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Macro and Multi-Asset

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The global economy remains in a strong recovery as fiscal stimulus and the reopening of economies spur growth. Over the past few months inflation has emerged as an important narrative, bringing with it both sector rotation and some volatility to risk assets. Our assessment of the current global economic regime as well as asset class valuations argue for a retained positioning in value, cyclical, and domestic risk assets. Looking to H2 of 2021, there seems to be an increasing chance that fading stimulus and base effects paired with more stubborn than expected inflation could begin to challenge the current rally in risk assets.

In this note we present our asset allocation views, an update of our key forecasts and macro indicators. In this month's research piece, Mohamed Ismail, Head of Fixed Income gives some insight into approaching Fixed Income investing from a systematic perspective.

Current Views

Neutral Risk Assets	Overweight Value vs Growth	Prefer South African equity over Emerging Market equity	Neutral USDZAR	Overweight SA Bonds and Property

Asset Allocation Views

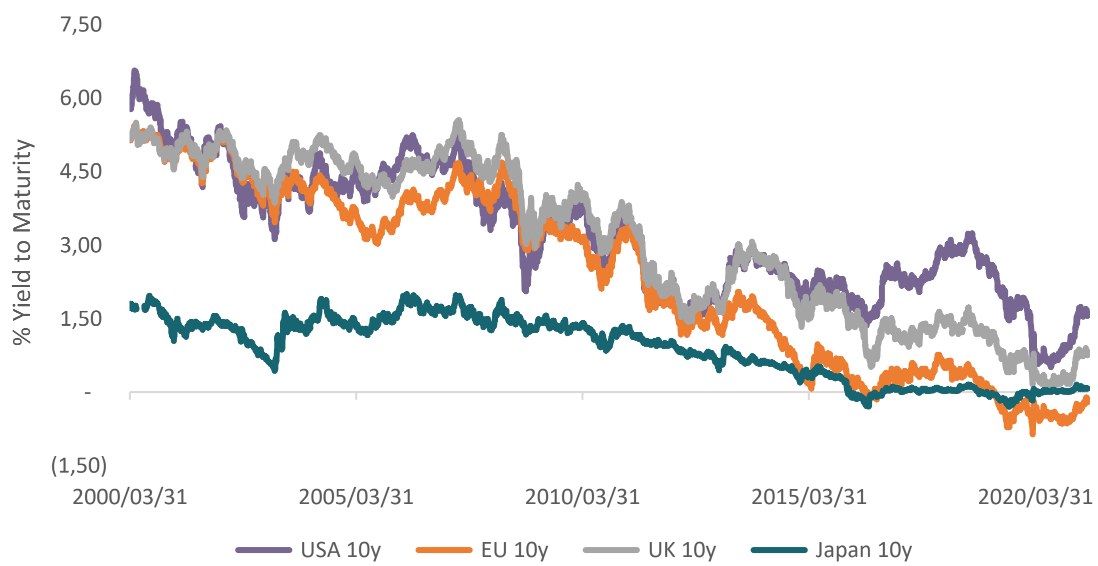
Asset Class	Valuation based 3-Year Forecast Return	Underweight	Neutral	Overweight
SA Equity			Neutral	
SA Property				Overweight
SA Fixed Bonds				Overweight
SA Inflation Linked Bonds				Overweight
Emerging Market Equity		Underweight		
Developed Market Equity		Underweight		
US Large Cap		Underweight		
US Mid Cap Value			Neutral	
UK Equity				Overweight
European Equity			Neutral	
Japan Equity				Overweight
Developed Market Bonds		Underweight		
USD Cash		Underweight		

Rethinking the approach to investing in Fixed Income

Every crisis brings about new disruptions and the opportunity to do things differently. For instance, the financial collapse of 2008 kicked off the age of fintech with blockchain, robo-advisors, and many such technology-enabled innovations in finance. The complexity grows further as calls for Environmental, Social and Governance (ESG) practices influence responsible investment to the extent that it has become a mandated activity to further sustainable development goals. With a view from above, disruptions constantly reshape an investment landscape for investors to navigate. This is good for competition and for financial markets.

