.

And yes, I deliberately omitted the Fed from that list on the basis barely anyone – including most of the FOMC members – has a clue what is going on there. US policymakers seem to be saying rates should be going up and yet, at the ECB, Mario Draghi has threatened they might actually be about to go down …

But why in fact do we need to invest in bonds at all? A lot of them have negative real yields and the attraction of the high-yield sector is on the wane as defaults inevitably start to rise. Yields are also on the up there, of course, but that should be taken as a warning not a magnet.

Over the past 35 years or so, the bond bull market has been the only game in town and, looking at the chart to the right, it may still be. The asset class posted its most recent all-time high in September – so no sign of a bear market … or at least not yet. Over the same time period, portfolio construction has been in thrall to modern portfolio theory and mean variance optimisation. Bonds, based on their historical long-term track record, are deemed to be less volatile and hence less risky than equities so exponents of mean variance optimisation will tell you an allocation of 60% to bonds and 40% to equities will be a nice and cosy low-risk strategy.



Yet that assumes bond and equity returns will behave in the same way they have done for the last 35 years, which seems ever so slightly unlikely, does it not? The current seven-year forecasts for real returns from US large cap equity and US bonds suggested by GMO, for example, are minus 0.6% and minus 1.1%. Stick that in your mean variance optimiser and see what comes out of the sausage machine …

Now, GMO suffers from the same problem as the rest of us – we are all fallible when it comes to forecasting, but the point with modern portfolio theory is that a small change in your assumptions can make a disproportionate difference to the asset allocation you end up with. GMO's three highest forecasts are for emerging market equity, emerging market debt and timber – an interesting sort of a portfolio that would cause a certain amount of indigestion for the 'Modernistas'. The long-term historical US equity return may be 6.5% but, in our monetary policy-constrained, experimental world that seems a far-off realisation too.

Liquidity received a mention in the opening paragraph and there is no doubt it could be an almighty problem one fine day. If that comes to pass, it will not be just the bond giants and their investors who will suffer, it will be all the bond funds – large and small. How long would any dislocation last? If it is a 'flash crash', high-frequency trading-type event, maybe not very long. If it is based on the perception rates are going up for some time and to levels that only five years ago were deemed 'normal', then probably a lot longer than most investors can stay solvent.

Those who were early to eschew bond world used cash as their proxy but, in a negative real rate environment – and one that looks like getting worse before it gets better – we need to look elsewhere. In short, we need 'alternatives'. Along with 'hedge fund' and 'derivatives, that word does not always receive a good press – 'Too difficult for the end-investor to understand', as the refrain often runs. But they will understand all right on the day their 60% allocation to bonds is found wanting …

While we wait for the Fed to make up its mind on whether or not to raise interest rates in December, we also need to contemplate negative nominal rates in Europe, which is one way Draghi could force the banks to use their reserves more effectively. He would hope for them to make more loans to businesses but it is just as likely the money will move into the asset markets.

With global GDP still anaemic at best – the CEO of Danish shipping giant Maersk has said the IMF's forecasts of growth are far too optimistic – how far can equity multiples be pushed until it is finally spotted the emperor is lacking in the clothing department? A mistake on interest rates either way could usher in the 'Spectre' of significant market volatility in both bonds and equities – the scenario that, in their infinite wisdom, the central banks are trying so desperately to avoid.

Clive Hale – November 9th 2015

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