For Professional Advisers Only

A Spotlight On:
The Sterling Strategic Bond Sector

December | 2018

Introduction to Sector

The IA Sterling Strategic Bond sector could most simply be characterised as a flexible bond sector in which investors outsource their fixed income allocations to fixed income experts who then asset allocate between corporate and government bonds. Whilst this can be true to an extent, we see the nuances of the sector being far more centred around investor outcomes, with particular funds attempting to achieve specific outcomes for investors around income, capital preservation or inflation protection. Investors should be aware that many funds in the sector can also include considerable currency positions (up to 20% of the fund), as well as allocations to more specialist asset classes such as emerging market debt, asset backed securities or loans. Some funds can even be invested up to 20% in equities. As of December 2018, the sector has c.£130 billion of client assets invested across 91 funds.

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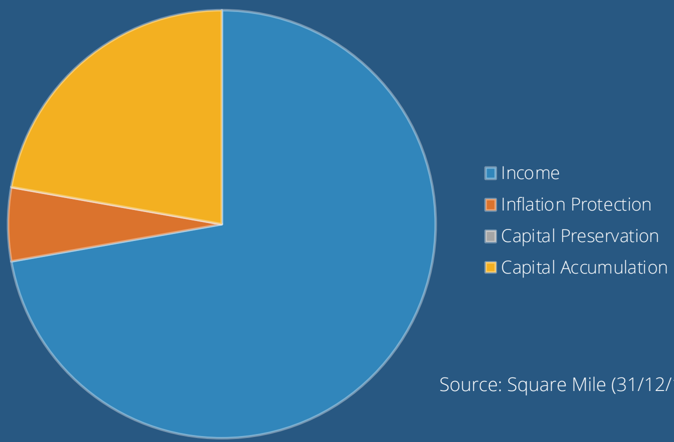
Sector Nuance

Unlike other major fixed income sectors, such as gilts or sterling corporate bonds, investors should be aware that fund objectives within the sector can be extremely varied and therefore different funds will fulfil various investor outcomes. The differing objectives of the funds can naturally lead to significantly contrasting holdings, with distinct risk and return characteristics. An income-focussed fund, for example, may have a structurally large weighting to high yield bonds, whereas a fund seeking to preserve capital will not. Alternatively, a fund may have large holdings in inflation-linked bonds in an attempt to protect against inflation, whereas another fund could have a large weighting in undervalued or distressed bonds in order to provide capital uplift. In December 2017, the JPM Unconstrained Bond fund switched out of the sector into the IA Targeted Absolute Return Sector in order to give investors a clearer idea of what to expect from the strategy. This example emphasises that investors need to be aware of the varied objectives of, and asset mixes within, the funds in this sector and be warned against treating the funds in the sector as in any way homogenous. Rather investors should understand what individual funds are trying to achieve. We see the variety of funds in this sector as a real positive, providing varied solutions for investor needs.

Given that many of these funds are flexible, and not based around an index, it is not possible to invest in the sector via a passive fund.

Targeted outcome of IA Sterling Strategic Bond funds rated in the Square Mile Academy of Funds



Source: Square Mile (31/12/18)

Recent Sector Performance

2018 was a challenging year for fixed income markets. Rising interest rates on both sides of the Atlantic, and the prospect of more increases to come, rattled the markets on numerous occasions. Of the core constituent markets of the sterling strategic bond sector, the sterling (investment grade) corporate bond market had a volatile year, ending down 2.2%. The European high yield market sold off considerably over the last two months of the year, driving the index down 2.5% for the year as a whole. Meanwhile UK government bonds ended the year up 0.6%, one of the very few markets to finish the year in positive territory, as investors sought the 'safe-haven' of developed market government bonds amidst market volatility.

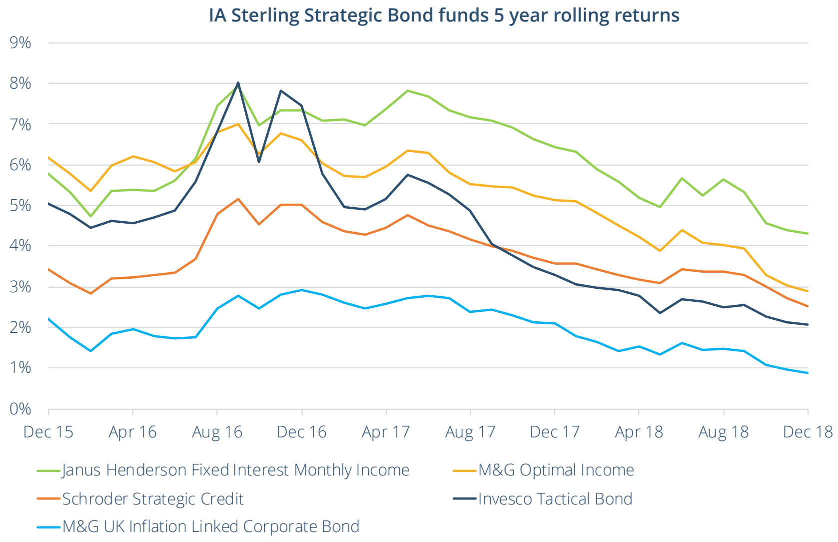
2017 was a very different story. Most investments rose, including many fixed income markets. The European high yield index saw the biggest gain, returning 7.6% for the year, as the perceived credit risk of high yield corporates reduced alongside the improving economic growth picture. The sterling corporate bond market and the UK government bond market also produced positive returns, although to a lesser extent, returning 4.9% and 1.8% respectively. The median return of the IA Sterling Strategic Bond sector, up 5.3%, was respectable within this context although there was considerable dispersion of returns within this.