Markets have displayed resiliency to changing dynamics and are progressively becoming more efficient. Bonds and fixed income are no exception and investors are less inclined to support opaque investment processes that boast informational advantages through fundamental analysis alone for outperforming benchmarks. Managers who have historically delivered beta returns under the guise of alpha will most likely find less investor demand for their products. For now, the advantage lies in data and model-driven decision making. Systematic approaches, or at least consideration toward these methods, are getting attention in the asset class, and much like the technology disruption over the past decade, a thematic shift in investment process is emerging in fixed income. Fixed income overall has had the longest period of declining real yields in uninspired growth conditions across developed and emerging markets. Given the depth of economic downturn from the pandemic, it is not inconceivable to have real yields turn negative. With negative real returns a reality, purchasing power is eroded as capital growth does not keep up with the growth in inflation. Aggressive monetary policy supported through asset purchase programmes by central banks will undoubtedly influence how long these effects will last for. Therefore, it is no surprise that low yields and muted long-term return expectations from fixed income (see Figure 1) are influencing investors to re-evaluate the value-add that the asset class provides after fees. In other words, does the current approach to fixed income create value over the long term?

Figure 1: Nominal 10 Year Bond Yields



Data Source: Bloomberg, Mergence

A Different Perspective

What do investors expect from the asset class? We would say consistency is the most important, followed by (1) income without significant loss to capital, (2) better than average real returns after fees, (3) more diversification from the asset class, and (4) a clear understanding of what are driving the investment returns. If investment managers cannot explain their returns, then they do not fully understand the risks they are taking.

Investors understand what alpha, beta and factors are in the context of equity returns. This understanding, or systematic approach, is finding favour when applied to fixed income and the investment process. A factor exposure such as momentum, value, quality, low volatility, and so forth enhances return by harvesting a risk premium associated to it. Though definitions may vary, bonds exhibit distinct factor characteristics much like these mentioned. For example, the value factor represents the difference between a bond's price in the market and the value perceived by investors, i.e. the intrinsic value. Other distinctions can be made for momentum; a factor where improving bond performance tends to prevail and carry; a factor where high yielding bonds outperform lower yielding ones. Identifying and taking an explicit exposure to a factor in a portfolio is an advantage in an inefficient market and rewards you in the form of a risk premium for as long as the factor persists. These market-factor anomalies are subtle to extinguish and keep markets less efficient from an arbitrage perspective. Ultimately, the goal is to generate uncorrelated sources of alpha, consistent with core objectives expected from any investor. In a low yield environment, this a welcomed addition to enhance performance.

To understand why a fixed income process should approach portfolio construction from a factor perspective, consider a key theme from investors – income without significant loss of capital. Exposure to duration[i] risk generally drives capital fluctuation over the investment period with the expectation of higher returns. However, there is evidence[iii] that lower duration portfolios tend to outperform higher duration ones. Investors are rewarded for taking less risk (analogous to low beta outperforming high beta). This is counterintuitive yet this (low duration) factor return for taking less risk persists. A similar phenomenon for quality in credit assets within fixed income is too observed. Quality is derived from either an issuer's (the borrower of capital) credit rating or a bond's credit spread and duration (low DTS[ii]). Exposure to better quality issuers, i.e., investment-grade, borrowers generate higher excess returns than exposure to non-investment grade borrowers.

The takeaway is that systematic methods can identify these inefficiencies in the market through quantitative analysis and support a more robust investment process in fixed income from the perspective of security selection and portfolio construction. Furthermore, the quantitative nature of implementation means that solutions can be accessed at lower cost. Table 1 below contrasts the path of fundamental and systematic approaches in an investment process.

