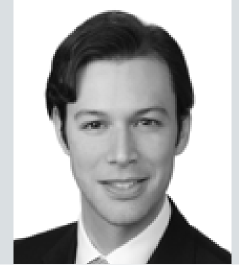
UNLIKE ANY OTHER

Fixed income investors endured a rollercoaster 2022, but fund managers see a silver lining as signs of recovery are becoming more apparent. **Andrew McKean** reports.



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Adam Grotzinger
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Fixed income markets had a tumultuous 2022. Despite having a reputation for staid and steady returns, fixed income markets' underperformance left investors reeling. Worse yet, investors were dealt a double blow as stock market indices also ended the year in the red.

At the heart of this implosion was a dramatic shift in interest rates, as central banks across the globe sought to slay the inflation dragon. The sharp recalibration of rates sent shockwaves through markets, causing bond prices to plummet.

Traditional strategies floundered as the US Federal Reserve and Reserve Bank of Australia (RBA) were forced to raise the benchmark interest rate several times, returning to levels not seen since the Global Financial Crisis. This left even the once-steady hand of fixed income strategies struggling to adapt, as both active duration risk and credit risk failed to provide effective protection against dramatic volatility.

Though some sub-sectors proved to be somewhat of a silver lining. Floating rate instruments, which have less duration risk and adjust with changes in interest rates, proved to be relatively better off. They provided a measure of protection against the downward price action that resulted from the rising interest rates, giving investors a lifeline amid the volatility.

Nonetheless, as the dust settles on a year to forget for fixed income investors, signs of recovery are becoming more apparent. The focus is shifting from rate hikes to potential cuts in the US, and the market is adjusting to the challenges of the past year, with pricing reflective of that expectation.

Fixed income autopsy

Reflecting on 2022, Neuberger Berman senior fixed income portfolio manager Adam Grotzinger[01] says fixed income markets faced an extraordinary year, as interest rates recalibrated higher, and central banks globally struggled to catch up to stubborn inflationary dynamics.

"Inflationary dynamics weren't transitory in nature and were stickier than anticipated. The crux of the downside to fixed income returns in 2022 was interest rates going higher and bond prices going lower because of that," Grotzinger says.

"If you ran a simple barbell strategy of owning long duration treasuries as the safe haven part of a portfolio, and credit as a yield enhancing portfolio component, both of those would've hurt you in 2022. That was tough for fixed income investors to grapple with, there was no place in the fixed income world that protected capital last year."

Despite being considered one of the worst years ever for fixed income portfolio managers, there's some good news. Although last year was painful, there's been a resurgence of value in the market.

"The phenomenon of negative interest rates and negative yielding bond markets is pretty much gone; we're in a world of positive real policy rates and positive real interest rates. The market has already priced in much of the tightening that may come if the Fed or RBA decides to raise rates a few more times," Grotzinger says.

"Last year's catch-up was central banks trying to keep up with persistent inflation, not transitory. As a result, current market pricing and expectations are already factoring in the possibility of future rate hikes."

While rates may continue to rise slightly, they are unlikely to reach the same levels witnessed last year. Most central banks have already made the necessary rate hikes, resulting in a more stable policy era with loss volatility, as inflation begins to wane. In fact, the debate is now whether they'll need to cut because policy is too restrictive for the future realities of growth and inflation.

However, Neuberger Berman believes that the Fed and other central banks are unlikely to cut rates as they attempt to combat sticky inflation, particularly in wages and labour. The fund manager's view is supported by recent developments, like the RBA hinting at future interest rate increases during its February monetary policy meeting.

RBA governor Philip Lowe affirmed the board's unwavering commitment to restoring inflation to the 2-3% target range.

"The board expects that further increases in interest rates will be needed over the months ahead to ensure that inflation returns to target and that this period of high inflation is only temporary. The board remains resolute in its determination to return inflation to target and will do what is necessary to achieve that," he said.

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> Adam Grotzinger

The Federal Reserve has also given little indication that it's nearing the end of this hiking cycle, despite US inflation figures tempering.

"The committee [Federal Open Market Committee] anticipates that ongoing increases in the target range will be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2% over time," a recent Federal Reserve statement said.

Schroders deputy head of fixed income Kellie Wood[02] says that 2022 was a challenging year for most asset classes, with the exception of cash, commodities and the US dollar, all delivering negative returns. Fixed income was also not immune, bond managers faced one of their toughest years in decades due to the dominating force of inflation, which produced the worst bond market returns since the 1980s.

According to Wood, 2022 was a year even she didn't want to invest in her own asset class.

