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CHALLENGING TIMES FOR BOND INVESTORS

By Joost van Mierlo

At a time when central banks worldwide are on the brink of retreating from their stimulus policies, it seems right to focus on some of the main challenges bond investors are facing.

How do you look at the current macro environment for fixed income investing?

Han Dieperink: 'I think it's quite challenging. For a number of years we've seen that spreads have been compressed. Risks are higher because duration is longer and rates are extremely low. A large part of the euro benchmark is still negative-yielding. The alternative is to look at global bonds. For instance US bonds. That was OK till recently. But hedging it back to euro is now becoming quite expensive. That's a challenge.'

Markus Schaen: 'I would agree. It is a rather challenging macro environment for fixed income investing; not only for us but for most investors. The upside potential for bond price appreciation appears clearly very limited at the moment. It will be very interesting to see (and not easy to predict) what will happen to bond prices when the various QE programmes around the world will come to an end in the coming months.'

Jack Julicher: 'We believe that a lot of the fixed-income categories are still very expensive. We saw a small correction after what happened in Italy. And from a geopolitical point of view I think there are still some risks. There is the risk of growing protectionism. The market also has to cope with the tapering of the central banks. The Fed is further in the cycle, but the ECB will also follow. It will clearly be an environment with more volatility.'

Mark van den Berg: 'Looking at securitized debt and structured credit I see challenges. Spreads are low. Interest rates are low. Besides this we see developments around the covenants and structural elements. The protection

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> Mark van den Berg is Portfolio Manager in the structured credit team within ACTIAM, since 2014 responsible for managing the ABS investments. Van den Berg joined ACTIAM in January 2011 as manager investment risk & liquidity. Before joining ACTIAM he spent ten years in risk management consulting for major Dutch financial institutions concerning alternative fixed income pricing and credit risk management. Van den Berg holds a Master's degree in Financial Econometrics and is a certified Financial Risk Manager.

mechanisms and credit enhancements are becoming lighter and lighter. On a positive note, we saw that at the time of the Italy turmoil the ABS market didn't move as much as the government bonds and the credits. So there's still some protection here.'

Dieperink: 'I'd like to add something about the risk of higher inflation. I think it's underestimated by the market. The market thinks 'well, we have some extra inflation right now and it will blow over'. But if you look at the output gap, if you look at unemployment, then the risk of inflation is building. And actually central bankers are now getting ready to create more inflation. So I think there will be more inflation.'

How will rising rates impact the asset allocation of investors? Will they shift assets from riskier products to less riskier products and will it be done on such a scale that it has a meaningful price effect?

Bob Homan: 'I saw the opposite in clients' behaviour when rates were coming down. A lot of money in saving accounts went into investments. Into bonds predominantly. And later somewhat more into equity. And that's going to reverse once interest rates rise again. If the interest rate on a savings account is going to rise above 1% I think some of that will be reversed.'

Andrea Dacquin: 'I can see this point from a retail perspective. It's different from an institutional point of view, several asset classes like investment grade credit, high yield and EM debt are still doing well in a rising rates environment.

Factor investing strategies can also be designed to have low tracking error, so that they are good replacements for passive strategies.

Of course everything which is long duration will be problematic. But BBBs, BB and B-rated short duration High Yield are a sweet spot from an institutional point of view.'

What about Dutch mortgages?

André Broijl: 'Dutch mortgages have proven to be a very resilient asset class. Although spreads have come down, in general it still looks like a good place to allocate money to. Spreads at this point appear yet to offer reasonable compensation for underlying credit risk and liquidity risk. Obviously, a rise in underlying interest rates and the impact on prepayment risk is something to watch carefully.'

Julicher: 'I think that when you look at the spreads in the Dutch mortgage market, at residential mortgages, it's still remunerating for the risk you take. Because it is a category with low credit risk. And for some of the institutional investors, it's an attractive category, also from a perspective of regulation. And if you look at the spreads I think levels are somewhere around 1,-1.5% now. A form of remuneration for the liquidity risk is incorporated in the mortgage yields. The crucial point is what will happen with interest rates? When interest rates rise gradually and monetary tightening will also be gradual, it's a perfect asset class. But in case of unexpected sudden rate hikes mortgages might be problematic because of low liquidity. You have to be prepared to hold your position when that happens.'

