Investment Insight

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Bonds – down, but by no means out

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Many investors were surprised to see their portfolios lose money through the tail end of 2016, particularly in the aftermath of the U.S. presidential election when many equity markets have been hitting new record highs. This is especially true for "lower risk" portfolios that have high allocations to bonds and from which investors invariably seek capital protection.

As we enter 2017, some investors will be looking at their investment statements and will notice that their portfolios have fallen in value over the last quarter. The reason for this has been the dramatic sell off in bonds, triggered by a market now looking to higher bond yields on the back of increased expectations for both growth and inflation. In Australia, this has seen the 10-year bond yield rise from 1.95% at the start of the quarter to 2.77% at the end of the quarter. Consequently, the value of these bonds has fallen, as bond yields and prices move in opposite directions, all things equal.

In this scenario, a diversified multi-asset portfolio that is traditionally structured with 30% in equities and 70% in fixed income will naturally find it hard when bond prices fall, and this was certainly the case last quarter. Even for those that were more cautiously positioned and holding more cash (like the Morningstar Managed Accounts), performance still suffered due to the broader market coming under fierce selling pressure.

This was by no means a typical sell-off for bonds. To put this into a historical context, the four months from the end of August to year end was arguably one of the worst periods ever in the nearly 30-year recorded history. Bond investors had no place to hide, with Australian bonds falling 3.1% from peak to trough and currency-hedged global bonds down 2.5%.

Unsurprisingly, the allocation to bonds was a significant drag on the performance for conservatively positioned multi-asset portfolios. In addition, weakness was also seen in other interest rate sensitive investments, particularly Australian listed property, even though we continue to hold much lower allocations to these assets than normal. It was not all bad news though with these falls being partially offset by positive contributions from international shares, while the higher levels of cash provided a buffer against the fallout from bond markets.

These sudden shifts are inevitable from time to time, although one can never be sure what the actual catalyst will be. The adjustments are also often sharp and quick as market participants try to adjust to the new environment, which in this case sees the market worried that President Trump's new policies will result in the need for much higher interest rates, even after the adjustment seen late last year…(continued)

Therefore, trying to time the market is not something we try to do. Instead, we look to take a longer-term approach and focus on those segments of the market offering the best reward for risk at any point in time. We do this by applying our fundamentally driven valuation process to identify where the best long term value lies, and not trying to pick the winners over the next 3, 6 or even 12 months.

Looking at recent bond market developments through the lens of our process provides a somewhat different view to that taken by the other market participants over the course of 2016. While the broader market was piling into bonds through the first half of the year, we were watching our valuation-implied return expectations for Australian and global bonds decline, which resulted in us steadily reducing our bond holdings. These return expectations bottomed-out around September, however, as yields started to push higher on the worry that central bank support would start to be wound back. The election of Trump saw the move higher in bond yields accelerate, which has generally seen our expected future returns from both Australian and Global bonds improve, taking them back into positive territory.

In terms of what this has meant for positioning for the portfolios, having previously had lower than normal bond holdings in the first half of 2016 based on our view that they were generally expensive, we are now gradually looking to increase our exposure to bonds given they now represent much better value. We have also looked to steadily increase our inflation linked bonds position to protect against the risk of higher inflation. These positions have and will be largely funded by cash, but even post these moves, cash levels will remain elevated as despite recent moves, bond yields are still very low in a historical sense.

Increasing the overall bond position of the portfolios at these higher bond yield levels should also help the portfolios become more resilient. Some of the key objectives of having bonds in a diversified multi-asset portfolio is to offer diversification and capital protection. At lower yield levels, these qualities can be brought into question, but having seen yields move higher, we are confident that were one, or even a few of a long list of potential risks (European elections, BREXIT, trade wars etc.) to materialise, the recently increased bond holdings should offer good protection for the portfolio(s).

If the events of 2016 have taught us anything, it is to expect the unexpected, and following the broader market is not always the best strategy. Whilst we may see losses in the short-term, we continue to believe employing a robust and repeatable investment process that acknowledges and adapts to structural shifts in an intelligent and pragmatic manner remains the key to identifying those opportunities providing the best reward for risk. Further, it gives us confidence that our portfolios, despite their Q4 2016 performance, are well positioned to meet their stated investment objectives over the long term. M

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