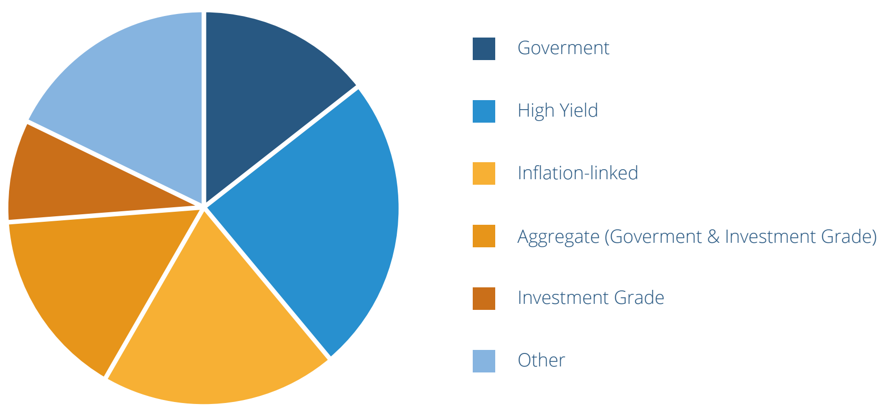
A Spotlight On:
IA Global Bonds

August | 2019

Introduction to Sector

At first sight the IA Global Bond sector can leave most potential investors feeling bewildered. The sector is made up of 180 funds investing in a variety of geographies across both companies and governments of varying credit quality. And that's before consideration of the plethora of currency hedging options available.



Source: Square Mile analysis of Financial Express data

Figure 1: Investment focus of funds in the IA Global Bonds sector

Sector Nuance

We believe the key when approaching this sector, as with any sector, is to consider what investors want from their money, as different funds will fulfil various investor outcomes. 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. Investors should understand what individual funds are trying to achieve. Both strategic and government bond funds are likely to have an income outcome, because of the coupons paid by the bonds in which they invest, however strategic funds may also be aiming for capital uplift or inflation protection through their investment strategies. Strategic bond funds, through the use of derivative products, could even be structured in such a way that they have a capital preservation objective.

Given the daily dealing nature of all the funds in the sector, the underlying liquidity of the bonds held in a fund remains highly pertinent. Liquidity in developed market government bonds tends to be extremely high, with major market participants often including the country's own central bank. However corporate and emerging market bonds can potentially present greater liquidity challenges, particularly during times of market stress. Investors in strategic funds should therefore be prepared to hold for the long term (at least five years) and be comfortable with potential shorter-term volatility in the performance of their fund.

Investors tempted to passively allocate within the sector should, as always, be aware that the most indebted, rather than necessarily the most credit worthy, governments and companies will naturally make up the largest part of indices and therefore passively managed bond funds. These large index constituents can also pay miniscule yields, such as Japanese government bonds which pay between -0.26% (5 year maturity) and +0.3% (30 year maturity) and make up c.20% of the Bloomberg Barclays Global Treasury Hedge GBP as at the 20th June 2019. Active managers, on the other hand, are able to avoid bonds they view as overvalued. Managers who have been able to consistently do this, net of fees, provide good value for money for investors. Alternatively, an investor purely seeking negative correlation to their equity market exposures could view a passive global bond fund as good value for money given its lower costs.

It is not possible for investors to invest passively in a global strategic bond fund, due to the prominence that asset allocation takes in a strategic bond fund's investment process.

Recent Sector Performance

In the past few years, returns have been sparse for both developed market global government and global aggregate (developed market government bond and investment grade corporate bond) indices.

Much of the relevant benchmarks are made up of US and Japanese government bonds. This has proved a very unpalatable mix from a return perspective in recent years, given that the Bank of Japan continues to suppress the yield paid on Japanese government bonds, through quantitative easing, in an attempt to boost Japan's low economic growth, whilst the U.S. increased interest rates 4 times in 2018, leading to a temporary decrease in the price of US government bonds already trading in the market.

2019 year to date returns (to June 13th) in the sector have been very pleasing in contrast, up 3.7% in GBP terms to 14th June. The main driver of this has been investor concerns over future economic growth and the resulting expectation that the US Federal Reserve will start to reduce interest rates, thereby increasing the price of US Government bonds already trading in the market.

