

# Time to get active in Global Fixed Income investments

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## David Knee

Co-Deputy Chief Investment Officer, Fixed Income (M&G UK)

Global fixed income assets are now able to play a more significant role in South African investors' portfolios. And with fixed-interest bond yields high around the world, David explains why M&G Investments believe these assets offer an excellent addition to these portfolios, and how M&G's large and experienced fixed income team is able to enhance their return potential even further through active management backed by deep understanding of risks, regulations and issuers. This article is based on a panel discussion he and other senior M&G fixed income experts participated in at the recent M&G Investments Global Investor Day in London.

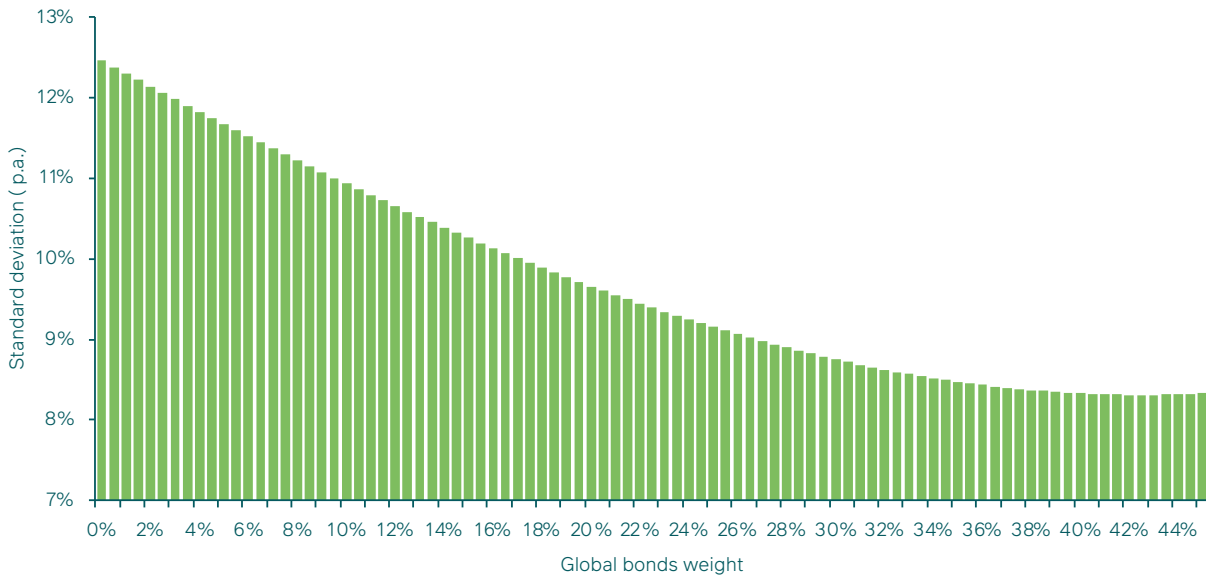
South African investors have necessarily limited their exposure to global fixed-interest bonds over the past several years for two primary reasons: unattractively low yields and the 25% offshore asset restriction for retirement portfolios under Regulation 28. Under the 25% limit, it made sense to allocate the global allowance primarily to global equities and cash, given the upside to potential returns of the former and high risk-reduction and liquidity benefits of the latter. However, the February 2022 increase in the offshore limit to 45% effectively opened up a new world of opportunities to South African investors, and at M&G Investments we believe global fixed-interest sovereign bonds, in particular, can offer considerable benefits to a local portfolio generally and currently present an excellent buying opportunity.

### Why global fixed income?

South African investors have several good reasons to consider adding global bonds to their portfolios, the most important being their effectiveness in lowering the risk of local balanced portfolios.

