

Who wants to be a fixed income investor? - Think carefully, it's not so easy

London 30 October 2013, by Steve Curry and Arjan van Bussel

Picture this, you have several billion Euros to invest in fixed income type products every year and are expected to deliver a return which outperforms the market. You are required to invest in relatively low risk debt instruments. You have to contend with the consequences of Central Banks weaning the markets off Quantitative Easing and the uncertainties as to which of the many muted regulatory regimes will be implemented and in what form. Lastly, you must keep a close eye on performance of your portfolio and the potential for mark to market losses. Welcome to the world of the fixed income investor. With this in mind, we surveyed fixed income investors to find out what investment strategies investors intend to deploy over the next eighteen months.

The survey

The survey was conducted in September 2013 and obtained responses from twenty nine respondents who represented the views of European investors which invest in fixed income instruments. The majority (72%) of respondents represented insurers, pension funds or asset managers. The remainder represented either banks or specialist funds in roughly equal proportions. A third of the respondents represented fixed income investors with more than EUR 20bln of funds under management and a quarter had between EUR 5bln and EUR 20bln under management. The survey was anonymous and the identity of the respondents was confidential.

The main messages

A number of key themes have emerged from analysis of the survey results:

- The search for yield, search for relative value, increasing risk appetite, macro economic uncertainty and regulatory change are the main factors which have caused changes in investment strategies in the last eighteen months
- Investors are not signalling a wholesale shift down the credit curve in the hunt for yield
- Investors do not expect a shift away from fixed income assets over the next eighteen months
- Investors do intend to shift their fixed income allocation away from sovereigns, large corporates and financial institutions towards medium sized corporates, private placements and structured credit

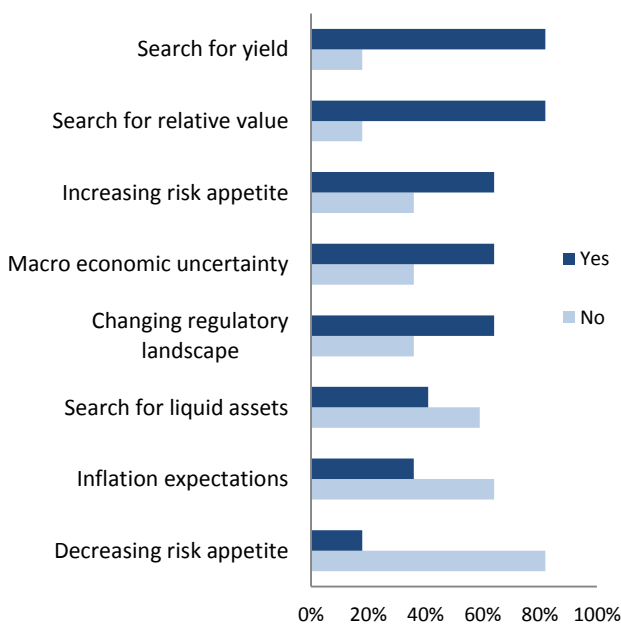
- Investors expect to place more emphasis on non-vanilla asset types in the next eighteen months
- Investors appear to be signalling appetite for less liquid instruments and flexibility in the format of assets
- Investors believe that banks will become more active in disposing of assets in the next eighteen months
- Investors do not believe that additional regulation is actually benefitting them

We look in greater detail at each of these key themes below.

Influences on investment strategies

Respondents were asked to select which factors had caused them to change investment strategy over the last eighteen months. Maybe not surprisingly, several factors have driven investment strategies (see Figure 1). The search for yield and relative value were cited by over 80% of respondents as having caused a change in strategy. Over 60% of respondents stated that increasing risk appetite, macro economic activity and a changing regulatory landscape also impacted investment strategy.

Figure 1: Have any of the following caused your company to change its investment strategy in the last 18 months?

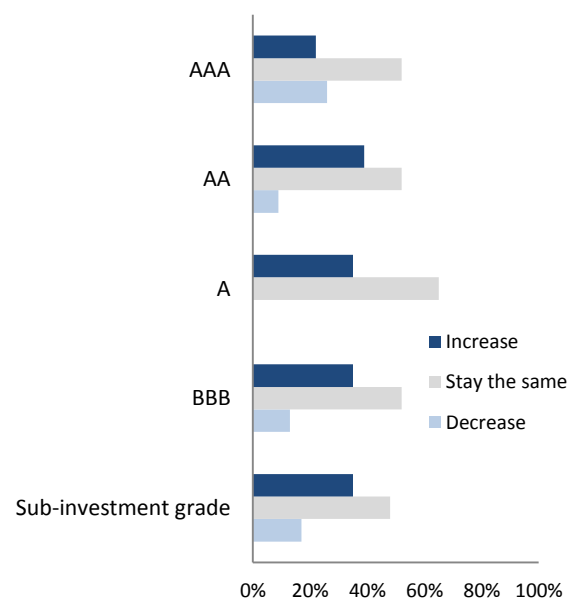


To us, there is nothing especially startling about these responses. They are broadly in line with what we would have expected to see but one factor which stands out is that over 80% of respondents indicated that seeking a lower risk appetite had not been part of their investment strategy. Furthermore, over 60% stated that their investment strategy had changed to include increased risk appetite. At first glance, this appetite for greater risk might signal a wholesale shift down the credit curve in the hunt for yield. However, when analysing an allied question, this does not appear to be happening (see section below on search for yield). Our interpretation of the results is that investors are signalling a generally higher level of confidence leading to a moderately less cautious appetite for risk.