"The investment landscape shifted away from a decade of low growth and low inflation to an environment of much higher macro volatility around growth and inflation outcomes," Wood says.

Subsequently, defensive fixed income failed to preserve capital and diversify equity risk.

According to Schroders, November year-to-date returns showed that global bonds were down 11.1%, Australian bonds were down 7.8%, and credit assets, including global investment-grade corporate bonds were down 14.8%. Riskier credit asset classes like global high yield fell 11.4%, while emerging markets performed the worst, down 18.5%.

Reflecting on the performance of fixed income investments, Wood says it's crucial to consider both the price or capital appreciation, and the coupon return. The steady stream of income from the coupon can provide a cushion for portfolios, particularly when yields are on the rise. But, at the beginning of 2022, yields were so low that they didn't offer much protection against capital losses when they rose sharply.

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"There was very little yield to protect from capital losses as we moved into an environment of aggressively rising yields. For instance, the Australian two-year bond, which started the year at a yield of 0.6%, has risen more than 250 basis points to just over 3%; this share increase in yields has driven the worst bond market performance we've seen in decades," Wood says.

There's also been several macroeconomic trends that have contributed to the underperformance of bond markets.

"Most of the decline in prices and the rise in bond yields can be attributed to elevated inflation. We've seen the market reprice the policy path of central banks in order to fight inflation," Wood says.

"Alongside rapidly rising bond yields, we've seen credit spreads widen as central banks have continued to withdraw liquidity from the market and embark on quantitative tightening. We've seen credit spreads widen, and that has further contributed to the underperformance of fixed income markets."

Fixed income outlook

Calastone managing director of Australia and New Zealand Teresa Walker[03] says: "Yields on fixed income funds are looking significantly more attractive in the wake of 2022's bond market declines. Investors have recently begun to hope that the interest interest-rate tightening cycle may be nearing its peak both in Australia and overseas. These two factors have tempted them back into fixed income funds in the last few weeks of 2022."

However, there is enormous uncertainty over the future course of interest rates and of economic growth around the world, so sentiment may turn bearish again in the coming months, she adds.

Neuberger Berman's Grotzinger acknowledges that the past year has been a wild ride, with inflation and interest rates skyrocketing and causing a major shakeup in asset valuations. But he suggests that we've hit peak inflation (in the US), and the coming year will see a gradual decline in pricing pressures.

"We're not going to stay at 6% inflation forever in the US, we think by the end of the year, it's more like 3.5%," Grotzinger says.

"Inflation is going lower and in the right direction; it may not quite reach the Fed's desired 2% target but this downward trend in inflation is good news, it should reduce volatility in capital and fixed income markets."

In the current environment, where central banks have maintained restrictive policies, there is a promising opportunity to generate income through short-term fixed-rate debt instruments, as they benefit from the front-end of yield curves.

Grotzinger says this presents an enduring structural opportunity for investors to leverage the interest rate differential offered by US policy rates, which are likely to experience less volatility this year. He anticipates this favourable market condition to endure, providing long-term investment prospects.

Moving into the latter part of 2023 and 2024, Grotzinger says the market's focus is likely to shift towards fundamental credit risk as growth slows and borrowing costs rise. This has implications for everyone, including governments, households, and corporations, as more dollars will be needed to service debt due to higher interest rates.

"As fixed income investors, our focus is on research and line item populated portfolios with companies and governments that can weather this 'higher for longer' world of interest rates," Grotzinger says.

"We think there are relative value opportunities in higher quality investment-grade sectors, such as corporate debt and agency mortgage debt in the US. These sectors not only provide good levels of income for high-quality assets but also present low dollar price opportunities that could lead to interesting total returns in the near future."

Likewise, Schroders believes that most of the underperformance in the bond market is in the past, and they see a peak in yields on the horizon. The firm believes that the current interest rate cycle is fully priced in by the market due to the level of inflation within economies.

However, with global growth starting to slow and inflation running at its hottest pace in decades, Schroders sees the possibility of a stagflationary environment emerging.

The firm's base case is for a recession in the middle of next year, with the risk of a faster and more severe downturn due to the synchronised tightening seen throughout 2022. This view is supported by Schroders' US recessionary dashboard, which continues to signal a recession.

"This environment is certainly more supportive of bond market returns, as the risks are shifting from upside inflation, towards growth reduction," Wood says.

"If the real risk of recession starts to be priced into markets in 2023, then bond markets could potentially deliver investors double digit returns making fixed income a better diversifier of equity risk."

