INVESTMENT

The new defensive: Is there life after bonds?

Matthew Smith July 27, 2020

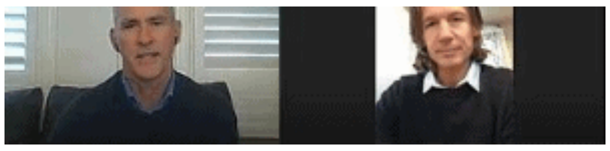
Bonds may not be dead, but speak to any multi-asset, fixed income investor or portfolio construction expert and it feels like there's a eulogy all but mapped out and ready to go for the once go-to defensive staple.

Quantitative easing and the idea that yields will be lower for longer has been around some time now, so investors have become accustomed to thinking outside the box when it comes to satisfying their income needs.

But with volatility returning to markets, and the spectre of risk growing, as the 'real' economy continues to detach from financial market valuations, defensive strategies are the topic de jure for those protecting wealth or simply preparing for whatever might be around the corner.

What that may be is the subject of some serious consternation among those tasked with navigating it; investors are facing into a series of divergent scenarios, starting with the reality of deflation and the real possibility of a reflationary scenario, as well as the potential for stagflation as debt monetisation escalates and central banks continue to be prepared to do whatever it takes.

"It's uncomfortable for investors, which is why people are so fixated on finding ways to be defensive," said Al Clark, MLC Asset Management head of investments. "A decade of depressed interest rates has forced investors further out the risk curve in an attempt to generate a reasonable return. The discomfort comes from investors finding themselves in volatile and expensive assets with few obvious ways of protecting themselves."



MLC's Al Clark (L) and Ben McCaw

Clark joined specialist bond and equities portfolio managers along with multi-asset class portfolio managers, fund researchers, high net worth and private client advisers to discuss the topic '*The new defensive: Is there life after bonds'* as part of a virtual roundtable held in July and hosted by *Professional Planner* in partnership with MLC.

"It's easy to talk bonds down and it's definitely true that the ability for bonds to deliver defensiveness into a portfolio by being reactive when growth gets shocked has obviously diminished somewhat from what it was when yields were higher," commented Ben McCaw, MLC Asset Management's senior portfolio manager.

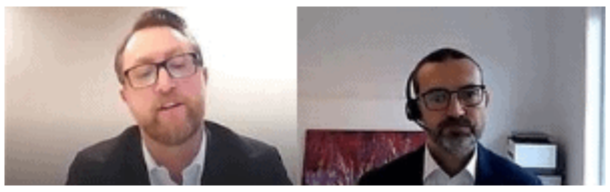
"Bonds are still delivering, but they're just delivering less," McCaw continued.

"And at the same time that they're delivering less, the trade-off with respect to the amount they could cost an investor, say, within an inflationary uptake, is also increasing. So bonds are still there but they're just providing less in this defensive debate," he said.

Dip into the toolbox

Investors have been quick to consult their defensive toolbox in light of the challenges of traditional defensive assets such as sovereign and corporate bonds.

"The defensive part of the portfolio is probably the biggest challenge at the moment," James Daikin, cofounder and principal of Park Street Advisers, described.



Woodbury's Scott Fletcher (L) and Park Street's James Dakin

"There's no low hanging fruit, no obvious places to hide. You're not getting decent negative correlation out of those traditional defensive assets, they don't offer you much cushion if there's a risk off event. You don't have any sort of yield cushion [with traditional defensive assets] to start with," Daikin said.

Gold, currency, alternatives and private assets were all mentioned in the context of a 'life after bonds' portfolio, as were volatility (tail risk protection), certain equities and equities options strategies along with cash. But the multi-asset and portfolio construction experts raised challenges associated with and replacing one kind of traditionally 'defensive' asset with another considering the complexity of the prevailing environment.

"This is the classic portfolio construction problem, right, you put something new in the portfolio, trying to fill a gap or solve a problem and it can be like an organ transplant," said Scott Fletcher, chief investment officer at Woodbury, a multi-family office and private wealth firm.

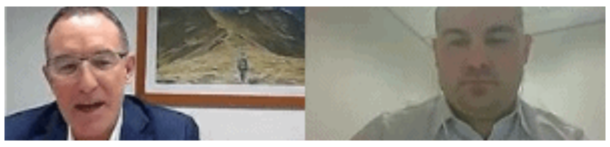
Fletcher also acknowledged that many advisers might be limited in their ability to access the slew of fixed income alternatives due to adherence to traditional asset class categorisation, licensing or platform reporting requirements.

"While some advisers or investors might frame their asset allocation approach to building blocks that already exist, the way I see it is their defensive assets or strategies have just been underutilised or misunderstood.

"It's like defensiveness isn't just a category, it's a lifestyle… It's not about defining criteria for a defensive part of your portfolio – what's in, what's out – it's also about defensiveness overall and introducing defensiveness into every part of your portfolio," he said.

Long live bonds

Being 'free form' with categorisations such as 'growth' and 'defensive' sounds good in theory, but advisers still need to be comfort
ntly be able to disseminate that information to the end client, Chris Lioutas, Insight
d.