Search for yield not causing a wholesale shift down the credit curve.....yet

Respondents were asked to indicate whether over the next eighteen months they expect to change their allocation towards AAA through sub-investment grade assets (see Figure 2). 50% of respondents said they would not be changing their risk allocation.

Figure 2: In which of these, public or implied, rating categories does your company intend to increase or decrease its exposure during the next 18 months?



Whether this is actually driven by risk appetite decisions or more practical constraints such as pre-determined investment criteria (which prevents such a shift) is not possible to determine from the responses, but we suspect the latter is a significant factor. Looking at the individual rating categories, the AAA rated assets stood out as the most susceptible to reduced appetite with more than 25% of respondents signalling that they expect to reduce their exposure in this category.

Appetite for fixed income is not diminishing

With interest rates at such low levels, we would not have been surprised to see some waning in appetite for fixed income. Maybe not a material drop in allocation towards fixed income but certainly some form of reallocation to other asset classes. The survey suggests the contrary with 44% of respondents saying they will increase their exposure to fixed income and another 11% indicating they will materially increase their fixed income investments.

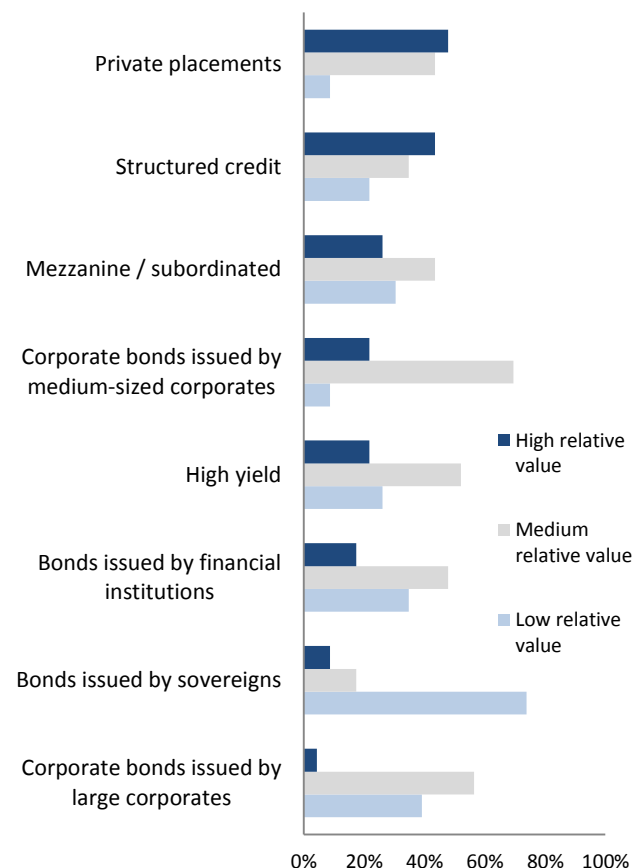
We are rather surprised by this result. Maybe it can be partially explained by investors not switching out of fixed income to attain yield but to stay with it and migrate towards less liquid fixed income instruments or down the credit curve. Another argument might simply be that insurers and pension funds attract regular monthly capital flows specifically for fixed income investments and don't have the flexibility to allocate elsewhere. Of course there is the possibility that when you ask fixed income investors where they expect to invest and whether they expect the business to grow they will simply say "fixed income" and "yes". Human nature remains a wonderful thing!

Investors do expect there to be differing levels of relative value among fixed income asset classes

From a relative value perspective, 74% of respondents felt that sovereigns offered low relative value. At the other end of the spectrum, private placements and structured credit were seen by 48% and 43% of respondents respectively to offer high relative value.

Combining the asset classes that are seen to offer both high and medium relative value shows an interesting trend. 91% of respondents said that bonds issued by medium sized corporates and private placements both offer high to medium relative value. High yield, mezzanine/subordinated debt and structured credit also scored relatively highly (see Figure 3) in terms of products which respondents believe offer high and medium relative value.

Figure 3: Which of the following asset classes do you think offers good relative value in the next 18 months?

