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# GENERATING RETURNS IN THE NEW FIXED INCOME AGE

In this interview, Fraser Hedgley, head of client portfolio managers EMEA at Nomura Asset Management, explains how flexible fixed income strategies are helping to exploit inefficiencies in the credit markets

Today's economic marketplace is far from what we might call standard. Quantitative easing and an extended period of low rates have propelled the market upwards, which has instead created a marketplace driven by liquidity.

Fraser Hedgley, head of client portfolio managers EMEA at Nomura Asset Management says: 'As liquidity has flooded capital markets, asset prices have ballooned and yields have been suppressed.' As such, fixed income investors face a dilemma: move up the risk scale and achieve more return potential, or reassess expectations.

Achieving flexibility within mandates is a large part of the answer, Hedgley says.

'Unless you operate with significant flexibility, you're simply not going to be able to meet clients' reasonable expectations of return. You need to take risk either by taking on duration, or by taking on credit risk.'

Fixed income funds with agile approaches over a broad variety of instruments are therefore proving increasingly attractive. The principle advantage of these strategies is their ability to react quickly to fluctuations and exploit short-term market opportunities across various regions, currencies and investment vehicles.

As an example, Hedgley highlights that Nomura's Global Dynamic Bond Fund used its flexibility to buy put options on US Treasuries in early 2018, and was thus able to profit from interest rates rising – a highly unusual trait for a bond fund.

## NAVIGATING RISK

It can be argued that politics is a more important factor today than any time in the last 20 years due to the remaining uncertainty of Brexit, populism looming large over Italian politics, trade tariff disputes and the growing gulf between political visions for the United States.

However, even the influence of politics has been 'utterly overwhelmed by the influence of central banks,' Hedgley says.

'We recently saw the Federal Reserve cut the base rate by 50 basis points and what followed was a significant spike in equity valuations. That lasted a few minutes before a collapse back down to previous levels.'

The cut was already priced in and demanded by the market, he suggests, while adding that a key concern right now is the Covid-19 outbreak. Furthermore, UK airline Flybe entered administration on 5 March, citing the virus's impact on air travel as partly to blame.

Hedgley says: 'We've got no real way of predicting or understanding how the virus is going to spread and to what extent it's going to impact global supply chains. In order to be able to protect our investors from broad risk-off sales in risky assets across the board, we have the ability to invest in equity put options which, for a limited premium, allow us a great deal of potential downside-risk hedging within the Fund.'

The Fund acquired put options on the Nikkei and the Euro Stoxx index in early February.



**FRASER HEDGLEY**  
Head of client portfolio managers EMEA  
Nomura Asset Management

'Those have helped us navigate what's been a rather difficult environment,' he adds.

## AGILE AND ACTIVE

Against this backdrop, it is a small wonder that investors are drawn to actively managed funds that exhibit low correlations to traditional asset classes and have the flexibility to protect against downside risk.

In 2019, the managers capitalised on Portugal's improving credit story by allocating significantly to its sovereign bonds – Portugal's GDP growth is twice the rate of the rest of the EU and Portugal was a target of ECB asset purchases. That exposure was

replaced – after realising a significant return contribution – with Italian sovereign debt in June 2019, which rallied hard after Matteo Salvini's Lega was side-stepped by the Italian prime minister, Giuseppe Conte, in the summer. The Fund exited that position soon after.

'In 2019 we also included allocations to India via local currency bonds and our exposure extended to Egypt via sovereign bonds,' Hedgley says. 'We have a limit on exposures to emerging markets, but these assets certainly helped the Fund perform strongly last year.'

By late 2019 the position in India was reduced to a fraction of its former size but the Egypt exposure has been maintained and joined by a local currency exposure to Russian sovereign debt.

Hedgley says: 'In Russia, you have one of the highest real yields in the world, inflation is under control and the central bank seems to be managing inflation and the currency in a stable way. You also have a debt-to-GDP ratio of 15% and a triple-B investment grade credit rating. What's not to like?'

He adds that allocating to select emerging market bonds, credits and sovereign bonds will be a continued investment feature of the Fund.

'What's interesting about the Fund's return profile in 2019 is not that our risky assets

went up, but that our hedging cost nothing. That's bizarre in an environment where equities went up by 25%.'

## AHEAD WITH CAUTION

At the beginning of a new decade, Hedgley expects risk markets, which remain at high levels, to respond rapidly to positive announcements regarding US-China trade tensions and disappointing real-world economic data.

**'Unless you operate with significant flexibility, you're simply not going to be able to meet clients' reasonable expectations of return.'**

Central banks, he adds, will have no choice other than to maintain accommodative monetary policies, which should provide a measure of support to risky assets while

keeping yield curves low.

'Yield was crushed out of the markets last year so we've been actively seeking returns in emerging markets. We also like the contingent convertibles market where yields are in excess of those available on European high yields and, in many cases, with slightly better liquidity conditions.'

Volatility is here to stay, but by protecting against it, as the Fund has been able to do so far, returns have been steady. So, the message remains one of opportunity – but perhaps 'risk-adjacent' opportunity.

Hedgley adds: 'What I would say is that we have remained very cautious about the potential impact of this new coronavirus strain. We think it's almost inevitable that it's going to spread in North America and Europe and therefore it makes sense for us to maintain a relatively cautious stance at this time.'

Yet in recent tough and unpredictable environments, total-return fixed income investments have proved themselves to offer acceptable answers and, further, a means in which to address client objectives.

'Some of the themes that we're investing in don't sound particularly exotic,' Hedgley says, 'but nonetheless, they can reveal quite exotic returns when the environment is right.'

## Disclosures

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