Although 2022 may have been a time to be out of fixed income, Schroders sees 2023 as a time to be back investing in the asset class.

The fixed income market has undergone several transitions in recent years, from being viewed as boring with very low yields to terrifying for some retail investors. However, there is now a growing interest in fixed income due to the huge restoration of valuation and the resulting increase in opportunity across the entire fixed income universe.

"Valuations have improved and there's increased potential returns in 2023. Expected returns have risen to the highest levels we've seen in decades for fixed income," Wood says.

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> **Kellie Wood**

"Higher bond yields allow for the re-emergence of carry and income within the asset class, and this has been absent over the last decade, in an environment of quantitative easing. It will enable a wider and more active use of bond allocations going forward, providing more consistent returns to multi-asset portfolios; this is especially the case once the correlation between bonds and equity returns shifts from positive to negative as inflation starts to moderate over 2023."

Meanwhile, MLC Asset Management head of Antares fixed income Mark Kiely[04] says liquidity in fixed income assets is currently decent despite the withdrawal of central bank policies that have supported it. However, as we move through 2023, there could be some liquidity issues in certain market segments.

"Corporate bonds have been performing solidly since the highs seen in credit spreads back in October last year," Kiely says.

"Credit spreads have narrowed with the market perceiving recession risks as being reduced and 'peak' or 'terminal' cash rates in sight for most regions including the US and Australia. We may have a bit more compression in credit spreads to come but opportunities are lower than they were late last year."

Long-term interest rates have remained stable since October last year, he continues.

"Many investors believe we may have seen the peak in long bond yields for this cycle and thus have been reweighting into longer duration fixed income assets," Kiely says.

"If inflation does prove to be trending back to target and terminal cash rates are reached in the near future then we probably have seen the peak in longer term bond yields. But we could see some fairly volatile repricing if market expectations change; ongoing economic resilience and/or employment strength could potentially be a trigger for this re-assessment."

Kiely thinks there are several opportunities available for investors seeking growth and income. While interest rates have substantially risen from the lows of early 2021, he sees long duration fixed income as attractive, although he cautions investors about the risk that inflation may not be as easily contained as currently expected.

Still, floating rate securities provide ongoing higher earning yields due to rising interest rate resets, making them a good option. Corporate bonds and credit securities also offer attractive opportunities, even though credit spread compression has reduced their appeal compared to last year, Kiely says.

Inflation-linked bonds are also offering a decent earning yield due to the pass-through of higher headline inflation rates, he adds.

Overall, investors should remain vigilant and take advantage of the opportunities presented by the current fixed income market, while being aware of the potential risks.

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ETFs vs. managed funds

As inflation rose and central banks acted to curb it, the prices of both corporate and government bonds declined, leading to Australians withdrawing $1.45 billion from fixed income funds in the first half of the 2022, Calastone reported.

Although there was some initial optimism in July and the first half of August, the global bond market suffered a surge in yields in the latter part of the third quarter, dampening inflows. By October, however, sentiment had improved, and investors added $824 million to their bond holdings in the fourth quarter.

Still, for the full year, flows into fixed income funds decreased by 95% to $562 million, compared to $10.54 billion in 2021.

Comparatively fixed income ETFs gained momentum among Australian investors in 2022, with the asset class receiving $3.6 billion in net inflows, up from $2.9 billion in 2021.

Fixed income ETFs are gaining popularity due to their cost-effective diversification benefits, allowing investors from all walks of life to gain fast exposure to this important asset class. BetaShares expects fixed income to continue to resonate with investors in 2023, given the asset class' attractive return potential across both fixed and floating rate bonds, and relative to equities on a risk-adjusted basis.

Moreover, speaking with *Financial Standard*, Betashares senior portfolio manager Chamath De Silva[05] says that investing in fixed income ETFs has advantages over traditional fixed income managed funds due to the low-yield nature of the asset class, where fees can significantly impact overall performance.

"The track record for active managers, traditional managed funds in beating passive benchmarks or indexes has been pretty poor, especially in Australia," De Silva says.

"Active managers, despite charging higher fees in aggregate have underperformed the broader benchmark over the past 15 years. The periods of underperformance have been most acute during periods of stress in equity markets."

ETFs offer advantages over traditional managed funds in fixed income investing due to their lower fees and capacity to access customised, and granular exposure to different fixed income building blocks, De Silva continues.

He says: "That's one of the great advantages about ETFs over traditional managed funds; when you take the overall holistic portfolio approach, at the end of the day, an active manager doesn't know what else is in your portfolio. So, active managers don't know what fixed income building blocks will be deployed for an investor's benefit."

