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Bevan Graham Salt Economist and Greg Fleming Head of Global Diversified Funds

Global bonds and active portfolio choices

One year ago, we released an Insight report entitled *"The Bonds are Dead, Long Live the Bonds!"*

We cautioned investors against remaining bound to global bond benchmarks, given the risk of fiscal deterioration set against a still-elevated inflation picture. Since then, broad bond indices have weakened while more specialised fixed income exposures have held up well despite higher yields.

As we noted, bonds are a broad universe and for those willing to go beyond the constraints of bond benchmarks, better opportunities have become available. We now re-visit the topic of global bonds, and why we still believe investors re-entering this challenged asset class should be highly selective.

The Indexing Cart versus the Portfolio Horse

As we noted last November, there is a problem with the conventional approach to investing in International Fixed Income securities. Firstly, many global bond funds track an international benchmark, which contains 29,500 individual securities (Bloomberg Barclays Global Aggregate- the BB Global Agg. for short.) Simplified versions of this benchmark index which are used for ETF construction may still contain 13,000 securities (e.g. the BlackRock iShares Core Global Aggregate Bond ETF.) There are a variety of sub-indices and alternative international bond benchmarks beyond the Global Aggregate, but most are based on making a reduction (or set of exclusions) from the full universe, and thus still retain a very large number of individual security holdings.

It is difficult to assess why even a "passive" fund manager would wish to construct a portfolio with such an enormous range of tiny holdings, were they not attempting to meet a market need by providing an investment vehicle able to proxy the characteristics of the Global Aggregate Index benchmark (which is not investible.) In practice, they may only do so because of regulatory requirements to track an established benchmark.

This suggests that the institutional funds management industry is guilty of putting the "benchmark-tracking cart" before the "optimal portfolio horse." Taking an exclusively benchmark-driven approach or focusing on minimising tracking error against an "over-populated" index, imposes significant risks, because global bond indices themselves suffer from a range of inherent flaws, to be discussed below.

For an active fund manager, it is consequential that each single security in a global benchmark has a very small neutral weighting. For instance, iShares BB Global Agg's ETF's largest single holding (excluding Cash) at present is a 30-year US Fanny Mae Mortgage-Backed Security (MBS) and the index weighting of that holding is just 0.7%. The second-largest holding is another 30-year Fannie Mae MBS, weighted at only 0.47% of the total fund. The third position is held by a Chinese Government Bond maturing in 2030, at 0.34% of the fund. It becomes immediately apparent that any investor wishing to take positions diverging from this vast and atomised benchmark is forced to accept substantial tracking error (TE) penalty as the price of limited and time-consuming scope for adding value to the Aggregate benchmark's return. Ironically, the very need to create a manageable investible fund tends to take the actual underlying holdings set away from the Index allocations, and several funds that claim to be

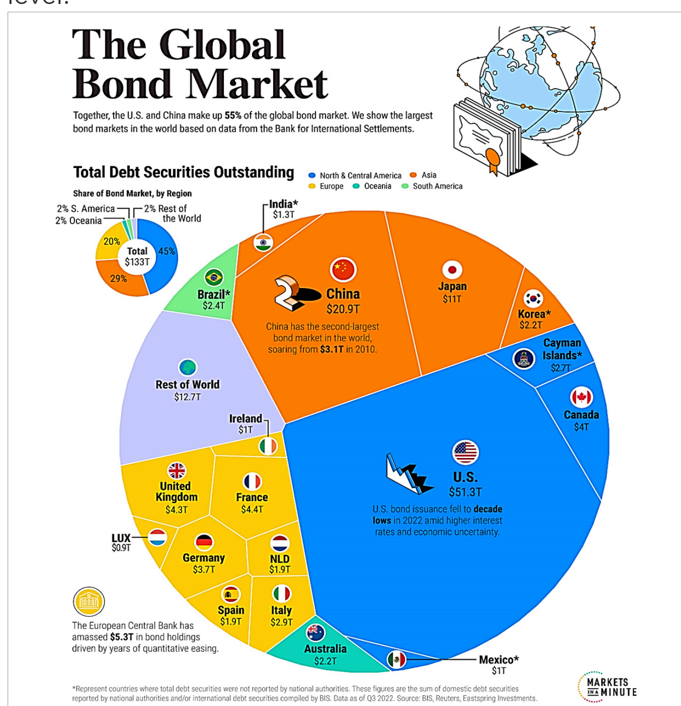
"Index products" are actually attempting to replicate the benchmark's returns, with a significantly lower number of total holdings than actually "investing to match the benchmark" would demand.

