FLEXIBLE BONDS

Sophisticated investors choose flexible answer

Daniele Fano, head of economic research at Pioneer Investments, tracks how Italian investors have become increasingly savvy, opting for flexible bonds that extract value from any source, independently from the benchmark but against a target return

Italians have experienced radical changes in their financial portfolios over the past 10 years. In many instances, they had to address in just a few years what others could learn over several decades. While rushing, they inevitably ran into a few bumps and awkward turns. But, overall, the journey has been successful.

Through mutual funds, asset managers have become a key actor and many investors have learned to appreciate the virtues of diversification, and also the benefits `of innovation.

Flexible bond funds probably represent the best example of the positive outcome of such evolution. They are sophisticated instruments that also have an interest within broad portfolio diversification strategies.

RECENT TREND TOWARDS INCREASED SOPHISTICATION

After roaring development in the 1990s, net flows have been rather inconsistent for Italian mutual funds: negative in 2004, positive again in 2005, close to flat in 2006 to date.

Flexible bond funds are the exception, having shown consistent and accelerating growth over the past three years. From January, until the end of April, bond funds had outflows for over €10bn, flexible bond funds were positive for close to €5bn.

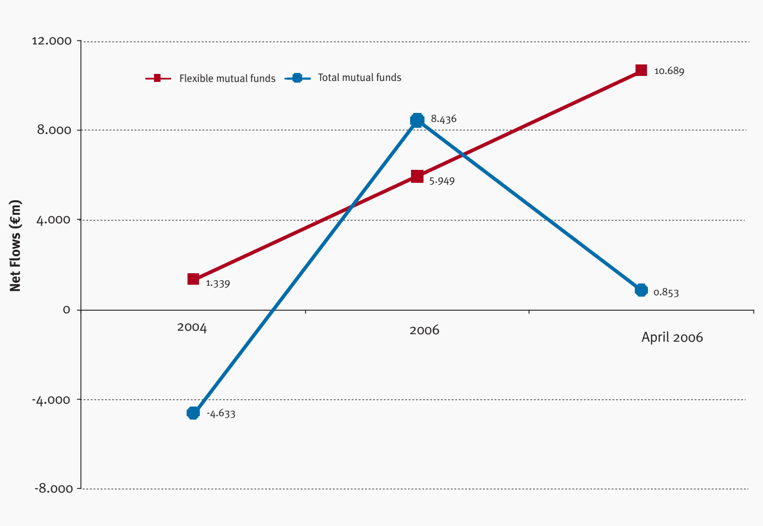
Flexible bond funds are sophisticated products: they incorporate the latest absolute return technologies. The main idea is to achieve a target by extracting value from any source, independently from a benchmark but against a target return. The portfolio manager is thus free from traditional constraints and has strong incentives to use his skills to produce excess return. He will look for areas where fundamental analysis can unveil market inefficiencies and, more generally, take calculated risks in order to enhance return.

"FLEXIBLE BOND FUNDS ARE SOPHISTICATED PRODUCTS: THEY INCORPORATE THE LATEST ABSOLUTE RETURN TECHNOLOGIES"

A flexible fixed income portfolio may seek duration bets, including negative durations via short futures positions. Within the credit universe, an absolute return portfolio can typically follow a carry strategy or, alternatively, a tightening of spreads strategy or leverage on credit default swaps. More generally, alpha-driven strategies, i.e. strategies capitalising on the ability of portfolio managers to spot market imperfections, can potentially contribute to extra performance.

A fund's absolute performance target, its investment time-horizon and underlying market conditions are key in determining the portfolio's asset allocation and its overall level of risk. Portfolio managers may be supported by a "risk budgeting" platform in order to control and monitor the potential impact of the multiple sources of risk. By definition, absolute return portfolios will look for minimising shortfall risk. Therefore, risk-budgeting will need to provide consistent measures of such

Figure one: Italian mutual funds market – flexible mutual funds versus overall market



Source: Pioneer Global Asset Management S.p.A. r Investment view - Eastern European Equityesearch estimation on Bank of Italy statistics

risks, the most common and well-known of which is VaR. 'Extreme' market risks will also need to be considered.

But how have so many Italians become sophisticated flexible bond investors? We can try to make a long story short.

LOOKING BACK: A 10 YEAR 'LEARNING CURVE'

Household portfolios have experienced a radical change in the past 10 years in Italy, with an increasing role of portfolio diversification and asset management. The role of equity ownership has increased as well as that of mutual funds and insurance companies.

If we look at the fixed income segment, we see that, from 1995 to 2005, direct ownership of bonds by Italian households declined from 31 per cent to 20 per cent of their total financial assets. In the same period deposits also experienced a sharp decline, while the role of bond and money market mutual funds rose from 3 per cent to 7 per cent.

This rapid transition, from owning mainly deposits and bonds with a touch of equities to owning more complex portfolios, has been accelerated by the convergence process that eventually led to the euro. For the Italian investors the experience has however been neither simple nor smooth.

Traditionally (since the early-1980s), government bonds had been a safe haven, interest rate volatility had been compensated by the capital gains provided by the disinflationary trend and by the relevant Italian risk premium.