## Graph 1

### Combining a South Africa 60 - 40 portfolio with global bonds



Source: M&G, ICE BofA indices (Ref .ER00, UN00, COA0). Data as at 30th April 2024

Graph 1 shows how a standard balanced portfolio with 60% SA equity and 40% SA bonds experiences a significant reduction in risk (as measured by its standard deviation) as increasing amounts of global bonds are added: with no global bond exposure, the portfolio's risk is around 12.5% p.a., which falls meaningfully to around 10% once an 18% weighting is reached, for example. This is due to both the diversification of geography, currencies and economies, and the inherent lower volatility of bonds as their weight expands in the total portfolio.

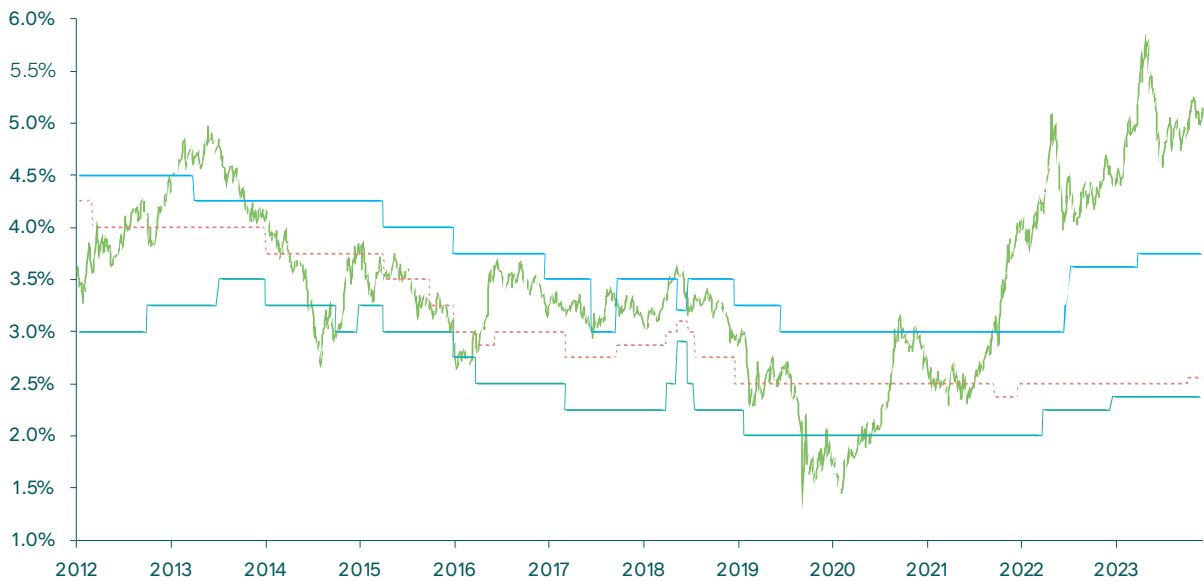
Another key reason to buy global bonds is their currently high yields on an absolute basis compared to history. Today's global bond yields reflect the steep hikes in base lending rates implemented by global central banks between 2021 and mid-2023, and subsequently kept steady. Although yields have fallen from their highs, they are still at attractive levels. For example, the 10-year US Treasury yield has been trading around its 20-year average of 4.5%, after having stayed below this level since 2008. At the same time, expectations are for central banks to keep interest rates higher for longer in the face of persistent (but lower) services inflation in many countries.

In fact, 10-year interest rate forecasts as priced into the US forward rate agreement (FRA) market are much higher than those of the US Federal Reserve (Fed).

## Graph 2

### Combining a South Africa 60 - 40 portfolio with global bonds

...or is it just supply fears making US Treasuries look so cheap?



Source: Bloomberg, Federal Reserve, 31 May 2024. Information is subject to change and is not a guarantee of future results.

Graph 2 shows the extreme differential – the largest since 2012 in a market that typically follows the Fed's indicated interest rate range fairly closely. This could be due to concerns over the increasing US fiscal deficit and need for higher funding in the bond market, although the US has fewer reasons to worry than other countries due to the US dollar being the global reserve currency. In the UK, however, the government needs to raise almost £1trn in debt over the next five years, which is equivalent to almost 40% of its outstanding debt stock. These pressures could also contribute to keeping global interest rates higher for longer should nervous buyers demand more compensation for owning sovereign debt.