Van den Berg: 'With regards to mortgages we see no credit risk at the moment. But the main risk is a prepayment risk. Because interest rates are very low at this moment. And interest rates will increase. The first effect is that the mortgage value of the portfolio will go down. But that will probably be hedged around your liabilities. The second issue is that if rates go up prepayments will go down because people will keep their low interest mortgage. And then we are stuck for 30 years with a mortgage with low interest rates. That's a risk we see at the moment.'

Dieperink: 'You see a lot of pension funds now investing in Dutch mortgages. I think it's time to really look into that. In an extreme global warming scenario we are not in the most favourable place in the world. And a lot of these mortgages are on houses at sub sea level. You can make fun of this, and of course it's a very small chance that something bad happens, but people are underestimating climate risk and the impact if something bad happens is large. If your house is literally under water, you probably also lose your job. And at the same time you also lose part of your pension. Of course there is some home bias in every portfolio. But certainly from a pension point of view I think we already have a lot of exposure to the Netherlands. So I think there's a case for avoiding extra Dutch risk.'

Where do you see the best opportunities in fixed income at the moment?

Homan: 'The first thing to look at are corporate bonds in Europe. With the ECB drawing back a bit bonds that were outside the purchase program of the ECB offer an opportunity. Those bonds will be hurt the least. And I think especially American, Australian euro-denominated bonds which were outside the program might be attractive. And the second thing is that every now and then in fixed-income there really seems to be an opportunity in stress situations like the recent one related to the political situation in Italy. The Bund versus Italy two-year spread was going above 3%. So if you really are a trader, those are definitely opportunities because that's 3% for two years. Even if Italy were to leave the euro in the end it would take time. You see this with Brexit. It takes three, four years to be effective.'

Dacquin: 'The only pocket that has generated positive returns this year is short duration high yield. We're looking only at the Solvency II eligible category, BB and B credit quality.'

Broijl: 'I think that emerging market debt could be attractive as well. Obviously from time to time these markets can become very volatile. And we have seen that now in certain areas, especially in Latin America. But this can also provide an interesting entry point and render a cushion in spreads that looks attractive versus the underlying risk in this particular segment of the fixed income market.'

Has fixed income lost its defensive characteristics?

Homan: 'No. I think you always have to be in fixed income for a part but I think at this moment you should underweight total fixed-income as well as duration. We don't want to be too risky on credits and since recently we're underweighted in high yield. We are overweighted though in emerging market debt.'

Dacquin: 'Fixed income is coming back to its genuine defensive nature as opposed to the past periods when it behaved more as an income asset. I think there would be a strong motivation for fixed income investors to pull out once we would have outright negative yields for considerable parts of the universe, which is not the case. I mean we're only talking about investors that have to be invested in fixed income for regulatory reasons here.'

> André Broijl, MSc, CFA, is Investment Manager at DSM Pension Services. He has been an investment professional since 1995 and a Fixed Income specialist since 2004. Before joining DSM Pension Services in 2016, Broijl worked at Mirabaud in London where he headed their Investment Grade Credit team, responsible for managing investment grade credit assets in several portfolios. Prior to that, Broijl worked at Achmea and before that he held various positions at ING Investment Management and Robeco. He started his career at Royal Netherlands Life Insurance. Broijl is a CFA Charterholder and has a Business Economics degree from the University of Groningen.

> **Andrea Dacquin**, CFA, DVFA/CEFA is Associate Partner and Head of Fixed Income at Quoniam and has more than 20 years' experience in fixed income. In her previous position, Dacquin was Head of the Portfolio Engineering Group at AXA IM in Paris, France, and held other senior positions at AXA IM for more than 13 years. Before switching to AXA IM she worked at Commerz Asset Managers (CAM) as a senior portfolio manager for global bonds. Dacquin has a degree in engineering and a Master in Engineering (Hons) in mathematical methods in economics. She has been a CFA charterholder since 2005.

What do you consider to be the most reliable alpha sources in fixed income?

Menno Meekel: 'Before you start selecting an active manager you have to take a step back. First take a look at the characteristics of the market and determine if there's sufficient alpha potential. If you decide the specific market is suitable for active management, then you can start your search. But if you look at current credit markets I think the most reliable source would be the individual bond selection. Especially now we're approaching the end of the credit cycle. So this is the time to focus more on idiosyncratic risks and relative value within credits rather than on the beta decision.'