While passive exposures in fixed income ETFs can sometimes have a disadvantage in that they may skew towards longer duration exposures, which can suffer in a rising rate environment, De Silva counters that there are numerous options within ETFs, including funds that focus on cash, and also credit income solutions such as floating rate notes and interest-rated hedged corporate bonds, which tend to be far more resilient to (and can even benefit from) rising rates than traditional fixed rate bonds.

Still, there may be some benefits for active management in less liquid or lower credit quality areas such as distressed credit or junk bonds, although it's debatable whether there is much potential for alpha generation in investment grade, where there is little dispersion between bonds and issuers, he settles.

Mutual Limited chief investment officer Scott Rundell[06] says traditional fixed income managed funds may have advantages over ETFs depending on the nature of it. While ETFs provide liquidity, they still require a buyer on the other side, whereas managed funds have a manager who can go out and sell assets to manage liquidity.

Additionally, managed funds can be more bespoke to meet specific investment needs, such as a term deposit fund designed to provide clients with liquidity and similar returns, Rundell says.

"Our firm works closely with financial planning groups, so if an investor didn't want to go through a planner or do it themselves, ETFs are probably an easy fix," he says.

"But most of our clients are through financial planners, so they have model portfolios and allocated advice accordingly, so really it depends on individual preference."

An adviser's perspective

Last year's market performance has made investors question the role of different asset classes in their portfolios.

FMD financial planner Nicola Beswick[07] says in times of volatility, clients become focused on minimising risk and preserving capital, particularly those in the retirement phase. Adding fixed income to a portfolio can provide stability and complement a client's wealth goals. However, it's also important to have a discussion with clients about how fixed income can impact returns and the equity side of their portfolio, she says.

"It's crucial to consider the three different types of investments - cash, fixed income/bonds, and equities - and how they can perform over time. The appropriate allocation of these asset classes in a portfolio depends on the client's time horizon and risk tolerance," Beswick explains.

Looking back on 2022, many investors are hoping to avoid a repeat of the market surprises and negative returns that were experienced. While it is impossible to predict with certainty what will happen in the future, there is optimism that the worst is behind us, she says.

Therefore, moving forward, it's important to consider the role that fixed income can play in a portfolio, providing stability and security in times of market volatility. By balancing a portfolio with a mix of cash, fixed income, and equities, investors can position themselves to weather potential future challenges.

> *In the past, we preferred shorter-term deposits due to the probability of interest rates increasing. However, our current thought process is different…*
> **Nicola Beswick**

As interest rates rise, managing interest rate risk in fixed income portfolios is crucial. Retirees, who have experienced higher rates of inflation, are more cautious and often hold more cash in their portfolios to reduce negative impacts from rising rates. Accumulators, on the other hand, see the potential to invest more in markets and are willing to take on more risk in the long term. Balancing fixed income investments with other asset classes is key to managing interest rate risk in a portfolio.

"We're currently having conversations around managing cash and fixed income products, particularly with term deposits. The focus is on whether to opt for longer-term or shorter-term deposits, as interest rates are expected to decrease in the second half of the year," Beswick says.

"In the past, we preferred shorter-term deposits due to the probability of interest rates increasing. However, our current thought process is different, and we believe that slightly more shorter-term fixed interest products may be in demand, given the past and potential future volatility."

Beswick adds that fixed income investments play an important role in a well-diversified portfolio by providing stability and income. She says while people may be more interested in understanding their portfolio when markets are down, it's important to educate them on the long-term benefits of a diversified portfolio and the role that fixed income can play in reducing risk and providing income.

Offering his two cents, Grotzinger says for individual investors looking to allocate capital in fixed income, there are a variety of areas in the market to access, including high quality, non-investment grade, and emerging markets.

But, the key is to consider what the investor is trying to achieve in their total portfolio and how these different parts of the fixed income market can help.

On incorporating passive versus active strategies in fixed income portfolios, it ultimately depends on the specific investment objectives and risk tolerance of the investor, Beswick surmises.

Active managers, while likely more expensive, can provide more nimbleness and flexibility in managing a fixed income portfolio, particularly during times of market volatility.

Passive investments, such as fixed income ETFs, may offer lower costs but may not be as nimble in responding to changing market conditions. It's important to consider the underlying assets of both active and passive investments and evaluate the potential risks and rewards before making a decision on which strategy to incorporate into a portfolio. In the end, a well-diversified fixed income portfolio may include both active and passive strategies, she concludes. FS