



# FIXED INCOME IN THE NEW WORLD

David Greene, Pioneer Investments



IAPF Annual Investment Conference

## Fixed Income in the New World The Devil is in the Headlines!

### Institutions Clamor for Specialized Managers

FundFire, March 11<sup>th</sup> 2014

### Investor demand elevates the product specialist

Financial News, March 11<sup>th</sup> 2014

### Insurers will outsource alternative funds

Financial News, March 10<sup>th</sup> 2014

## Putting diversity at the heart of investment

FT Adviser, March 2014

"Active and high conviction investment management remains the cornerstone of the fund industry, especially outside the US market."

International Adviser, March 6<sup>th</sup> 2014

## now is the time to hedge interest rate rise risk

Citywire, March 11<sup>th</sup> 2014

### Witan's Bell sounds 'poverty' warning on bonds



Head of £1.5 billion Investment Trust says bond investors face losses akin to those suffered after WW2.

Citywire, March 4<sup>th</sup> 2014

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# Fixed Income in the New World

## Drawbacks of passive management

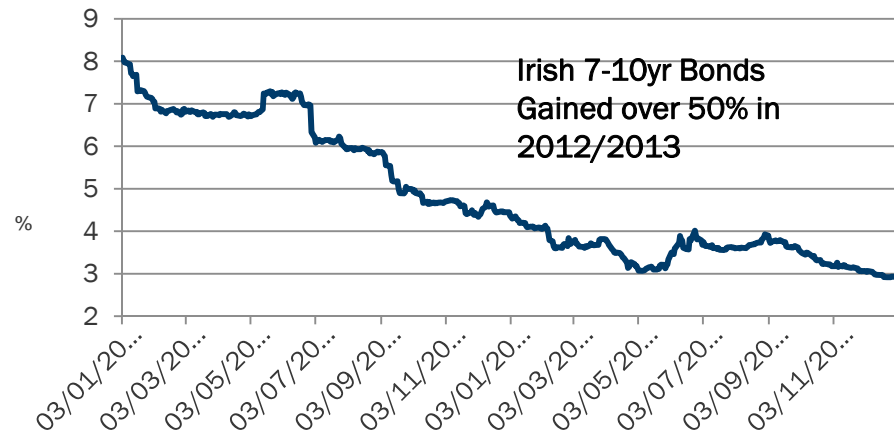
### Stuck in a Bad Trade...

*You have a situation like Greek debt in 2010. Obvious that Greece was going to be down-graded, and get hammered but didn't actually fall out of indices until end-June, by which time the damage had been done.*



### Stuck out of a Good Trade...

*Or you miss a situation like Irish debt in 2013. Ireland was still sub-investment grade but yields were falling fast. By the time Ireland was upgraded and included in indices, the smart active managers had made money for clients.*