Firetrail Investment's Patrick Hodgens (L) and Insight's Chris Lioutas

"If you say bonds are dead you have to firmly believe that no central bank will ever entertain negative cash rates, and I don't think anybody can ever say that. We've got them in Japan and Europe, the US… and the RBA have said never but I don't really take that to mean a whole lot," he said.

"As long as the growth side of the portfolio continues to produce the returns that we think it's going to return, then that's OK. If we think that growth returns are going to be significantly lower, along with bond returns, then the total return must come down in obvious respects and that's where it becomes problematic," Lioutas said.

While 'growth' has performed, pushing price/earnings multiples to historically high levels, rather than diversifying away from equities investors are increasingly looking to diversify within the equities asset class, Patrick Hodgens, managing director of specialist equites manager Firetrail Investments noted.

"Obviously you have the market neutral strategy which is an alternative to bonds," he said.

Hodgens went on to talk about segments of the equities market that, while expensive, still have the potential to be winners over the long term including health care companies, market leaders and technology.

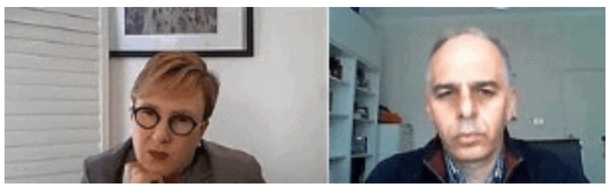
"I can't imagine total returns or real returns being achieved in the next two to three years in bonds. But I think being smart about infrastructure, being smart about real assets, agriculture, gold companies, gold, I think you can mix and match and get good exposure, good diversification with real income through time," he said.

Fixed income drift

Within bond funds, managers are increasingly reaching the limits of their classifications, Libby Newman, Lonsec director, managed funds research has observed.

"Traditionally bond fund managers would use credit and duration as levers, we're increasingly seeing a bit of creep with bond fund managers using currency more as a tool more than they have in the past, and more of their alpha is coming from currency pairs rather than duration," Newman, who recently completed a round of fixed income and bond fund manager reviews, said.

"So we're trying to ensure that the classifications that we've got for the funds in fixed income and bonds are true to label so advisers know what to expect in terms of what's on the tin," she said.



Lonsec's Libby Newman and Antares Capital's Tano Pelosi

In the multi-asset realm where Newman also focusses her coverage she notes there's been a number of managers who have largely dismissed bonds as an asset class, some to the point where they don't hold any bonds, she described.

"You really have to do your homework," said Tano Pelosi, portfolio manager for fixed income specialist Antares Capital.

"We've been doing a lot of bottom-up work across the whole universe of investment grade credits. So our credit guy's been very busy," he said.

In particular Pelosi says his team is spending a lot of time looking at strength of balance sheets, liquidity provisioning, working capital, access to capital markets and reliability of cash follows.

"We need to do a lot of work to get comfortable with the types of risks that we are now faced with, selectively grabbing the credit spread premium or yield that is on offer," he described.

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the long period of time.

"The opportunity costs of holding cash is high," he said.

"To many investors, cash is can be a first port of call for injecting some defensiveness into a portfolio. It seems to have very little cost to start off with, but the costs accrue over time. I think they accrue over time in a way that often begs regret from a lot of investors," he said.

The group talked about a range of outcomes in the near term, from a depression-type situation where rolling lockdowns across the globe sap the real economy to the point where fiscal stimulus and monetary support cannot offset the problems; to the upside bullish case where the fiscal stimulus which has already been injected into the economy takes effect and is very difficult to reverse. They also threw into the mix the impact of escalating geopolitical tensions – yet another variable that could swing the base case one way or the other.

Antares's Pelosi said his own personal view is that central banks have a strong mandate to reflate, which may mean capping yields.

"I know there's been a lot of concern already on the call that bond yields could rise here and lead to bonds under-performing. To me that would seem incongruent with the set of policy objectives employed across most developed market economies," Pelosi said

"We've already seen the RBA capping yields here. I think it will be only a matter of time before we see other central banks capping yields so that you've got lower volatility in bond yields and essentially economies reflating – willing inflation higher," he said.

"Clearly that has broader ramifications for other asset classes… but you can clearly see that central banks have a very strong imperative here to offset any deflation risks. So that is something that is really occupying our minds," he said.

Abstract from history

While there is a tendency for investors to rely on categorisations, doing so can mean treating the environment as if it's stationary, MLC's McCaw pointed out.

"We are always in a state of flux. It doesn't matter whether you're talking about periods of time that are measured in decades, or periods of time that are measured in years – it's always a moving feast," McCaw said.

Categorisations in the variability of the conditions we face means investors and asset allocators must think critically about the role that any particular asset plays in a portfolio, he said.

"So de-label it, doesn't matter whether it's defensive or not defensive – or defensive or growth – but focus on what that asset brings into the portfolio today," he said.

"Defensive hopefully means putting together a bunch of assets that are complementary to one another with complementary return profiles," McCaw added.

"All of which hopefully have got a positive expected return. And that is sort of the essence of putting together a decent diversified, robust, multi-asset portfolio."