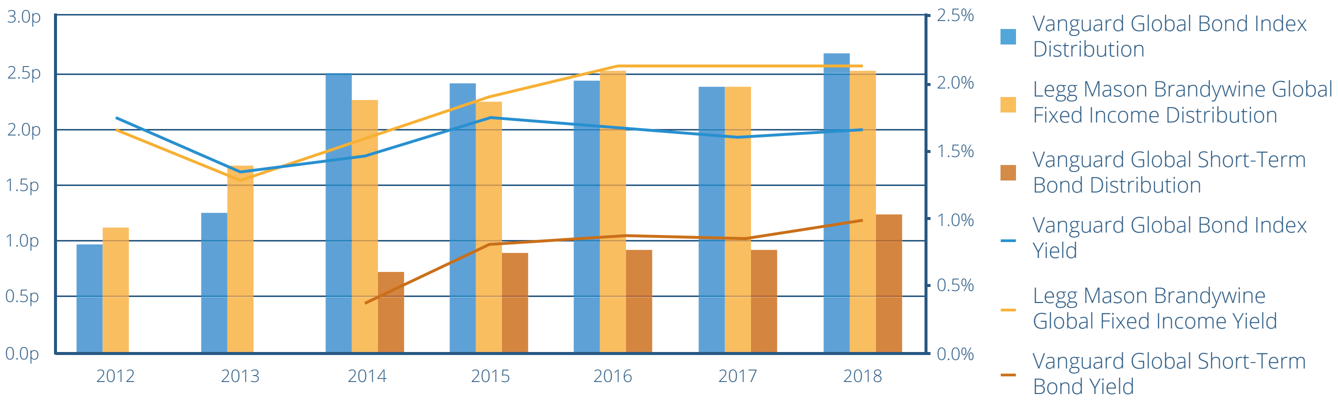
What government bonds do continue to provide, however, is returns which are not correlated to equity markets, with the Bloomberg Barclays Global Treasury Hedge GBP actually marginally up in 2018, +1% in GBP terms, compared to most equity and credit markets that were down between -2 to -10% for the year.

Funds in Focus

For an active global government bond fund, we like the **Legg Mason Global Fixed Income** fund. The fund is managed by an experienced team who have proven themselves capable of seeking out and investing in value opportunities in varied market conditions. The strong investment process, with a focus on undervalued bonds and currencies should, in our view, continue to provide opportunities to achieve the fund's targeted income and inflation protection outcomes.

This is an active approach, with the managers often taking large emerging market government bond positions, and the performance of the fund has differed quite substantially from that of the benchmark at times.

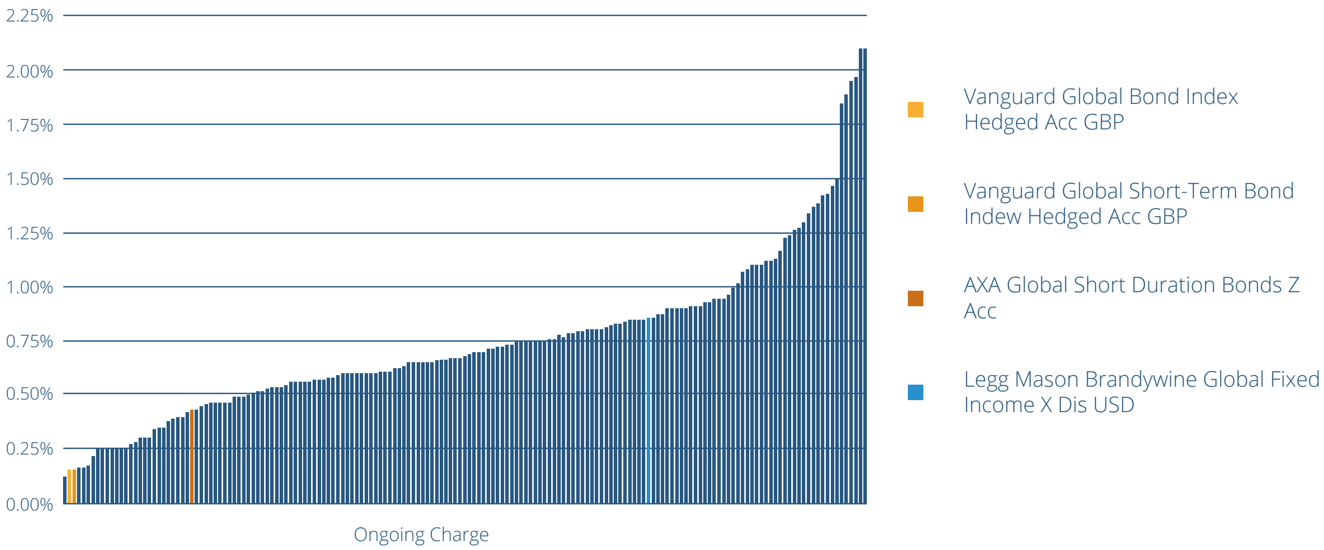
From a passive perspective we like the **Vanguard Global Bond Index** fund and the **Vanguard Global Short Term Bond Index** fund. We believe that Vanguard have a very strong commitment towards managing passive strategies, as well as a good historic record of tracking the indices on these funds. The benchmarks of the funds are approximately 55% issued by governments, with the balance in corporate and government related agency bonds. From a country perspective, approximately 40% of the debt is U.S. domiciled, c.10% in Japan and 3-5% within emerging markets.