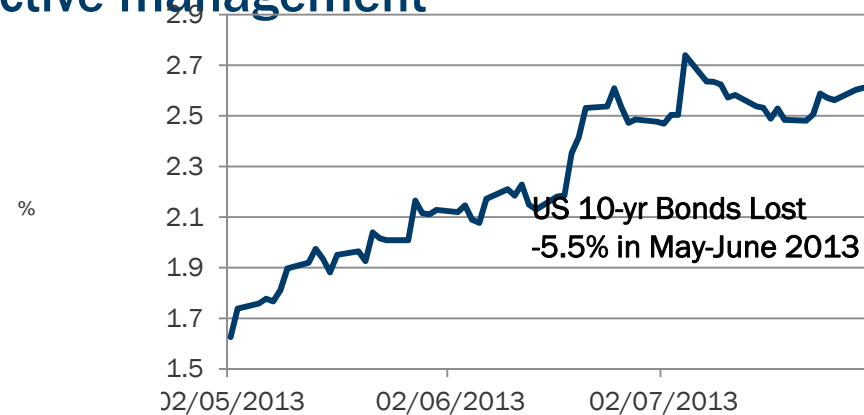


# Fixed Income in the New World

## Drawbacks of traditional “long-only” active management

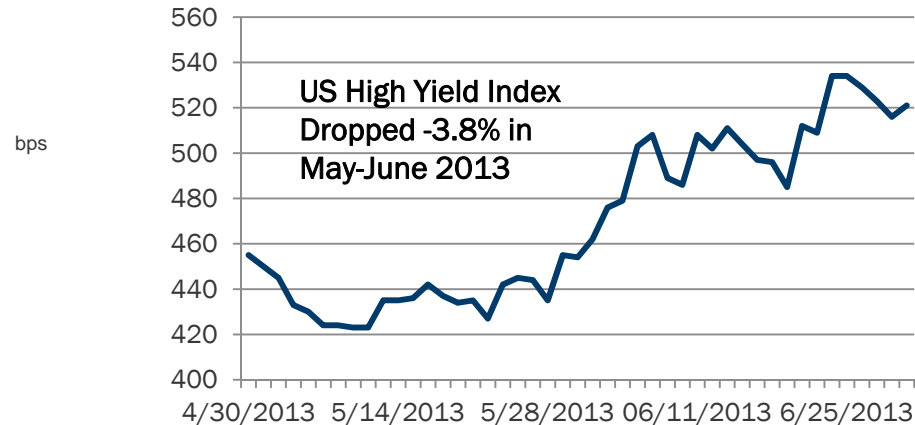
**Performance gets dominated by a few big positions/bets.**

*Remember asset managers getting caught with long duration US Treasury exposure in the summer of 2013?*



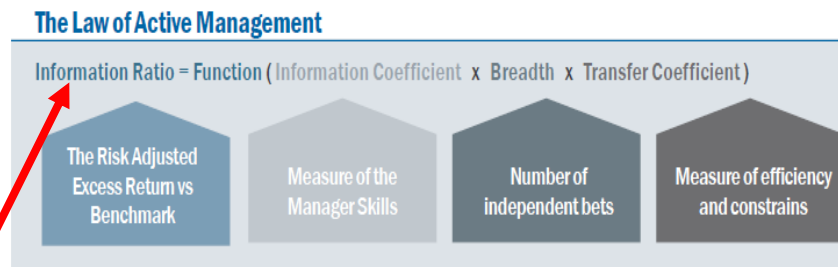
**Everyone’s a trend-follower, until they aren’t.**

*The hunt for yield has driven asset managers into non-traditional asset classes over the past few years. But when times get tough, it’s hard to get out without significant losses.*



## Fixed Income in the New World

### What drives a good Active Management strategy?



Source: The Law of Active Management. Grinold and Kahn 1999, and Clarke, de Silva and Thorely 2002.

**Excess Return (Alpha)**  
**Tracking Error**

- **Information Coefficient** – ability of managers to access & process large amounts of information
- **Breadth** – number of diversified & lowly-correlated alpha sources
- **Transfer Coefficient** – ability of a managers to convert ideas into successful investment positions