Global bonds allocations often suffer from indifferent investment vehicles

For New Zealand investors and large fund managers, this may all simply not seem worth the trouble, with the result that International Bonds funds are very often allowed to become the "portfolio zombie" – a rarely-adjusted and sluggish allocation, whose only benefit to investors is essentially as a volatility-suppressant.

Alternatively, other managers succumb to the temptation to seek out "exotic" credit exposures such as leveraged loans or private debt facilities. While valid asset types for those clients who properly understand how these securities operate, it is not necessary to compromise portfolio liquidity to deliver superior risk/return outcomes within the Fixed Income sleeve of portfolios. For single sector mandates, an unfortunate situation has arisen in New Zealand where because the bulk of the Index-tracking products are rather bland and undifferentiated, client focus moves on to the management fee level, and thus these converge toward ETF levels.

Currently, the total value of the international bond market is USD 133 trillion (NZD 225 trillion,) segmented as shown in the graphic below. Two-thirds of this debt is Sovereign, Supra-sovereign and Agency issues, and one- third is Private sector / Corporate in nature. The total investment universe offers active investors a large, diverse opportunity set, and the opportunities need to be assessed independent of a benchmark-implied holding level.



Source: Bank for International Settlements, VisualCapitalist.com

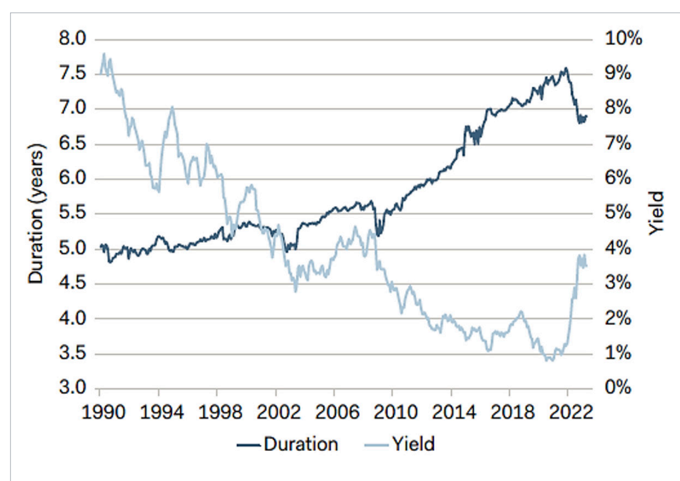
International bond benchmarks' dominant allocation to developed market government bonds, (potentially also set beside opaque Chinese State securities) comes at the expense of allocations to more interesting and attractively-priced areas of the market. Credit markets and emerging local currency markets comprise relatively small portions of the main global bond benchmarks, but they can offer significant excess and absolute return opportunities to active investors willing to research fundamentals and valuations. The application of skill in the international fixed income asset class is conventionally thought of as difficult, but that reflects the limited scope many bond asset managers have been allowed to move meaningfully away from benchmark index weightings.

Global representativeness is not an investment objective

It seems arbitrary to use the overall indebtedness of an issuer as the main weighting criterion for the size of their representation in an international bond fund.

However, when the inclusive global benchmarks are taken as the starting point for fund construction, interest rate exposures are determined by how much debt is outstanding and by the maturity of the underlying bonds. This means the largest interest rate exposures taken on by the investors are to the largest and most indebted countries. Today, these countries face common challenges: slow growth, worsening demographics, and, over the last decade, typically low yields. Evan as yields have risen sharply in 2022-3, they still may not sufficiently compensate the passive or developed-market-focused investor for longer-term fiscal and/or interest rate risks.

The long duration of the Global Benchmark still not compensated by yields



Source: Bloomberg Index Services.