Source: Financial Express and Bloomberg

Figure 5: Income profiles of Legg Mason and Vanguard funds

In terms of a strategic global bond fund in the sector, we like the **AXA Global Short Duration Bond fund**. Essentially a short-dated strategic bond fund, the fund's yield is lower than a fund investing across the full maturity spectrum due to the lack of term premium (extra yield received for lending for longer time periods) available. There are, however, some major advantages to employing this "low duration" approach. The first is the inherent protection it affords against rising interest rates. With around 20% of the portfolio maturing each year, the manager should be able to re-invest maturing bonds at higher yields, thus potentially allowing the fund to benefit in a rising interest rate environment. The second is that such an approach has, historically, proved to be less volatile than one investing in the market as a whole.



Source: Financial Express

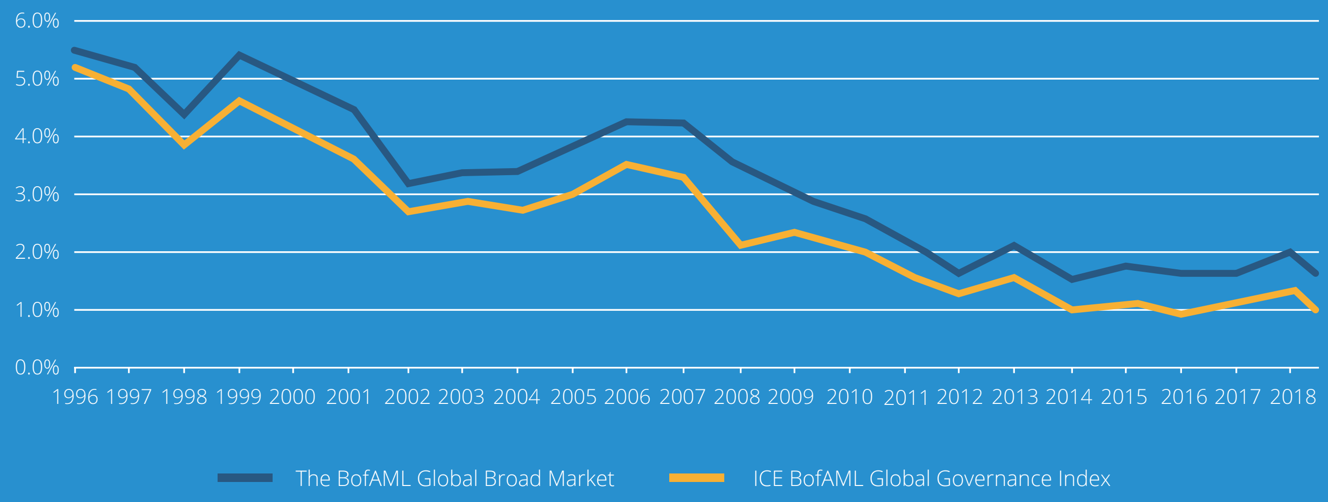
Figure 6: IA Global Bonds Value for Money

Ongoing charge figures (OCFs) in the sector range from 0.2% to 2.1%, 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

Yields in the main indices of global bonds remain low by historic standards, and income expectations for the sector looking ahead are therefore also low. That said, given slowing global economic growth and expectations of interest rate cuts by the US Federal Reserve, the outlook for the global economy is also less certain, and the diversification potential which high quality global bonds bring may be attractive to investors.

Conceivably, funds in the sector could therefore continue to provide small, defensive returns in the years ahead. And these returns could, crucially, prove to be negatively correlated to investors' higher risk global equity holdings.



Source: Bloomberg

Figure 7: Yield over time

Important Information

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