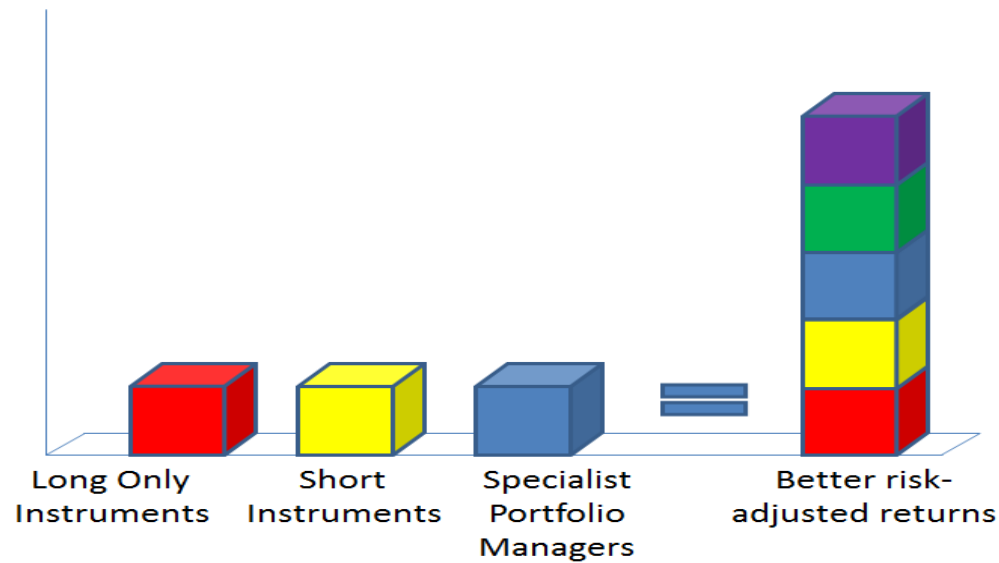


# INFORMATION COEFFICIENT



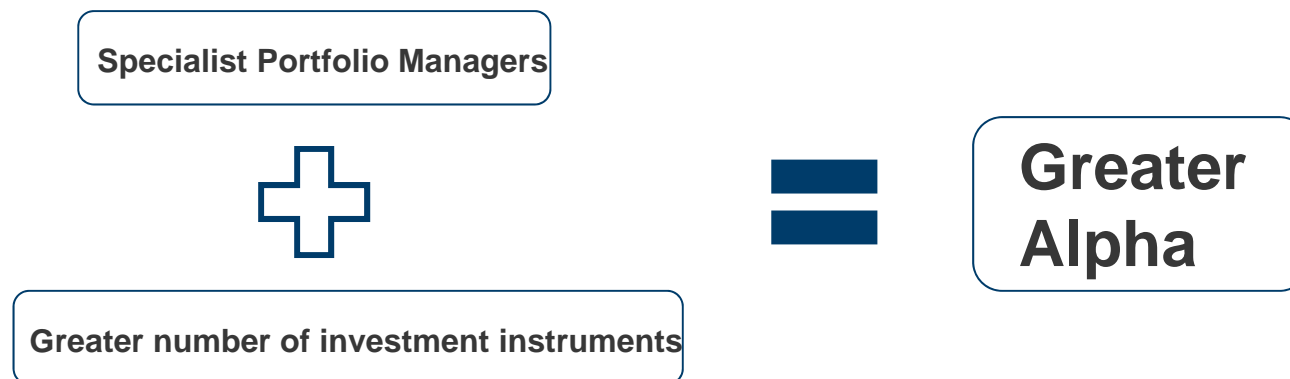
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## Fixed Income in the New World Information Coefficient



Specialist portfolio managers, focusing solely on individual market segments, coupled with the selective use of derivatives, and the ability to implement negative duration positions, can lead to higher excess returns, for a similar amount of risk. These portfolio managers are able to access areas of the fixed income markets not open to traditional “long-only” managers.