Table 1: Overview of a Fundamental and Systematic Investment Process

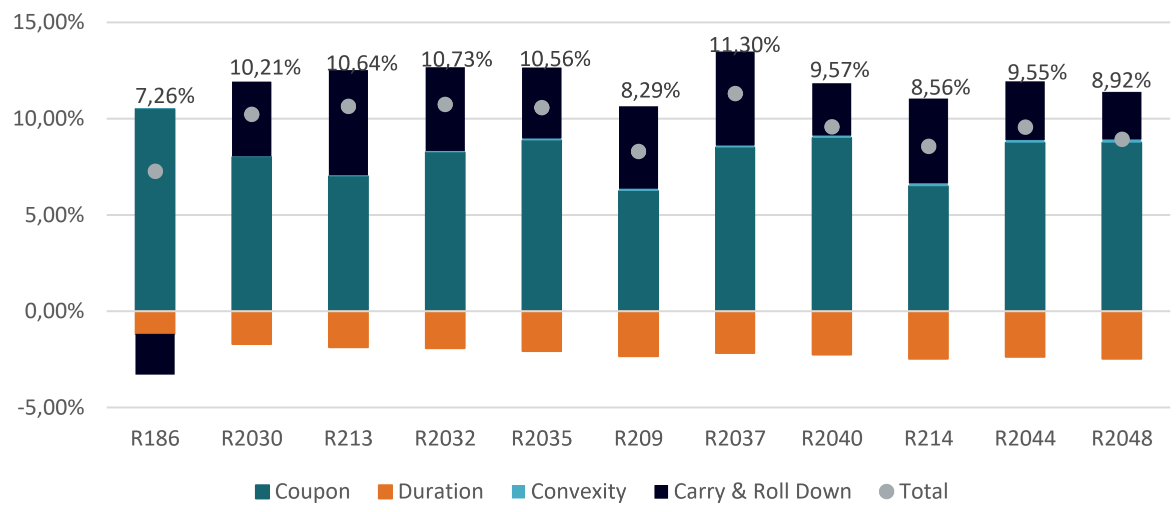
		Fundamental	Systematic
Investment Approach	Pursue alpha through	Deep fundamental and macro analysis	Rigorous scientific research
	Driver of portfolio	Portfolio manager centric	Model – driven with manager oversight
	Trades primarily by	Applying market knowledge and expertise	Analysing available data and evidence
Analysis & Construction	Investment tools used	Meetings, checklist, and due diligence	Risk models, back testing, regime analysis
	Primary form analysis	Collective expertise and team consensus	Testing of model outputs
	Positing sizing based on	Conviction	Optimisation and risk - budgeting
Strategy Edge	Core competency	Depth of holding analysis	Breath of holding analysis
	Alpha source	Short term, idiosyncratic opportunities	Time varying, repeatable insights
	Manage volatility through	Flexibility and adaptability	Defensive portfolio construction

Data Source: BlackRock; https://www.blackrock.com/institutions/en-us/literature/whitepaper/systematic-fixed-income-overview.pdf

To illustrate this point, consider the following approach to security selection in our fixed income portfolios. Figure 2 below describes the 1-year forecasted expected returns from nominal South African (SA) Government Bonds that make up the FTSE/JSE All Bond Index (ALBI). Bond selection is determined from a simulation-based analysis of the yield curve, and reconstruction of expected return through attribution of risk factors. Each simulation of the yield curve is a macro-economic scenario that occurs with a certain probability.

A suitable, liquid basket of government bonds is used to bootstrap the SA Government Bond yield curve through each simulation and is used for valuation as we step through time over the investment horizon. Cashflows paid on each bond security over the investment period are reinvested at predicted interest rates inferred off the constructed yield curve because selection must consider the trade-off between interest rate risk and reinvestment risk over the period. As the yield curve evolves probabilistically under each scenario, a distribution of expected returns is generated. Each expected return generated is further attributed in terms of carry & roll-down, duration, convexity, and income. We determine that duration risk carries a negative return premium over a 1-year investment period. Factors such as carry, and convexity are positive contributors to future expected returns.

Figure 2: 1 Year Expected Return Breakdown for Nominal SA Government Bonds



Data Source: JSE, Mergence

Give Credit Where It is Due

Indeed, most of the developments in factor investing have centred around equities. This is not surprising since the asset class benefits from high liquidity, electronic trading, low execution costs and, crucially, availability of clean data. In contrast, factor-based investing in fixed income has yet to come into its own. This could be that fixed income benchmark indices are easy to beat with naïve exposure to credit risk. Does this mean that all excess returns over benchmark indices are alpha? The short answer is no. Rather pure outperformance, or alpha, is measured after excluding returns earned from exposure to factors. Therefore, when assessing exposure to credit risk and excess returns, factors inherent to a bond such as quality, value, carry and so forth, should first be considered, and not absolutely be interpreted as idiosyncratic. From this perspective, investors can begin to separate the source of value-add from fundamental and systematic approaches in the investment process.

Our view is that value is created when both these fundamental and systematic approaches work together. Portfolio managers can access a broader synergic framework to generate and evaluate their investment ideas through. This co-operative model underpins a robust investment process that makes for sharper security selection, more efficient portfolio construction, and sounder risk management. A good investment process should be established upon the following principles – it must be (1) objective and unbiased, (2) disciplined, and (3) repeatable. Integrating a rules-based architecture into the investment process creates the transparency for how investment ideas are identified, evaluated, and implemented upon in financial portfolios, and defends unbiased decision-making as far as possible. Investors look for consistency and maintaining discipline in the process is necessary to find optimal and consistent returns in any economic environment.

