Investment INSIGHTS

Investing during a pandemic: Three results a global fixed income strategy can deliver

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Halfway through 2020, the world remains in the grip of a global pandemic, an economic shock of unprecedented scope and magnitude. Investors' initial response was a flight to safety. Risky assets — whose valuations depend upon uncertain future cash flows — initially suffered severely. Equities, corporate bonds and real estate all sold off sharply only to stage a dramatic rebound.

"We are now living in a world of ineffable and unquantifiable uncertainty, one which is likely to be volatile," said David Wakefield, CIO, global fixed income & currency at Mondrian Investment Partners.

In this environment, a high quality, global developed market fixed income strategy, managed appropriately, can offer U.S. dollar-based investors three quintessential results that can be more difficult to reach today than any time in recent history: return enhancement, downside protection and diversification beyond their home market.

Global fixed income is an asset class in which prudent active management can provide ample scope for additional return above a simple passive approach without taking undue risk. In order to stretch returns, many asset managers quickly establish a structural overweight to higher yielding and sometimes relatively illiquid corporate or emerging market issuers.

"While there is certainly a place for investment in such assets, they can often negate the traditional role of fixed income, which is to provide a cushion against the downside of risky assets," Wakefield said. "High quality fixed income should be in place when an investor needs it most."

Of course, for U.S. dollar-based investors, an allocation to global fixed income brings with it currency exposure. But currency risk can either be mitigated via hedging or productively managed to provide an additional source of potential return.

STRATEGIC AND TACTICAL

The strategic case for global fixed income rests on diversification. Wakefield said that because the global bond asset class encompasses a wide range of countries, it can provide opportunities for diversification versus domestic bond portfolios. The characteristics of global bonds also provide excellent diversification against riskier asset classes such as equities and high yield credit, he said.

Historically, global bonds have outperformed during short-term periods of market turmoil. As a result, they can help stabilize portfolios during times of crises like today. By their very nature, market crises are unpredictable and will always occur. Global bonds, therefore, should act like an insurance policy — helping to cushion against losses in riskier asset classes.

What's more, high-quality global bonds tend to be countercyclical and as such offer excellent long-term diversification benefits to domestic portfolios. Although global bonds underperformed in the 1995-1999 and 2010-2014 periods when equities did well, they outperformed in 1990-1994 and 2000-2004 when equities underperformed. (See table.) Global bonds can therefore reduce the volatility of domestic portfolios. Over the longer term, global bonds have outperformed U.S. bonds and can therefore enhance a portfolio's risk/return characteristics.

Excellent Long-Term Diversification Benefits

	1985 - 1989	1990 - 1994	1995 - 1999	2000 - 2004	2005 - 2009	2010 - 2014	2015- 2019	1985- 2019
US Equity	18.5	8.1	29.0	-3.6	0.0	14.8	11.0	10.1
EAFE Equity	36.1	1.5	12.8	-1.1	3.5	5.3	5.7	8.2
US Bonds	11.8	7.5	7.4	7.4	4.9	3.9	2.3	6.4
High Yield	11.9	12.1	9.3	7.0	6.5	9.0	6.1	8.7
Global Bonds	15.1	9.7	6.4	8.8	4.5	1.7	2.0	6.8

Annualized unhedged US dollar returns (%)

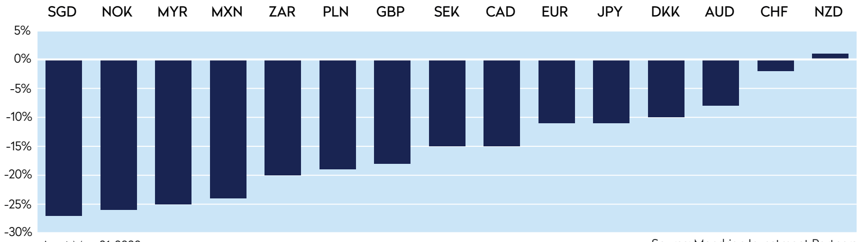
Source: Bloomberg Barclays, FTSE, MSCI

If the strategic case for high quality global fixed income is clear, what of the tactical case? What do current valuations suggest about global fixed income and why should institutional investors be particularly interested in global fixed income right now? After all, bond yields are near all-time lows and indeed even negative in some European countries.

"In such an environment, inflationary pressures are likely to remain weak and bouts of risk aversion frequent — these alone are good reasons to hold high quality bonds," Wakefield said.

However, many investors remain biased to their home bond markets. Although U.S. bonds might be yielding more than their ex-U.S. counterparts, the U.S. dollar is overvalued against virtually all other global currencies, which can provide a significant source of potential return for U.S. dollar-based investors. (See chart.)

PPP Currency Valuation vs USD



As at May 31, 2020

Source: Mondrian Investment Partners

Rather than be biased toward any particular market that can be subject to its own idiosyncratic shocks, Wakefield said Mondrian believes it makes more sense to hold a diversified basket of high-yielding, high-quality instruments.

INFLATION AND SOVEREIGN CREDIT RISK FACTORS

"Mondrian's approach to global fixed income is to provide investors with a diversified portfolio of global bonds that overweights markets that possess the highest risk-adjusted prospective real yields," Wakefield said. "In other words, markets that have a nominal yield that best compensates investors for both inflation and sovereign credit risk. To that end, we forecast inflation across all the markets we consider and conduct thorough sovereign risk assessments."

Mondrian's proprietary sovereign credit risk assessment incorporates a range of factors that includes environmental, social and governance, he said. Although the firm considers similar factors to external rating agencies, the nature of its approach allows its portfolio managers to be nimble and identify a change in sovereign credit risk as it occurs. This approach has enabled the firm to add value, particularly in lower rated markets such as the Eurozone periphery in recent years, Wakefield said.

Currency is another key component of the process, and Mondrian analyzes foreign exchange valuations using its own real exchange rate approach. The firm's portfolio managers can modify currency exposures accordingly by hedging exposure to currencies they deem expensive and increasing exposure to those they deem cheap.

In addition, Mondrian can overweight corporate credit and emerging markets debt to pick up additional yield, but portfolio managers only tap into these markets opportunistically when being adequately compensated to do so. The firm's disciplined approach to credit avoids running a structural overweight. Rather, it is guided by its quantitative measure of value as to when to allocate. As a result of this approach, the firm had no credit on its government benchmarked funds when volatility spiked earlier this year and moved to an overweight position only at the end of March.

"Over the 30 years that Mondrian has used this approach to global fixed income, we have found that it can provide investors with consistent long-term outperformance that does not sacrifice portfolio protection characteristics that a high-quality fixed income mandate should provide," Wakefield said. "In other words, a global fixed income allocation can provide return enhancement, downside protection and diversification, three goals that, thanks to the coronavirus pandemic, are in sharper focus today than any time since the global financial crisis." ■

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