Over the last five years the sector in aggregate has underperformed each of the major constituent asset classes. This is predominantly due to the active short duration (interest rate risk) positioning within many of the funds, which has consistently weighed on returns in an environment where bond prices have continued to rally.

Funds in Focus

By far the largest funds in the sector are the **Pimco GIS Income** and the **M&G Optimal Income** funds, with the most familiar to the UK market being the M&G fund. The fund's manager Richard Woolnough has been at the helm since 2006 and has forged himself an excellent reputation, particularly thanks to his defence of investor capital during the Global Financial Crisis in 2008. The fund has been running a low duration position in recent years, which has weighed on more recent relative returns.

The **Janus Henderson Fixed Interest Monthly Income** fund, managed by John Pattullo and Jenna Bernard focuses on generating income for its investors and has delivered a respectable 4.5% to 5.5% distribution yield in recent years despite the low income environment. The managers of the fund have structurally had more duration than many of their peers over recent years, a position which has, on the whole, helped their relative returns.

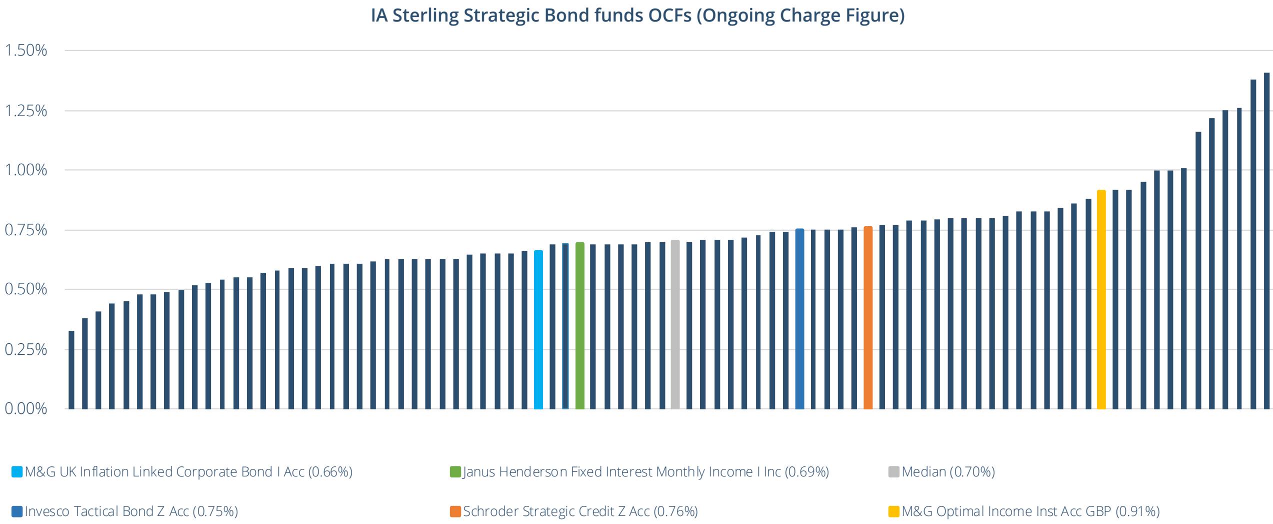


Source: FE Analytics (31/12/18)

In the **Schroder Strategic Credit** fund, Peter Harvey and his team have maintained a remarkably stable income distribution in recent years, sticking to their process of investing in quality companies with acceptable levels of credit risk. This income consistency has been no mean feat given a backdrop of reducing income payments in global fixed income markets.

A fund which has been defensively positioned for a considerable period of time is the **Invesco Tactical Bond** fund, managed by fixed income stalwarts Paul Causer and Paul Reed. This is managed with more of an absolute return mind-set, however the managers' cautious positioning has dragged on relative returns in recent years.

Compared to those funds mentioned already, Ben Lord's **M&G UK Inflation Linked Corporate Bond** fund has given the lowest net returns from a total return perspective over recent rolling 5 year periods. Until recently these returns were broadly in line with UK inflation, which is the fund's objective, so investors who bought the fund for its inflation protection outcome should have been broadly satisfied with this outcome.



Source: FE Analytics (31/12/18)

Ongoing charge figures (OCFs) in the sector range from 0.3% to 1.4%, with the median charge 0.7%. While there can be good reason for investors to pay fees above the median, such as to access experienced managers or more specialist asset classes, we believe that investors should consider whether their fund selection provides them good 'value for money' within this context.

Sector Outlook

Despite the array of managers and strategies within the sector, both current positioning and future investment outlooks are starting to converge. Most managers believe that interest rates will continue to rise across developed markets in the medium term to a 'new normal' of c.3% for 10 year UK government bonds. That said, some managers remain firmly in the 'lower for longer' camp, pointing to disappointing inflation data and the rapid advancement of business disruption lead by the likes of Amazon and Google. This disruption, they say, will continue to suppress inflation and, therefore, the need for interest rate rises in developed economies. Other managers do not overly concern themselves with macroeconomic views, but simply focus on selecting companies with good cash flows that will pay back their debts.

The constituents of the sector have also seen some change of late. North of the border, David Roberts, Phil Milburn and Donald Phillips have delivered solid relative performance in their first 6 months under the 'Liontrust Strategic Bond' banner, whilst in recent months Man GLG have hired Craig Veysey and Francoise Kotze from Sanlam following their impressive performance in recent years. Perhaps a final word on a bastion of UK fixed income markets as the industry says goodbye to Ian Spreadbury of Fidelity International, who retired at the end of 2018. Mr Spreadbury's commitment to his investors, his investment performance and his humility have all been exemplary and we wish him all the very best in his next adventure.

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