Global Bonds Q&A

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Q1. The US Federal Reserve is expected to continue its rate hiking and the European Central Bank (ECB) is slowing its bond-buying program. What can be done to protect investors from rising interest rates?

Some investors believe that a rise in interest rates will always be accompanied by a fall in the value of bond portfolios. However, this is not true, and we believe the case for investors to maintain exposure to fixed income remains strong.

› Bonds are a good portfolio diversifier, offering a defensive hedge against many geopolitical risks and economic slowdown.

› Rising interest rates expectations are often already priced in by the market. Thus, investors should not expect bonds to lose value unless the expected rate increase is greater than what has already been priced in by the market.

› A long-term investor that reinvests the income generated by a bond may benefit from an interest rate rise over time. This is because despite the potential initial loss in market value from a higher interest rate, the income generated is reinvested at higher interest rates over time.

› Rising interest rates will impact some fixed-income securities more than others. Therefore, we believe it's important to hold a diversified fixed income portfolio. For example, investors should diversify across different credit risk ratings, different types of issuers (e.g. securitised bonds, investment grade credit, local currency emerging markets debt, bank loans, high yield).

› An actively managed global strategy can also mitigate potential losses from rate rises by allocating to more attractive markets where yields have already risen and underweighting those where there is a greater risk of significant rate increases.

Q2. Why does Russell Investments see value in non-investment grade bonds?

Rating agencies such as S&P, Moody's and Fitch assess the credit quality of a large number of bonds and other fixed interest investments. While rating agencies provide a continuous scale of ratings, investors often split them into two distinct categories:

› Investment grade (IG, ranging from AAA to BBB- in S&P and Fitch's rating scale, and from Aaa to Baa3 in Moody's rating scale) and

› Non-investment grade (non-IG, BB+ and lower, or Ba1 and lower).

We believe that there are significant investment opportunities within the non-investment grade category for global bond investments. Bonds with non-investment grade ratings are typically riskier, however, we believe investors are often compensated for the risk that they are prepared to take. Beyond the higher expected return that typically compensates investors for the additional risk we see a variety of reasons why non-investment grade exposures have the potential to add value to global fixed interest portfolios.

These are:

› Deeper discounts in price exist after ratings downgrades due to the requirement of certain investors to rapidly exit their holdings;
› Ratings are often standardised, capped and don't necessarily reflect the investment value; and
› Ratings can artificially restrict the investment opportunity set.

We discuss each of these issues in more detail below.

Potentially deeper discounts after downgrade: Some investors have guidelines or are subject to regulations that do not allow them to invest in any instruments rated non-investment grade. Investors with more passive approaches are similarly impacted, since the Bloomberg Barclays Global Aggregate Index, does not include non-investment grade exposure.

In the case of downgrades below investment grade, these investors are often required to sell positions quickly. This creates opportunities for investors with the flexibility to hold non-investment grade positions to add value, since the selling pressure might lead to discounts that are not justified by the actual change in credit quality.

Additionally, a skilled manager might be able to identify securities before they are upgraded, for example, from BB+ to BBB-. This will usually increase the value of the security, but this approach is only possible when the manager is allowed to hold non-investment grade securities.

Ratings are standardised, not sensitive to pricing, and sometimes capped: Rating agencies often use quite standardised approaches to ratings, which might provide further opportunities for investors. As an example, no matter how solvent a company, its rating is typically capped by the rating of the country in which it is domiciled. In many emerging markets, it is possible to find companies with ratings that do not reflect the strength of their balance sheets. Rating agencies may assign a non-investment grade rating to a security that is not expected to fully repay, however, this bond could be an extremely attractive investment if the price is low enough.

Access to specific markets and strategies: To achieve the best potential outcome for investors, we have a broad opportunity set for global fixed interest, which is not artificially restricted by a small rating difference. Currently, two sectors with significant non-investment grade exposure are of particular interest to us: non-agency mortgage backed securities in the United States and emerging market debt.

Q3. Why does Russell Investments favour non-agency residential mortgage backed securities?