Homan: 'I think the most reliable source is within credits. Either you go to AAA or to BBB depending on your outlook for the financial markets. So for example until 2008 you could take a lot of risk. So that's the time to be in the BBB space. And currently you have to be in the quality space. If you play that game well then you'll be able to create alpha.'

Dacquin: 'In my opinion a systematic, factor-based issue and issuer selection is a very reliable source for alpha. This approach allows to exploit all investment opportunities, not only those related to well researched, large issuers.'

What are the most important attributes of a good active manager in fixed income?

Schaen: 'We regard credit selection as the most reliable alpha source in fixed income. Above average credit selection relies on superior bottom-up research. So for us, when we select fixed income managers, we look thoroughly at their team of credit analysts. How deep is the team? What is the coverage per analyst? How experienced is the team? How long have the analysts been at their positions? How long have they been with the firm? Does the firm offer a complete career path within credit analysis? All these things. But even best credit research is only useful if the analysts' recommendations get implemented in the portfolios. So of course you also look at the quality of the portfolio managers and their interaction with the analysts.'

Broijl: 'I am also not necessarily looking for the biggest team because that's when you would always end up with the BlackRock's and Pimco's of this world. I think it's very important that the process is structured very well and also believe that it's very important that a team uses quantitative models to support the decisions they take. We gained a lot of computing power over the past several years, making it possible to support investment decisions with more data and models. And taking this a step further, in the future I see artificial intelligence adding to the process as well.'

Dieperink: 'Adding or replacing? Because that is the idea. You already see that credit analysts are being replaced by machines because in the spreadsheets of a credit analyst literally hundreds of data points a day are coming in. Machines do a better job already.'

Broijl: 'I think to me that's just a little step too far. In the end although models and machines can do a lot, and especially in volatility trading they seem to be very capable, from time to

> **Han Dieperink** is Chief Investment Officer of Rabobank Private Clients since November 1st 2009, promoting passive and factor investing combined with ESG-integration. Previously he held positions as Investment Strategist and Chief Investment Officer at Schretlen & Co. He studied civil and tax law at Leiden University and served in the Royal Netherlands Navy.

time we see models and machines go wrong and we need people to correct them.'

Dacquin: 'It's really about avoiding rotten apples. I am convinced, that the knowledge of an analyst can never be scaled up to thousands of issuers. This is where quantitative security selection techniques come into play allowing to process vast amounts of data in an objective and timely manner. So for large relatively homogenous universes like Investment Grade or higher quality High Yield, quant is the superior approach.'

Van den Berg: 'On high yield and more exotic debt, you really have to define the expertise of the investment team which is experienced based on a detailed and thorough due diligence. Ideally you should have an in-house team executing these due diligences and continuous monitoring. In some markets it has more added value to work with specific partners based on strict arrangements.'

Do you believe in factor investing in fixed income? And what are the factors to consider in fixed income?

Dacquin: 'Oh yes. Actually hundreds of factors have been identified in academic literature. I would say there are four big categories that everybody somehow is looking at in different forms. The first would be risk. This is the low vol factor in the equity space and short duration investing in fixed income. The second factor is value, a holistic concept relating value to risk and quality. The third is quality. And the fourth category is sentiment, or momentum. The challenge is that these factors are correlated, so that you must combine them in a multi-factor framework for a thorough analysis. This also increases diversification and maximises factor exposure.'

Van den Berg: 'We use some elements of factor investing in our day-to-day investments, but we do not invest using these algorithms structurally. The factor value is the most important one for us which we use for screening and relative value purposes. We use the factor illiquidity for our insurance clients in specialised mandates.'

Dieperink: 'I think factor investing is a different animal in equity than in fixed income. Because in equity you have managers having difficulty trying to outperform the market. That creates all these different factor premiums because active managers make mistakes. In the fixed income sphere you don't manage for the upside, you manage for the downside. It is a completely different thing.'

Julicher: 'As an investor with a long term focus we regularly follow a strategy of buy and maintain. But the point I want to raise is if you interpret factor investing in fixed-income as let's

> **Bob Homan** is head of the ING Investment Office since 2008. He is responsible for the investment strategy for the Dutch ING clients. Since 1999 Homan was responsible for the investments department of WestlandUtrecht Effectenbank. Homan started his career with Dutch Postbank and worked for several private asset management companies afterwards.