Footnotes

[i] Duration is a risk metric used to describe the price sensitivity of a bond (or portfolio of bonds) to changing interest rates. It measures the extent of a capital gain or loss over a short period of time given the change in interest rates.

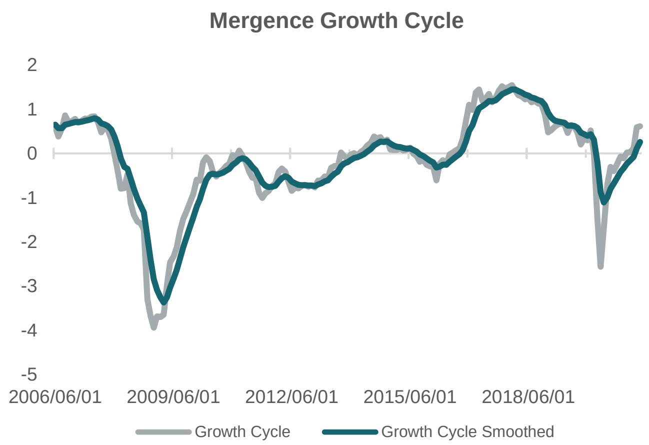
[ii] DTS is referred to as credit duration times spread.

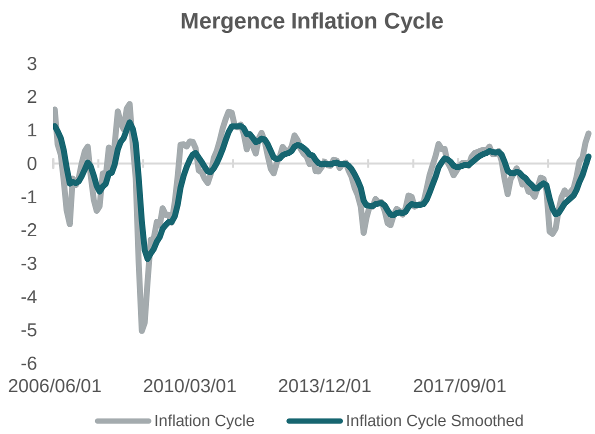
[iii] https://www.robeco.com/en/insights/2020/02/harvesting-factor-premiums-across-global-bond-markets.html

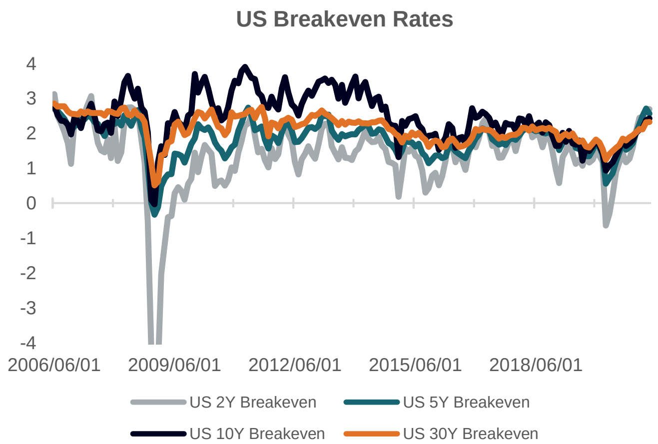
Key Indicator Forecasts

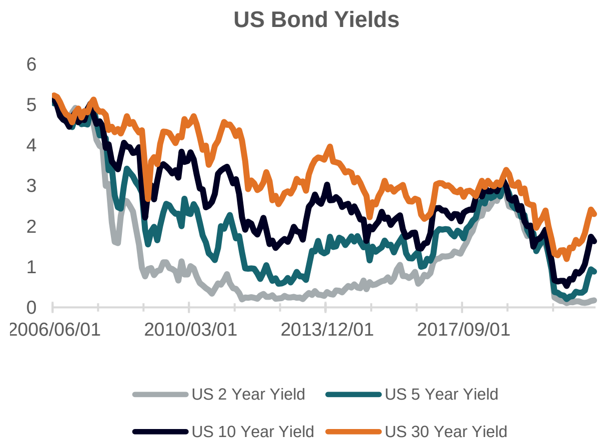
Indicator	Current	1 Year	3 Year	5 Year
USDZAR	13.8	14.7	15.6	16.7
SA 10 Year Yield	8.93%	9.25%	9.20%	9.0%
SA Inflation		4.10%	4.4%	5.0%
US Inflation		2.3%	2.2%	2.0%
US 10 Year Yield		1.83%	2.37%	2.5%
Fed Funds Rate	0.0%	0.25%	0.5%	2.25%
SA Repo Rate	3.5%	3.75%	5%	6%