Securitised products involve the pooling of financial assets, such as home mortgages, commercial mortgages, credit card receivables, auto loans, student loans and other financial assets, and turning them into tradable securities. The first products to be securitised were Mortgage Backed Securities (MBS) which are bonds typically backed by a large number of home mortgages[1]. These securities provide another way to take credit risk; diversifying corporate credit risk and providing exposure to a sector where there is strong potential to add alpha.

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[1] [1] Bonds backed by non-mortgage-related financial securities are called Asset Backed Securities (ABS).

We first made a dedicated investment in non-agency MBS in June 2009; this was at the trough of the market – the aftermath of the GFC and sub-prime crisis. This timing was very opportunistic and allowed the Russell Investments Global Bond Fund NZD Hedged (the Fund) to benefit from solid, but very undervalued securities. Since 2009 our dedicated securitised manager has added more than 500 basis points (bps) per annum. Since their addition in the Fund in 2011, the added value has been more than 400bps per annum.

We have moderated our exposure recently but we still have a 10% allocation to our securitised manager, Schroders, as we continue to see this area of the credit market as the most attractive. The sector has strong fundamentals; supported by strong consumer balance sheets, rising house prices and rating upgrades. While valuation is not as attractive as in the past, it still compares favourably to other sectors. Finally, the technicals remain very supportive with very strong demand and almost no new supply.

Q4. Do you hold non-rated securities?

While the vast majority of securities we own have a credit rating from at least one of the major rating agencies, there are a number of securities that are not rated. This is typically because the company has decided not to ask for a rating, which they would have to pay for. While it is interesting to see what rating an agency may assign to a bond, we believe it is important to use managers that do their own credit research and evaluate every investment – this is the case in Russell Investments' funds. It is also worth noting that non-rated bonds can actually have very high credit worthiness; it should not be assumed that a non-rated bond is equivalent to a non-investment grade rated bond. Non-rated bonds can also offer some additional yield because of their lack of rating as some investors may not be able to buy non-rated bonds.

Q5. What is your outlook for the next year and how is the Fund positioned for this?

We still see solid global economic growth over the next year and expect central banks to continue to normalise rates and reduce the size of their balance sheets. While this may sound bearish for bonds, there is already a lot of this priced in to the markets; particularly in the US where a further 3 rate hikes are priced in over the next 18 months. As a result of this, we are overweight the US bond market which we see as fairly priced (we had been underweight at the beginning of the year). We also see value in the Australian market and select emerging markets where there are attractive levels of real yields on offer.

In contrast the European and Japanese markets still have very little priced in the way of rate hikes and offer no premium to expected inflation. As a result, we maintain large underweights in Europe and Japan, which leads us to run an underweight duration position at the overall Fund level.

On the credit side, we still see potential for some sectors to outperform governments and so remain overweight credit risk. However, our overweight is much reduced from a year ago. In terms of relative value, we still see best value in the securitised area where we are overweight non-agency mortgages and some Commercial Mortgage Backed Securities (CMBS) and Asset Backed Securities (ABS). However, we are underweight the investment grade credit sector given the relatively high leverage and because we are late in the economic cycle.

Q6. What performance expectations do you have for the Fund?

It is difficult to forecast returns over a short period but over the medium to long-term, the yield should give you a reasonable idea of what to expect. Currently the yield of the Global Bond Fund, hedged to NZD, is close to 4%. This should be seen as a starting point for the short-term and if there are any unexpected near-term shifts in rates or credit markets, this will then move us away from that.

A sudden pick-up in economic growth and/or inflation would likely hurt returns, while any moderation in growth or inflation pressures would likely be positive.

Q7. Where do you expect excess returns to come from?

Over the medium term, we look to deliver approximately 100 bps of excess returns with 35% coming from active interest rate management, 25% coming from active currency management and 40% coming from active credit management. Over shorter periods, any one factor can dominate and in the last couple of years credit has been a key driver. Looking ahead, we still see potential for excess return from our credit positioning, however, with our exposures much lower and spreads much tighter, we expect credit to take more of a backseat. We believe as more countries normalise their interest rates, we will see greater opportunity for added value in rates and currency markets.

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