> Jack Julicher is CEO of ASR Asset Management, with approx. €55 bn assets under management, and Chief Investment Officer of a.s.r. vermogensbeheer, the number four insurance company in The Netherlands. Julicher has over 30 years of experience in the financial sector. Before joining ASR Asset Management in 2003, he worked at the Ministry of Finance, the Nationale Investeringsbank and Stad Rotterdam Verzekeringen/ASR Bank. He studied macro-economics and finance at Tilburg University and the IMF institute.

say a kind of rules-based quantitative approach based on algorithms, then I think you are entering a danger zone. You can identify those factors based on ex-post back tests or research. However, those factors are not stable over time. They are not stable over business cycles. They are not stable across regions. And you need fundamental judgements to take the right decisions in situations of stress for example. So I think it is useful to apply or consider factors. We all implicitly use factors I believe. But completely relying on a rules-based quantitative factor approach of fixed-income is not advisable in my opinion.'

Is fixed income factor investing going to replace low cost beta investment solutions (passive market cap solutions) or active investment solutions?

Meekel: 'From the research we find that the excess returns from fixed income factor investing have a low correlation with the excess returns from fundamental managed strategies. This gives you an argument to look for a combination of passive and fundamental active managers together with factor focused managers.'

Dacquin: 'Yes, alpha profiles of traditional and factor managers are different and it makes sense to combine them. Factor investing strategies can also be designed to have low tracking error, so that they are good replacements for passive strategies.'

Broijl: 'I think here at this table we actually do agree that fundamental investors are essentially looking at the same things as quantitative investors, especially in fixed-income. I am in favour of hybrid models, so a good team supported by the right tools. And obviously you need to have the process in place to cover the entire universe, because the universe is quite big. Therefore you really need processing power and the right tools.'

Bonds are mostly traded over-the-counter and not on an open exchange. Transactions costs are higher and vary in time, rating and transaction size. Is it possible to combine that with a quantitative-based strategy?

Dacquin: 'Definitively yes! Trading, or a lot of trading, is a negative. But you can turn it into a real advantage. You need to have the infrastructure that will allow you to estimate realistic transaction costs not only from the bid-offer spreads but also from the inventory. And if you have a real-time data feed to those inventories, you can estimate your transaction costs and integrate it continuously into your bond-specific expected returns. In this respect having an appropriate back testing set-up is crucial. Academic and market practitioners back tests are made with assumptions that are not realistic, particularly with respect to turnover and transaction cost. The results of such back tests without realistic transaction cost and turnover constraints are useless.'

Meekel: 'I am curious to know what the factor exposure of your portfolio would look like if you decide not to trade because transaction costs are too high. For example when you cannot buy the top 5 ranked bonds based on their factor exposures and you have to buy the next 5 in the ranking. What is the impact on the factor exposure?'

> **Menno Meekel** is Senior Portfolio Manager Fixed Income at Altis Investment Management. He joined Altis in 2018 from Rabobank Private Banking where he worked for over 9 years. In his role as Senior Investment Analyst he was responsible for fund selection and was a member of the Invest Committee. Meekel works since 1998 in the financial industry and most of the time for Rabobank as a Client Investment Consultant and for IRIS Research as an Investment Analyst. He has a Bachelor Degree in Financial Economics and passed CFA level I and II. He also is a registered analyst at the Dutch Securities Institute in The Netherlands.

Dacquin: 'Actually you use those factors to generate your alpha, that is you maximise the factor exposure. You are buying those securities that will provide that factor exposure after adjusting for transaction costs and minimizing risk. So basically you are always adjusting to your model because you are buying those that are the best and if you will not buy the best you will buy the second best or the third best. But you still are buying securities from the top.'

Do you believe that integrating ESG factors in investment decisions can add value or mitigate risks?

Schaen: 'ESG is very important to our clients and to our organisation. For example, if I look at our selection policy, ESG integration in the investment process is a hard requirement to be selected as a manager for us these days. And within monitoring, ESG integration is one of the factors we score managers on. And in line with clients' expectations we keep on setting the bar higher in that area each year.'

ESG is becoming, next to risk and return, a third factor in fixed-income investing.