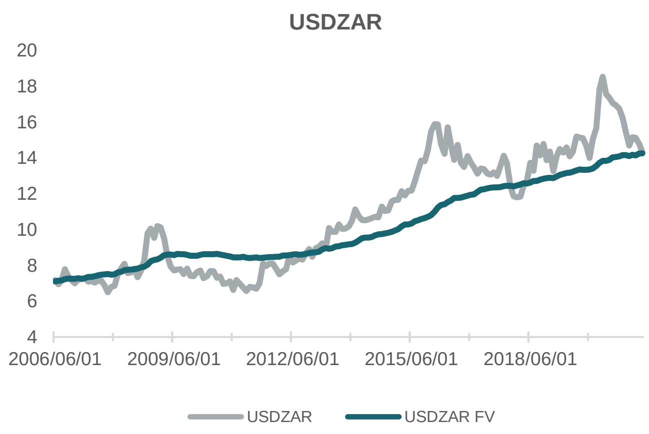
Key Charts










USDZAR
20
18
16
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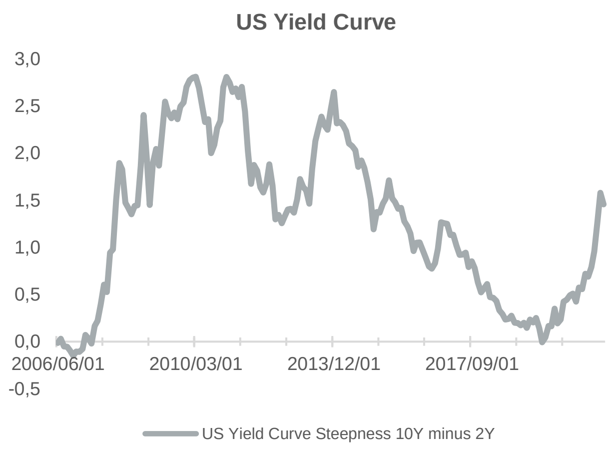
2006/06/01
2009/06/01
2012/06/01
2015/06/01
2018/06/01
USDZAR
USDZAR FV


US Yield Curve
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2,5
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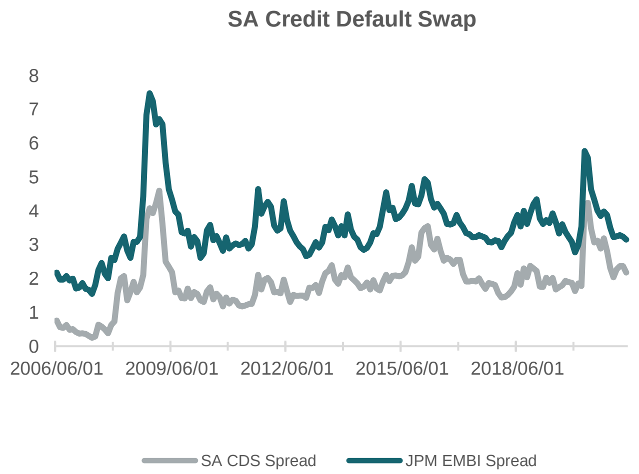
2013/12/01
2017/09/01
US Yield Curve Steepness 10Y minus 2Y


SA Credit Default Swap
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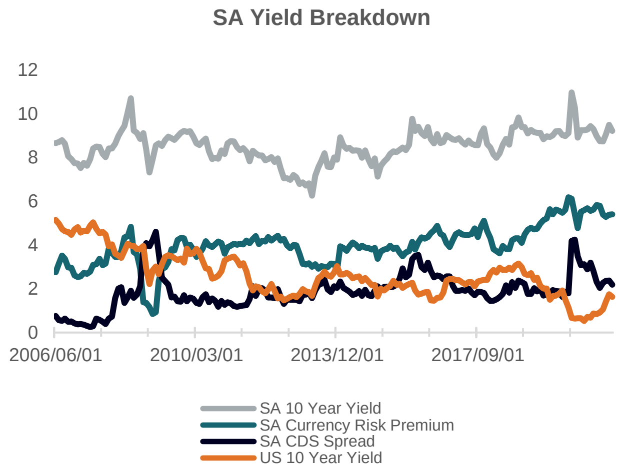
2015/06/01
2018/06/01
SA CDS Spread
JPM EMBI Spread