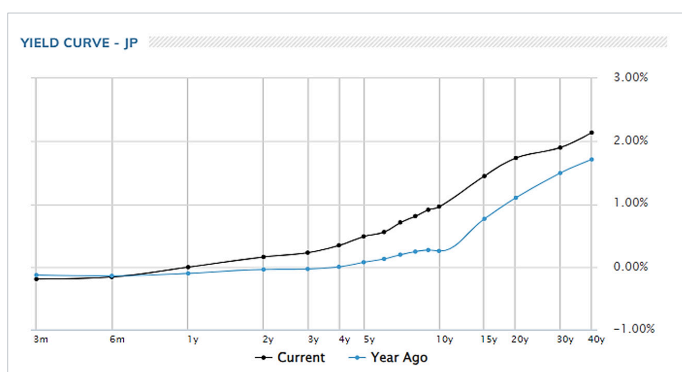
This may not be immediately apparent, because of the markedly higher yields on US and some European sovereign bonds that have received much media

attention. However, Japanese Government Bonds (JGB) represent more than 11% of the Global Aggregate Index. More than 60% of that sovereign debt has a duration of longer than five years. Given that the typical nominal yield on these JGB securities has only just moved above 0.5% p.a. anticipating an acceptable multi-year return from such securities (as the Bank of Japan begins to let yields creep upwards toward a "guide level" of 1.0% on the 10-Year maturity) is implausible.

More than 30 years' worth of returns data has established a reasonably linear relationship between a given bond's current yield, and its subsequent 5-year total return. It is only since August this year that Japanese Government Bond yields have moved into noticeably positive territory, and as at the start of November, after a perceived shift in Bank of Japan Yield Curve Control, the 30- Year JGB was yielding 1.9%.

Because post-GFC central bank financial or economic "rescue initiatives" have increasingly involved deliberately forcing yields lower for significant periods, there is no guarantee that this mechanism (Quantitative Easing) will not be used again within the maturity time horizon of many of these longer-dated government bonds. Allowing for that means that investors should not rush to view the currently prevailing, higher level of yields as necessarily implying that a given bond portfolio's expected rate of return will prove to be acceptable, especially if sovereign creditworthiness remains in a slowly-unfolding downtrend due to unsustainable taxation and spending / entitlement levels that hamstring economic policy in much of the Developed World.

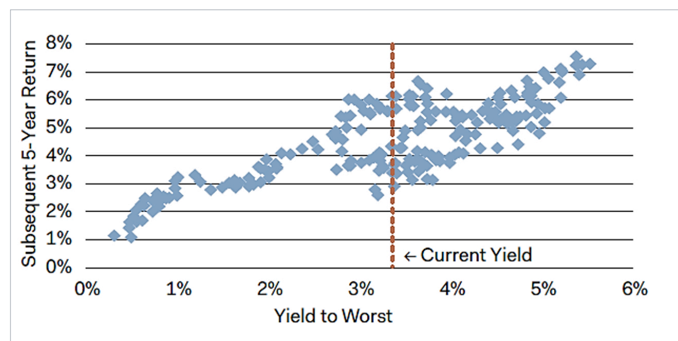
Lifting yields from repressed levels in Japan now (barely) underway



Source: MarketWatch data to 2 November, 2023

Europe is also a problem waiting to happen

If we look at the Euro Area, which comprises 18% of the Global Benchmark by weighting, while the returns outlook is better than for Japan, neither is it particularly attractive. The chart below shows 24 years' worth of data for the Euro component of the Bloomberg Global Aggregate – essentially, the full history since the common currency was created with its first 11 member states. The relationship between current yield levels and subsequent 5-year realised returns is less linear than for Japan and the USA. However, assuming less future QE from the European Central Bank, returns in the 3%-4% range for Euro sovereign bonds are entirely plausible. Many EU states have significant fiscal challenges ahead, which are not yet reflected in local bond yields. Assuming the European Central Bank will always act to force EU member states' bond yields down towards Germany's levels is optimistic.