Julicher: 'I believe that companies that follow a proper and transparent policy with respect to ESG will perform better in the long run. And if we look at the actual performance we can now see that they don't perform worse. A sustainable return goes along with a better return in the long term. Integration of ESG factors in the investment process provides portfolio managers with additional information to build portfolios that are better diversified.'

Van den Berg: 'At our firm ESG is really one of the top priorities as we believe it can both mitigate risk and add value. We manage mandates that go from what we call responsible (meet a minimum set of criteria) to direct impact investing. We have also our own ESG integration assessment score for, amongst others, green bonds. And I think the G part on ESG – good governance - is really about mitigating risk. We focus especially on the environmental and social side investment opportunities to tackle for instance climate change, land and water.'

Meekel: 'Maybe it's more attractive to have a look at it in a different way. Let us start by looking at companies with a dismissal ESG record. If you start engaging with those companies the ESG impact result will probably be higher compared to engaging with the already best in class companies.'

> **Markus Schaen** is Senior Fund Manager Fixed Income at MN. His primary responsibilities include the selection and monitoring of MN's external fixed income managers and the monitoring of MN's internal fixed income teams. Prior to joining MN in 2008, he was Corporate Treasurer of Koninklijke Wegener, where he was also a trustee of the company's pension fund and a member of the fund's investment committee. Schaen graduated in 1995 from Maastricht University with a master degree in economics and business administration. He is qualified as a Chartered Accountant and as a Chartered Treasurer. He completed the Pension Executive program at Nyenrode University.

Julicher: 'But Menno, I think there is a solution to that simply by comparing yourself with a kind of benchmark. That's the point I want to make. But I believe that ESG is becoming, next to risk and return, a third factor in fixed-income investing. And it is very important.'

Meekel: 'I agree, but from UN PRI surveys we learn that only 25% of the fixed income managers engage on only 25% of the portfolio. Let us conclude that for the impact to become meaningful a lot of work has to be done for investors. The best way is probably to team up in order to achieve better results.'

Homan: 'In Belgium the regulator is currently defining a set of standards for ESG investing. If you want to call yourself an SRI-fund or SRI-investor you have to adhere to certain standards. It will be a combination of exclusion and some best-in-class standards.'

Dieperink: 'Did I hear you correctly when you were saying that Belgians were before the Dutch with this kind of regulation?'

Homan: 'No, I think they are somewhat later. But now they're developing it. And instead of every asset manager doing it for themselves they define some standard. That's helpful.'

Can we find ESG-factors or other factors in the sovereign debt market, including EM debt (most research is aimed at US corporate bond market)?

Schaen: 'Within MN we have developed a country framework incorporating financial and non-financial factors. This framework is based on ESG factors. We look at perception of corruption, climate risk and the economic competitiveness in EM countries. When we now apply these ESG factors combined with credit rating criteria, the number of countries in EMD HC comes down from 65 to 38. To compensate for the fact that the underlying ESG factors are lagging in nature, we also apply a qualitative overlay to address this shortcoming. In addition, the underlying managers are also expected to inform us pro-actively on developments in countries that are likely to affect scores in the country framework so that we can remove (or add) a country from the eligible country universe.'

Dieperink: 'Are any countries left in Latin America?'

Schaen: 'Actually still most of the benchmark countries. Bolivia is screened out due to its score in the country framework while Venezuela is on our exclusion list.'

Dacquin: 'There are not many academic papers on ESG in fixed income but it appears to be the conclusion that the G, governance, is most significant, especially in EM.'

CONCLUSION

These are challenging times for bond investors, but it's clear that it's still possible to identify investment opportunities. Participants are looking at lower risk high yield bonds and emerging markets debt. The Dutch mortgage market remains attractive although it needs to be looked at carefully. One of the things to avoid is to get too much exposure to the Dutch market.

The investment process itself is constantly being adjusted, including the attention for factor investing and the progression of quant investing. The advance of artificial intelligence is clearly visible. Fund managers rely on machine learning methods to screen through the hundreds of different data that roll into their spread sheets on a daily basis. But the experience and insight of the fund manager and his or her team remain crucial.

With all the challenges and with all the new developments it is clear that ESG-principles have become a cornerstone in fixed income investing. This is unlikely to change. In fact, within the world of fixed income the governance aspect is crucial. This is true everywhere but even more important with regards to debt of emerging countries. At present this is one of the main windows of opportunity in the eyes of the participants.