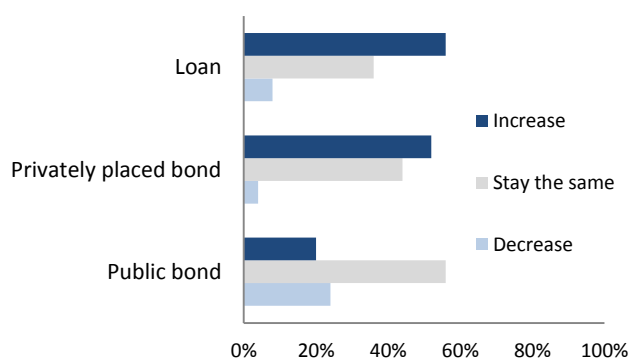


There is not such a pronounced view on which asset classes offer low relative value, other than sovereigns. Having said that, at the less attractive end of the value spectrum were bonds issued by large corporates, bonds issued by financial institutions and mezzanine/subordinated debt (see Figure 3) with between 30% and 39% of respondents saying that each of these products will not offer good relative value in the next eighteen months.

Investors appear to be signalling appetite for less liquid instruments and flexibility in the format of assets

Further evidence that investors are looking towards less vanilla assets can be seen in the type of assets respondents expect to increase and decrease in the next 18 months (See Figure 4). 52% and 56% of respondents said they expect to increase their allocation towards loans and private placements respectively. It is interesting to note that these instruments are typically less liquid than public bonds. This may indicate an easing of the emphasis that fixed income investors have placed on the need for highly liquid instruments since the onset of the financial crisis in 2007. Other factors that may be contributing to the appetite for private placements and loans is the gap left by banks exiting certain markets and the ability for investors to create more value for themselves by being involved in transactions earlier.

Figure 4: How do you expect your company's exposure to the following debt formats to change over the next 18 months?



The theme of insurance companies increasing their allocation to illiquid assets has also been cited by Moody's, the rating agency, in a research article dated July 2013. They point to three main reasons for this: Firstly, the insurers' desire to reduce concentration risk to sovereign and bank risk which are no longer seen to be risk-free. Secondly, the need to chase yield in a low interest rate environment. Thirdly, bank deleveraging presenting interesting opportunities for insurers, which are awash with liquidity, to fill the void. In the same article they also point to the fact that Europe may be showing signs of a trend (influenced by similar macro factors) which has been seen in other markets such as the US (where financial intermediation is high) and Japan (where interest rates have been low for a prolonged period) with private placements and loans taking a larger share of asset allocation. Moody's claims that 16% of US and 13% of Japanese insurers' investment portfolios are made up of private placements and loans to corporates.

Investors believe banks will become more active in disposing of assets in the next eighteen months

72% of respondents indicated that they expect banks to be more active in asset disposals over the next eighteen months. In our view there are factors which would support this; we are getting closer to Basel III implementation and many banks are already assessing their leverage ratio, profitability at banks across Europe is generally improving making it easier for them to accept discounts needed by buyers of portfolios and asset prices have recently improved thereby reducing the discount needed to attract buyers. It might also be that bank risk departments will only accept an "extend and pretend" mentality for a finite period before clear action has to be taken (especially on problem credits). On the other hand, we also see signs of a more competitive environment for assets among

banks. Bank funding costs have fallen. The impact of deleveraging has caused interest income revenues to drop and some banks are looking to bolster their absolute revenue levels. We at Bishopsfield Capital Partners take a less bullish view on bank asset disposal. We believe that whilst many bank balance sheets and profitability have improved, there will continue to be reluctance, at least among European banks, to take any drastic action. We expect them to continue favouring the “wait and see” approach. For the most part this has been the case post crisis, there was not the weight of asset disposals that were forecast and in many ways the banks may have called this right. Many of the assets that were marked down have proven to be “money good” at maturity so holding on to them was an appropriate strategy from both a credit risk and profitability perspective.

Investors do not believe that new regulation is really benefitting the investor community

The plethora of new regulation for both issuers and investors either introduced or in the process of being introduced, has weighed heavily on fixed income markets in recent years. Investors were asked three questions surrounding new regulation and it is striking that for the most part respondents are lukewarm as to the value these changes bring; 50% of respondents disagree that new regulation being implemented will benefit investors; 64% don't believe that the cost to investors of implementing new regulation will be outweighed by the benefits they receive, and 68% of respondents neither agree nor disagree that transparency from issuers has increased substantially. This in itself might be a concern for regulators given their heavy push for more transparency as a way of making risk analysis more robust.

Conclusion

The main findings from the survey are highlighted on the first page. From these findings, we believe that a number of broader conclusions can be drawn. Firstly, fixed income is a core asset class for institutional investors and looks set to remain so. Secondly, re-allocation among fixed income asset classes is underway with private placements and structured credit being the main winners and sovereigns the main loser. Thirdly, less liquid assets, possibly even in loan format, are becoming more acceptable to investors and this is a clear sign that disintermediation is firmly underway (see also Nawas and Vink, “Debt Finance and Disintermediation after Lehman Brothers”, 2013). These main findings demonstrate that fixed income investors are adjusting their investment strategies. Although this does not seem to include a material shift down the credit curve, the fact they are again showing appetite for less “vanilla” investments is a sure sign that confidence is returning. Who wants to be a fixed income investor?

If you agree with our views in this Market Insight, and even if you don't, we would be delighted to hear from you (info@bishopsfieldcapital.com).

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