That aligns well with the latest Capital Markets Returns Assumptions from Bank Credit Analyst (Sept. 2023):

	GLOBAL	US	EURO AREA	JAPAN	UK	AUSTRALIA	CANADA
ASSUMPTIONS							
BLOOMBERG AGGREGATE INDEX	3.5%	4.9%	2.5%	0.3%	3.0%	4.3%	4.1%

Source: BCA Research Return Assumptions 2023 Edition

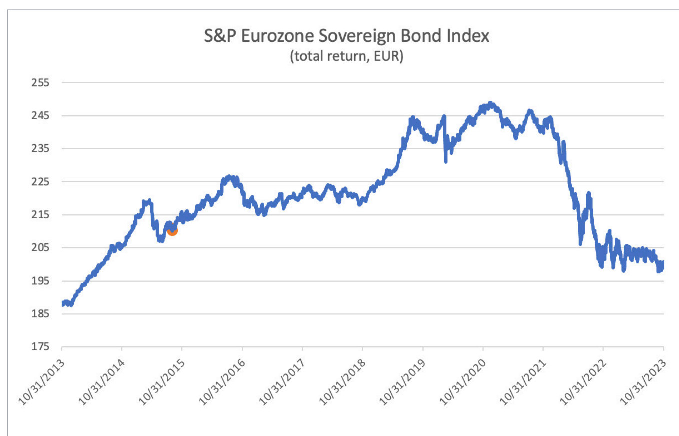
Higher yields have now made potential returns more attractive than at many periods during the last decade. The US Treasury bond is now offering a real yield above 2.4% and a nominal yield in the 4.7% region. Nevertheless, a passive or index-dominated approach essentially locks an investor into owning all global bond markets, regardless of their present yield levels. As these yield levels have been subject to deliberate repression in recent times - and may be again - the imperative to actively avoid vulnerable types of debt securities is strong, and a high degree of active management is crucial.

Bonds can bite, and need careful handling

As we noted in our Insight published last November, there is no permanent "free lunch" in markets. After a decade of efficacy, New Zealand short-term interest rates have moved close to key international peers', reflecting many central banks singing from the same hymn sheet in the fight against allowing inflation pressures to become embedded in consumer and business' expectations. As at the time of writing, the official policy interest rate in both the US and NZ is 5.5% and the 2-year bond yield in NZ is just 0.5% above the US 2 Year Treasury Note's yield (5.4%

versus 4.9%, respectively.) Regardless of interest rate differentials and country risk premia considerations, the main thing that has changed recently is that investors now know that even the "safest" bonds can suffer considerable value losses when rates rebound from low yield levels. While the year-to-date 2023 value loss from global bonds is (to 31 October) -1.7% in the Hedged Global Aggregate, this adds to the larger negative returns in 2021 and 2022, cumulating in a 3-year annualised return of -4.5% p.a. and a 5-year annualized return from the Index of -0.2% p.a.

A clear example of international index-driven risk is the total returns history of the Eurozone Sovereign Bond Index over the last 10 years. From the index' launch in August 2015 (orange dot) the total return rose 18.5% cumulatively to peak in December 2020, then fell by 19% to its November 2023 level, giving a 5-year annualised return of minus 1.8% per annum, and an anaemic 0.6% per annum total return for the full decade.



Source: Standard & Poor's Global Indices, data to 1 November, 2023

Not an insignificant asset class

For decades, it has been conventional in portfolio construction to allocate a substantial portfolio share to International Fixed Interest. Recent New Zealand survey data shows that as of September 2023, this allocation on average within a KiwiSaver Balanced Fund structure was 23% of total assets, 27% in the average Moderate Fund, and as much as 34% within the typical NZ Conservative Fund profile. These levels have moved higher over the last year, by 0.5%-1%. Normally, such an upward adjustment reflects the investment managers' improved returns expectation from the asset class on a medium-term basis.

The average Growth Fund, by contrast, held 11% in the International Fixed Interest asset class this year – around 1% more than last November's 10% average weight. These allocations to global bonds appear high, when compared to the proportion of portfolios devoted to NZ bond securities, which sit somewhere between half and three-quarters of the percentage dedicated to their international counterparts.

Key reasons for this proportionality are first, a general favouring of widening diversification where possible; an associated secondary preference for the vaster number of liquid bond securities available on global capital markets compared to the quite shallow New Zealand fixed income universe, and thirdly, the residual impact of a historical hedging premium available to New Zealand investors, whereby a fully hedged international bond portfolio could return an additional 1%-3% p.a. above the running yield return.