In M&G's view, it is not an ideal environment in which to start cutting interest rates, especially given the elevated prices of global risk assets. Not only are stock markets hitting all-time highs, but in the corporate credit market, keen investor demand for both investment-grade and high-yield bonds, driven by higher interest rates, has pushed spreads versus government bonds to unattractively low levels, as illustrated in Graph 3. However, global government bonds, especially those in developed markets, do fulfill many of our investment criteria.

### Graph 3

#### Global Investment Grade Credit Spreads



Source: ICE BofA indices COA0, UC00, ER00, 30 April 2024

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#### How do we approach investing?

We essentially have eight elements underpinning our thinking about investing that apply across all types of assets, including global bonds.

- Because the future is unknown, we avoid strategies where success depends on forecasts such as interest rates, inflation and growth. Instead, we employ our long-standing value-driven approach to identify assets that could perform strongly regardless of the economic cycle.
- We eliminate as many unwanted and unrewarded risks as possible, by ensuring all interest rate and currency risks in a portfolio are neutralised.
- We have an active approach, adding value by taking advantage of credit market inefficiencies caused by investor overreaction, artificial barriers and silos that result in mispricing. Adding to this, we selectively add or reduce portfolio risk as conditions change through individual stock selection.
- We conduct extensive fundamental research in order to recognize pricing anomalies, remove barriers to investment and widen the opportunity set across different companies, currencies and geographies wherever possible.
- We avoid low-probability strategies.
- In our view, an investment should always have a value rationale, otherwise it is simply speculative.
- We always ask whether we are being compensated for the risk. We believe there are no “bad” bonds, just incorrectly priced ones.
- Our team has the patience to wait to invest at the “right” price. We believe this is the most underrated and best-rewarded investment strategy that exists.

## Creating outperformance for our clients

It is well-known that it is difficult to achieve market-beating returns from global fixed income assets given the market's huge size and high efficiency. However, the successful application of this philosophy and process over the past two decades, as well as the excellence and experience vested in our people, have delivered a 20-year history of outperformance for our M&G clients across many types of fixed income portfolios. We have built up a global team of nearly 50 credit analysts to cover more issuers and dig deeper to truly understand the companies' strengths and weaknesses and how they impact credit risks. The analysts and portfolio managers can then be prepared for unexpected events that cause pricing anomalies and take advantage of them by already knowing which companies are more at risk, and which are more resilient to that type of event.

For example, when Credit Suisse failed in March 2023, the team was ready. One of our banking analysts had recently conducted particularly in-depth research, having closely followed the bank's problems since the first run on its deposits in October 2022. Combined with our understanding of regulations and the banking system, M&G was able to value Credit Suisse's various levels of debt in its capital structure, from senior to subordinated (including its AT1 bonds), under different future scenarios of government rescue, buyout and failure, to the benefit of our clients.

Meanwhile, the Credit Suisse collapse triggered indiscriminate selling across most global bank bonds (and all AT1 bonds), creating a significant buying opportunity for the M&G team within a short window of time. Because we knew which banks were the strongest, and risk was lowered by the early European Central Bank and Bank of England statements honouring the rules for investor repayment, we felt comfortable purchasing HSBC AT1 bonds. HSBC had one of the very lowest risks of a deposit run, and we were able to purchase the bonds at a spread 800bps higher than they had offered before the market sell-off.

This is only one example of the numerous ways in which we are adding value to client portfolios, through both avoiding losses and adding above-market returns. South African investors would be wise to consider the inclusion of an actively managed, carefully analysed and diversified mix of global fixed income assets such as those in our M&G portfolios to help improve the performance potential of their local portfolios on both a risk and return basis. Investors can gain this exposure through the **M&G Global Balanced Fund**, the **M&G Global Inflation Plus Fund** and the **M&G Global Bond Fund**, all of which have been specially tailored to meet local investors' unique needs.

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