Once the golden years of high nominal and real interest rates and rising prices were over, the Italians had to learn how to deal with the risk/return trade-off the hard way.

As the equity bubble was getting bigger in 1999, many moved too hastily into stocks. And when the bubble burst, the market witnessed a return to bonds. The nostalgia for high yields attracted investments into Argentina and Parmalat bonds.

But, fortunately, the story of those turbulent years is not only one of short-termism.

Italian mutual funds have given a vast number of investors opportunities for broad diversification on international markets and across different types of instruments. They now represent a relevant and reliable portion of household portfolios. Moreover, they have relentlessly developed financial innovation and increasing product sophistication.

With total return products, the Italian mutual fund industry has provided a response to the post 2000-2002 demand for clear targets and for immunisation from excessive volatility.

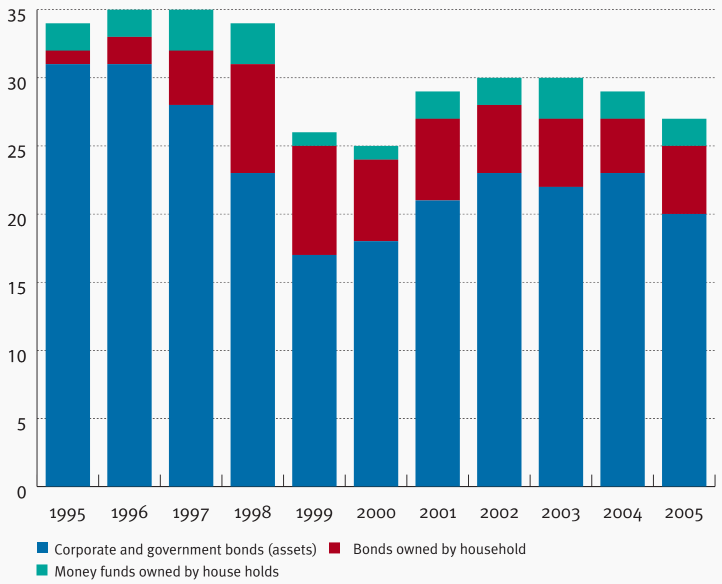
An alternative, or sometimes a subset, of total return products are guaranteed products, where a third party intervenes as an insurer.

In comparison to guaranteed products, total return products can offer similar protection on the principal or on some minimum return objective, but do not incur the costs of protection. Of course, the client should be aware of the instruments through which such protection is sought. In most cases the protection is based on the use of rated bonds and is thus very solid, so that the cost of additional guarantees from third parties can be foregone without incurring relevant risks.

We may thus conclude that flexible bonds can have in-built the antidotes Italian investors, who have concentrated too much risk in single issues of corporate bonds, emerging market bonds or long duration government bonds, are looking for:

- They can offer ample downside protection;
- They are usually transparent in terms of return targets;
- They have day-to-day market market;
- They provide full accountability on portfolio composition and costs;
- They can offer upside potential through the possibility of limited diversification in riskier asset classes and 'alpha-driven' strategies.

Figure two: Securities other than shares, bond mutual funds and money market funds as a % of household financial assets



Source: Pioneer Global Asset Management S.p.A. Research estimation on Bank of Italy statistics

ABSOLUTE RETURN STRATEGIES AS A PORTFOLIO COMPONENT

There is still vast scope for improving the quality of Italian household portfolios in terms of efficiency and diversification. The appropriate use of bonds should be viewed in the broader context of portfolio construction, where different instruments should be optimally combined according to the investors' risk appetite, time horizon and ability to weather out market volatility.

The problem is that we are still far away from such an ideal scenario. Italy is similar to this extent to other developed nations where surveys show that individual portfolios tend to be relatively inefficient. The reason is that investors usually own just a limited number of instruments and forego the advantages of much broader diversification.

In the case of Italy, we have recently carried out a survey showing that only individuals who follow overall advice end up with portfolios that are close to the efficient frontier. The majority has just a few single shares and wide concentration in single fixed-income instruments.

Even in the United States about half of investors do not access the equity market, thus foregoing the equity premium over time. In Europe, the percentage of access to equity markets is even lower. Moreover, as behavioural economists have shown, investment choices are often dictated by 'framing', i.e. attitudes that depend more on considerations of fashion, status or trend, rather than on rational choice.

Diversification is a difficult concept to capture from a practical point of view. Enron employees responding to a questionnaire well before the scandal erupted considered that a 401k portfolio equally distributed between company stocks and mutual funds was well balanced.

Asset managers and distributors should help investors overcome these drawbacks. In fact, this is a positive-sum game, making everybody happy: the investor, because he improves the quality of his portfolio, and the industry, because it offers longer-term value added.

As far as flexible bond funds are concerned, the advantages are represented by stable return profiles and low correlation with other assets, the disadvantages are mainly represented by limits to upside potential.

They should therefore be particularly appropriate within diversified portfolios of investors with a relatively short term time horizon.

More generally, as investors move towards life-cycle solutions, absolute return products will increasingly have a role of their own, side by side with other financial instruments.