One less-obvious motivation for holding a broad international bond portfolio was also simply that the global bond universe is so wide and diverse, that returns tended to be mutually-diluting across the total pool of bond holdings, thus providing a mechanical reduction in overall volatility for a portfolio and for a fund so invested.

That latter rationale is no longer quite as valid, as bond market volatility has been higher recently than history would suggest was probable. Furthermore, correlations in returns between sovereign bonds and equity markets are also running at 25-year highs. Bond volatility and Equity volatility are mutually re-enforcing at present, rather than mutually mitigating, and therefore the simple blending of generic Fixed Income and Equity exposure for diversification purposes has had disappointing results. That opens an opportunity, for forward-looking Trustees and investors to envisage deploying more targeted and distinctive parts of the international bond markets.

Summary: finding green shoots in a scorched asset class, without over-diversifying

Few would dispute that generic Fixed Interest, both domestic and international, has proved to be a problematic asset class over the last two years. What is perhaps less well-understood is that in an environment of persistent inflation pressure, the undifferentiated and often still-overvalued index-linked bond universe still holds potential portfolio and asset class perils. Governments are struggling with the legacies of a long period of distortionary and interest-rate suppressive economic cycle management policies which date back to the GFC.

The proposition for investors, of blindly accompanying already highly indebted entities, as they feel their way along a fiscal tightrope in the next decade, is not compelling. Challenges are now becoming clear in Fixed Interest management, as demographics drive pension liabilities higher, taxes are politically sensitive in a slow growth world, inflation is serving as "the debtor's friend," and all bond issuers face rollover dates when their current debts will need to be re-financed at market clearing, substantially higher yield levels.

We believe that these hazards are not insurmountable, but they can only be managed through taking a truly

active approach, requiring flexible asset allocation between each segment of the large and heterogenous global bond market. The Bloomberg Global Agg contains about 3,500 credit issuers, providing significant scope for bottom-up research and issuer selection. Managers with an experienced credit research and trading team and emphasis on intensive fundamental analysis can isolate opportunities within this wide selection. Careful research of each investment mitigates default risk and can provide the conviction needed to maintain holdings through periods of market stress. Arguably, the main global bond benchmarks in common use have deteriorated and become historical artefacts, kept in use mainly through an excessively conservative view as to where risks truly lie in the decades ahead. By contrast, being unconstrained by a benchmark allows the better funds to focus on delivering consistent, uncorrelated returns from various sources of bond excess return – which also reduces market directional risk.

Salt's solution for NZD-hedged International Fixed Income Investing

The **Salt Sustainable Global Fixed Income Opportunities Fund** is deployed both as a single-sector wholesale solution and as an asset class building block in our Salt Diversified Funds. Our high confidence in the strategy, and its applicability to several client types and investment timeframes, reflects the esteem we have for the fund manager partner in Morgan Stanley Investment Management, and our selection process, which requires that the Fixed Income recommendations we deploy for our clients really "stack up" on their own merits. Sustainability is in certain key respects another facet of Quality, and we are consistent in checking those factors are bringing positive features to our full investment fund range.

Our global bond fund's philosophy allows investment decisions to discount geographic and sector limitations; we are not constrained by referencing individual holdings to a benchmark, but rather we utilise an active, flexible approach to investing in global fixed income securities, to generate an attractive rate of return over a full three-to-five-year market cycle.

Salt Sustainable Global Fixed Income Opportunities Fund: Key features

In order to offer an alternative, actively-managed global bond solution

- Active, flexible approach to investing in the full universe of global fixed income securities.
- NZ PIE structure, with returns hedged to NZ dollars.
- Portfolio management by highly experienced specialist Morgan Stanley Investment Management team.
- Sustainable investment management approach integrates Environmental, Social and Governance ("ESG") considerations into investment decision-making, with minimum thresholds of sustainability for the corporates and sovereigns in the portfolio.
- The Fund may hold a proportion of its portfolio in Sustainable Bonds, defined as labelled debt instruments where the issuer has committed to financing or attaining specific environmental and/or social objectives.
- The Bloomberg Global Aggregate Index is employed solely for measuring the Sustainability objectives of the Fund.
- Distributions are paid twice-yearly and may be redeemed as cash or re-invested as fund units.

Please consult our website for further details:
https://www.saltfunds.co.nz/fixed-income-fund

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