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# BREADTH

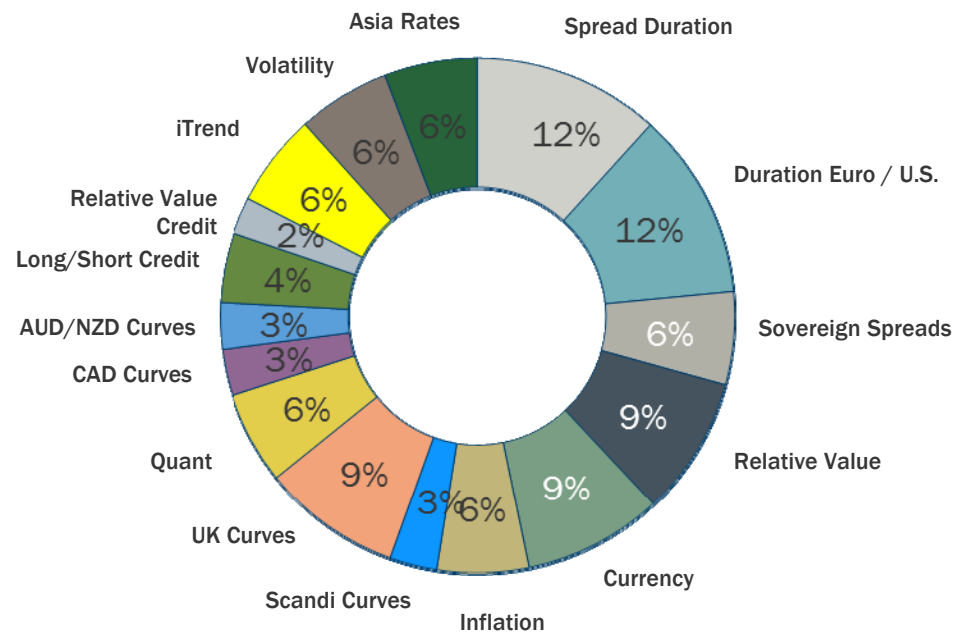


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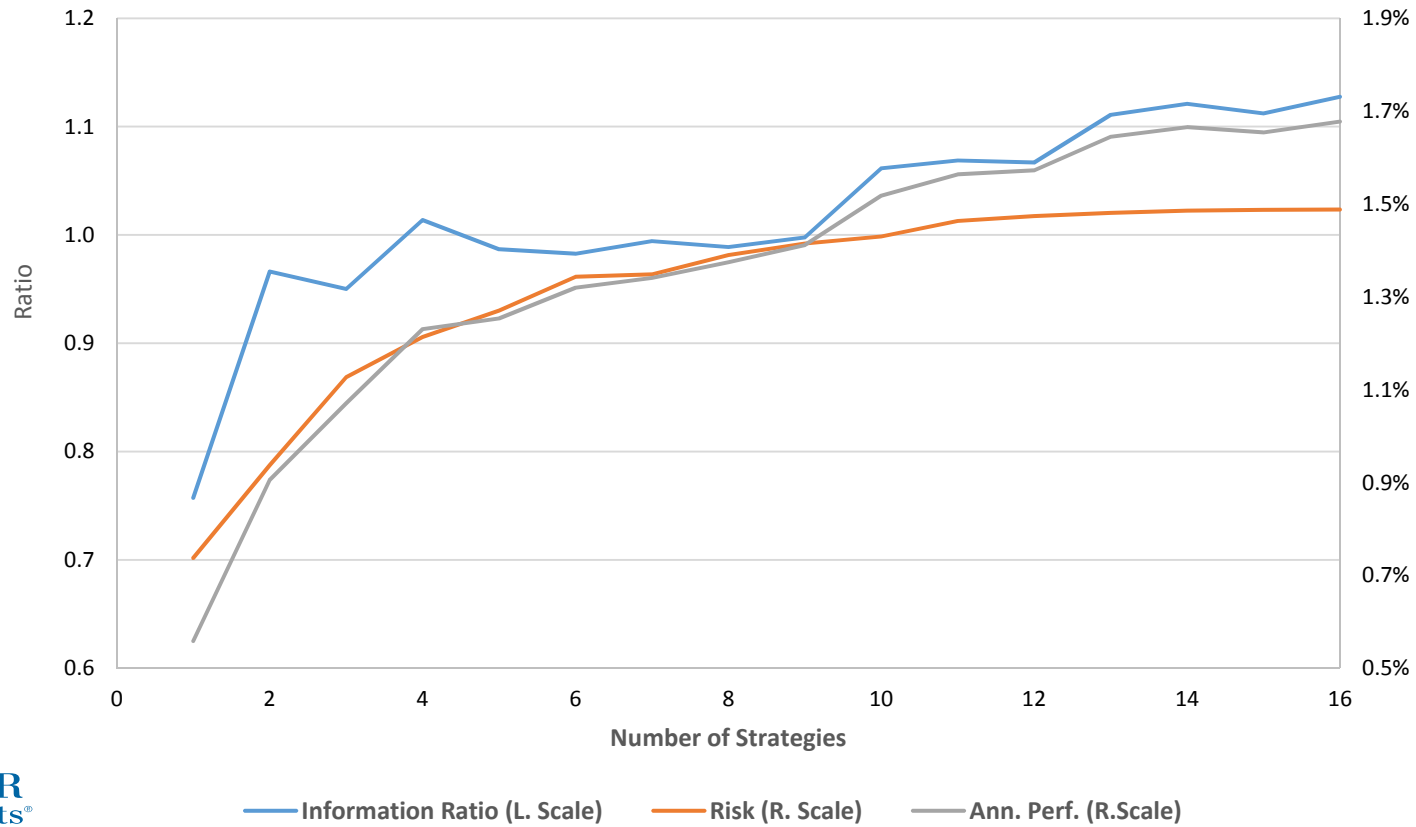
# Fixed Income in the New World

