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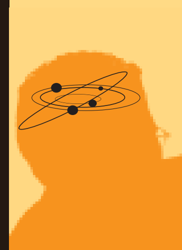


TOTAL RETURN PRODUCTS

PORTABLE ALPHA PROVIDES KEY FOR UNCERTAIN ENVIRONMENT

Private clients are increasingly demanding an investment approach which allows their manager to separate the ability to take fixed income risk into various dimensions

For years, while equities plummeted, bonds were uncontroversially the place to be. Now, with financial markets fraught with uncertainty, the European bond investor faces difficult decisions aplenty.

On the one hand, a higher interest rate environment should inspire investment in those areas of fixed income with low correlation to government bonds; on the other, tight valuations and a high degree of leveraged carry trades in the market render high yield relatively unattractive.

‘The approach behind total return is to operate in terms of portable alpha. Thus, a manager can separate the ability to take risk in fixed income into various risk dimensions’
Robert Andrew, ABN AMRO Asset Management

The high net worth individual (HNWI), at this hard-to-judge crossroads, would be wise to consider an alternative way to exploit European bond strategies: total return products.

The background to all this is an interesting – not to say bewildering – juncture in financial markets. Although market participants are prepared for higher interest rates, there remains a degree of uncertainty thanks to three factors. First, interest rates have been very low, which makes it hard to assess how much they should go up.

Second, the unpredictable process of unwinding carry trades. The first hints came some weeks ago when emerging market spreads blew out dramatically, and they are still unpredictable.

Third, it remains uncertain what type of impact monetary policy tightening will have on the global economy.

US BOND MARKET

No clear view of the situation in Europe is possible without first considering the US bond market, to which it is so closely correlated. Growth in US gross domestic product (GDP) has been above trend, and, importantly, has not just been relying on the consumer. Rather, improving labour market conditions and investment are both boosting GDP growth.

Inflation figures seem to be deteriorating, with a 2.3 per cent headline figure for April compared with a 1.1 low at the start of the year. The main reason is that higher energy costs are feeding through, and that firms’ pricing power is increased in the strong economy.

However, with a good deal of excess capacity, inflation should not get out of control.

OIL PRICES

The US economy is likely to remain above trend in the short term, move towards trend at the end of this year, and slip below it by the end of 2005. Tax rebates have been just about fully paid, and growth will be

constrained when they fall out of the system. Moreover, interest rates are up, putting mortgage rates up and equity withdrawals down.

The favourable tax treatment on corporate investment is likely to fall out of the system by the end of the year. Oil prices are a factor, as they effectively put a tax on the economy.

And, finally, there is evidence that the Chinese policy of slowing the economy is starting to work.

The Federal Reserve is likely to start a tightening policy by July, with 75 to 100 basis points on interest rates by the year end, and up to 100 basis points in 2005.

It is unlikely to be more aggressive than that, as the economy in its current state is more sensitive to rate rises than in the past. (See Chart 1.) There is a high degree of financial leverage.

AND IN EUROPE...

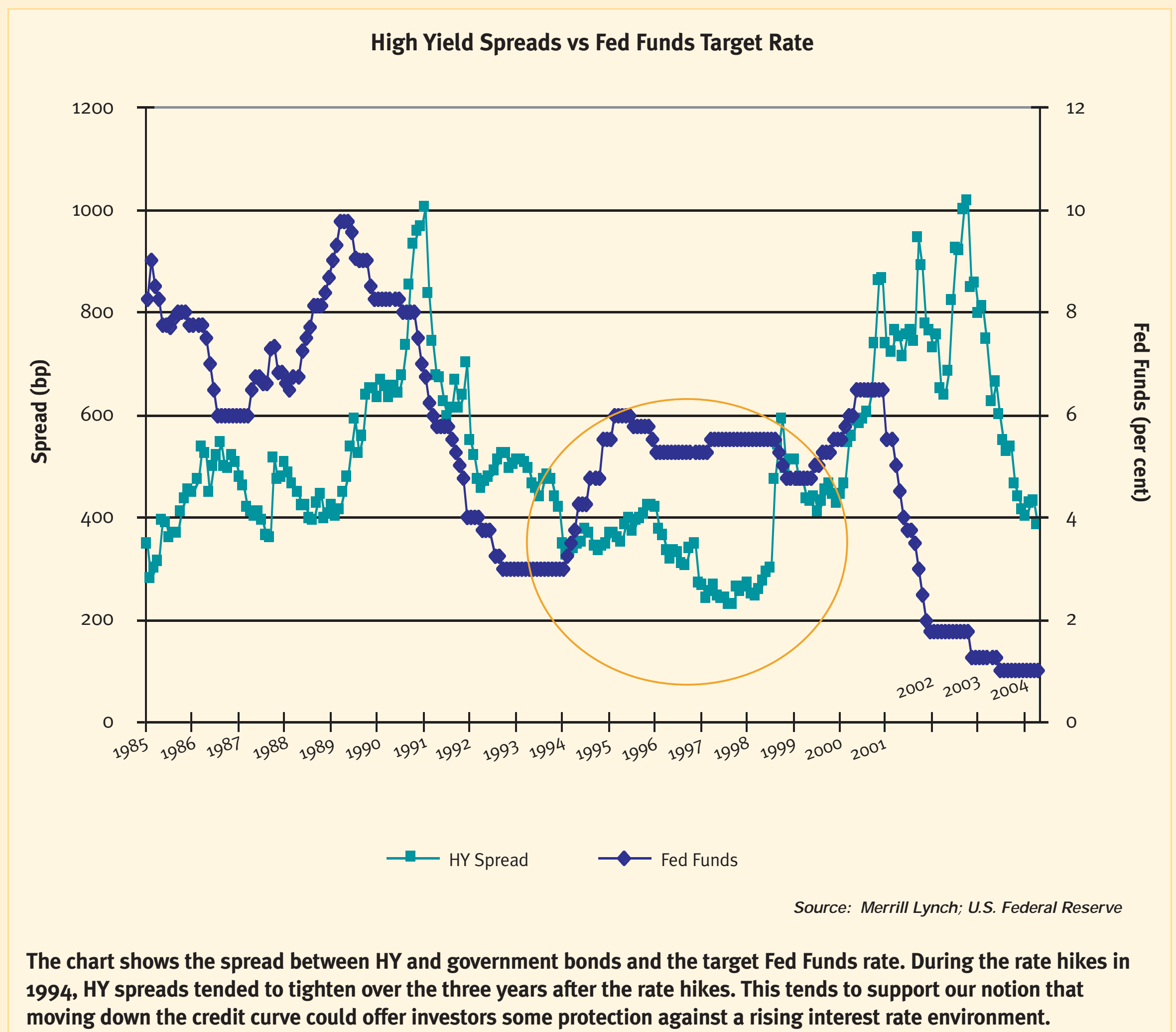
So what does this mean for Europe? Global growth is the main driver of the eurozone economy, particularly exports. Inventory building also makes a positive contribution. However, the eurozone lacks support from domestic demand, and the labour market continues to be a problem.