SA Yield Breakdown
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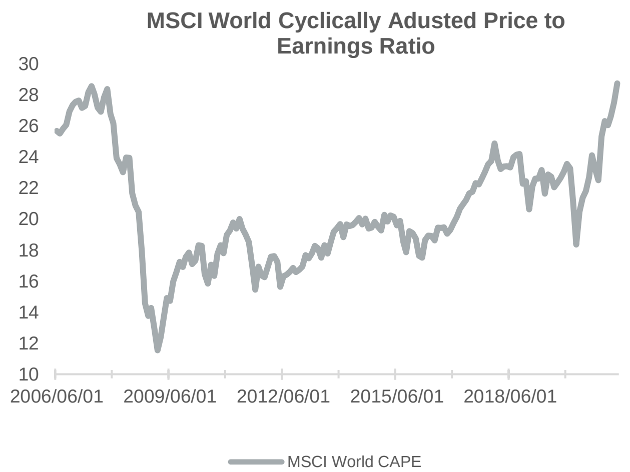
2017/09/01
SA 10 Year Yield
SA Currency Risk Premium
SA CDS Spread
US 10 Year Yield


MSCI World Cyclically Adusted Price to Earnings Ratio
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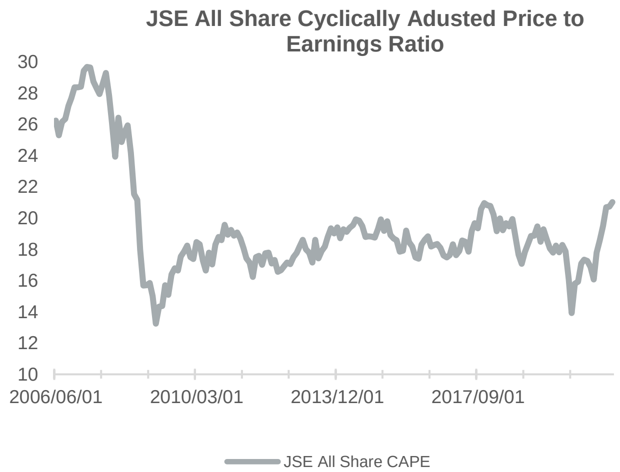
2015/06/01
2018/06/01
MSCI World CAPE


JSE All Share Cyclically Adusted Price to Earnings Ratio
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2006/06/01
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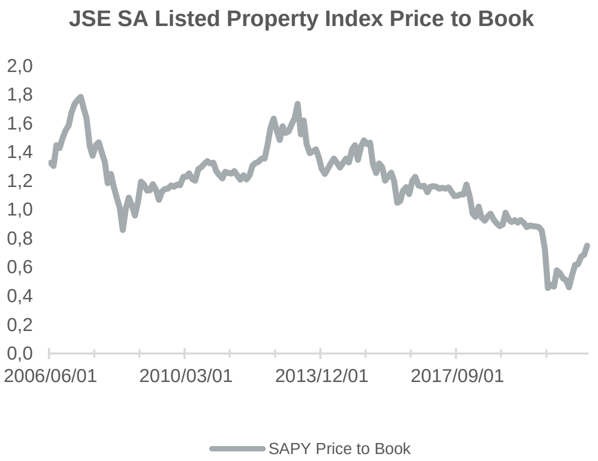
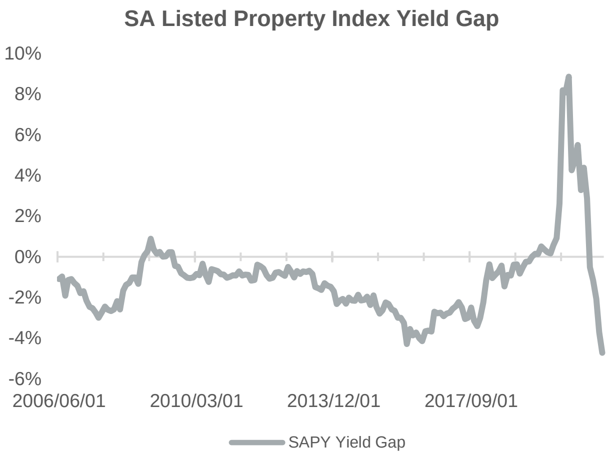
2017/09/01
JSE All Share CAPE





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