Annualised growth for the first quarter this year was 2.5 per cent. Going forward, 1.5 to 2 per cent is more realistic. The negative output gap should keep a lid on inflation.

The European Central Bank is likely to leave interest rates unchanged this year, but increase them by up to 50 basis points in 2005. The Bank of England will probably add another 50 to 75 basis points before the tightening cycle is over.

With all this in the background, European bond markets are being pulled in opposite directions. Strong economic growth, high inflation and likely monetary tightening are negative factors, but market participants have already priced in significant rate increases.

According to the consensus view, growth is set to slow and inflation not to have a sustained rise. On balance, bond yields are more likely to go up than down but only modestly. Eurozone bond yields should go up from 4.6 to 4.8 per cent over six months.



The chart shows the spread between HY and government bonds and the target Fed Funds rate. During the rate hikes in 1994, HY spreads tended to tighten over the three years after the rate hikes. This tends to support our notion that moving down the credit curve could offer investors some protection against a rising interest rate environment.

Given the current view on interest rates, European bond investors would do well to consider the euro version of a currency fund, which can benefit from the rising rate environment

In an environment of modest growth and higher interest rates, government bonds should typically underperform riskier fixed income products. When interest rates are relatively high, it makes sense to increase exposure to fixed income assets with low or negative correlation to government bonds. That is, to high yield, or emerging markets.

Based on Merrill Lynch indices, the correlation of 10-year treasuries to high grade corporate bonds is 0.92, whereas the correlation of 10-year treasuries to high yield is only 0.19. So should the HNWI be rushing all his European bond assets into high yield?

Not necessarily, because high yield bonds have problems of their own. Valuations are somewhat tight, and there are a high degree of leveraged carry trades in the market, including of course the markets for riskier bonds. It makes sense, then, not to have a huge exposure to such long-only type asset classes.

Over the long term, rates can be expected to peak not too far from current levels, and so long-only European bonds would become attractive again. But, in the meantime, HNW investors would be advised to reduce their exposure to interest rate risk, while being cautious about high yield. The question is: how?

GREATER DEMAND

The answer, for the shrewd HNWI, lies in total return opportunities – an area which has seen increased demand from private clients of late.

The approach behind total return is to operate in terms of portable alpha. Thus, a manager can separate the ability to take risk in fixed income into various risk dimensions: credit (high yield and investment grade); currency (active positions in currency markets – through foreign exchange or derivatives); interest rate risk; Asian and emerging market bonds; and global fixed income versus local fixed income opportunities.

A currency fund is a short-long type product. By using a quantitative approach to take an active position in foreign exchange markets, the manager can avoid the risks associated with subjective forecasting of where currencies will be going forward.

Given the current view on interest rates, European bond investors would do well to consider the euro version of a currency fund, which can benefit from the rising rate environment.

FLEXIBILITY

Another alternative is a Euribor-plus type product, which focuses on the fixed income alpha areas. It looks at the information ratios and combines them in an optimal way to deliver a portfolio.

The aim is to optimise the amount of time in which the respective alpha areas can utilise the risk budgets available to them – some, obviously, have less in rising interest rate environments.

The fundamental issue, within a tightly controlled risk framework, is that the manager has the flexibility to go long-short. This takes bond investing to the extreme, being describable as a liquid version of a hedge fund but without the formal borrowing. And, crucially for our perplexed European HNWI, it gives scope for the manager to deliver returns whatever the interest rate environment.

It is possible to deliver different versions of such a product, depending on risk appetite. To get 100 to 175 basis points excess return over the Euribor (Euro Interbank Offered Rate), the fund would have around 9 to 10 per cent tracking error.

So, for the adventurous investor, it can sit well along more conventional cash and bond products and allow European bond portfolios to deliver even when interest rates are high.

Robert Andrew, senior portfolio manager, global markets group, fixed income, ABN AMRO Asset Management

CORPORATE STATEMENT

ABN AMRO Asset Management Limited is a strategic unit of ABN AMRO Bank N.V., and is headquartered in London and Amsterdam. We have been managing portfolios since 1933, and are able to combine our global resources to deliver specialised investment products, which benefit from our local expertise. ABN AMRO Asset Management's global asset management capability is co-ordinated through key regional centres based in Amsterdam, London, Chicago, Atlanta, Hong Kong and Singapore. In total, there are more than 30 units around the globe offering local expertise from within a global organisation.

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