## Diversified sources of returns is Key.....

**Performance Target Breakdown**



## Fixed Income in the New World Breadth of alpha sources is crucial...



— Information Ratio (L. Scale) — Risk (R. Scale) — Ann. Perf. (R. Scale)

## Fixed Income in the New World Correlation also vital...

	Credit Long/ Short	Currency	Inflation	Interest Rates \$ Block	Interest Rates Asia	Interest Rates Japan	Interest Rates Scandi	Interest Rates UK	Quant Fixed Income	Relative Value	Volatility	Core Strategy
Credit Long/ Short	1.00	0.01	0.18	0.08	0.18	0.17	0.23	-0.03	-0.24	0.10	0.25	0.00
Currency	0.01	1.00	0.05	0.16	0.13	0.18	-0.11	-0.06	-0.20	-0.20	0.01	-0.17
Inflation	0.18	0.05	1.00	0.06	0.11	0.09	0.12	0.04	-0.18	0.01	0.33	-0.17
Interest Rates \$ Block	0.08	0.16	0.06	1.00	-0.14	0.11	-0.01	0.20	-0.23	0.02	0.01	-0.01
Interest Rates Asia	0.18	0.13	0.11	-0.14	1.00	0.22	0.06	-0.22	-0.33	-0.14	0.30	-0.22
Interest Rates Japan	0.17	0.18	0.09	0.11	0.22	1.00	0.19	-0.17	-0.37	-0.07	0.42	-0.06
Interest Rates Scandi	0.23	-0.11	0.12	-0.01	0.06	0.19	1.00	-0.03	-0.09	0.09	0.31	-0.21
Interest Rates UK	-0.03	-0.06	0.04	0.20	-0.22	-0.17	-0.03	1.00	0.32	0.13	-0.33	0.10
Quant Fixed Income	-0.24	-0.20	-0.18	-0.23	-0.33	-0.37	-0.09	0.32	1.00	0.10	-0.60	0.31
Relative Value	0.10	-0.20	0.01	0.02	-0.14	-0.07	0.09	0.13	0.10	1.00	0.07	0.11
Volatility	0.25	0.01	0.33	0.01	0.30	0.42	0.31	-0.33	-0.60	0.07	1.00	-0.29
Core Strategy	0.00	-0.17	-0.17	-0.01	-0.22	-0.06	-0.21	0.10	0.31	0.11	-0.29	1.00

# TRANSFER COEFFICIENT



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## Fixed Income in the New World Rigorous Risk Management....

	Number	Total Excess Performance	Average per Position
Total	279	6.772%	0.023%
Winning Positions	146	13.433%	0.094%
Losing Positions	133	-6.661%	-0.050%

....results in Better Absolute & Risk Adjusted Performance

Year	2011	2012	2013	Total
All Decisions	70	97	112	279
Hit Ratio	48.57%	52.58%	54.86%	52.0%
Win Loss Ratio	2.46	1.48	1.65	1.87
Best Winner	0.79%	1.65%	0.42%	
Worst Loser	-0.20%	-0.25%	-0.17%	

*A Manager's Win/Loss Ratio is the key to success...*



Source: Pioneer Investments as at 31 December 2013 - Absolute Return Bond.

## Fixed Income In The New World

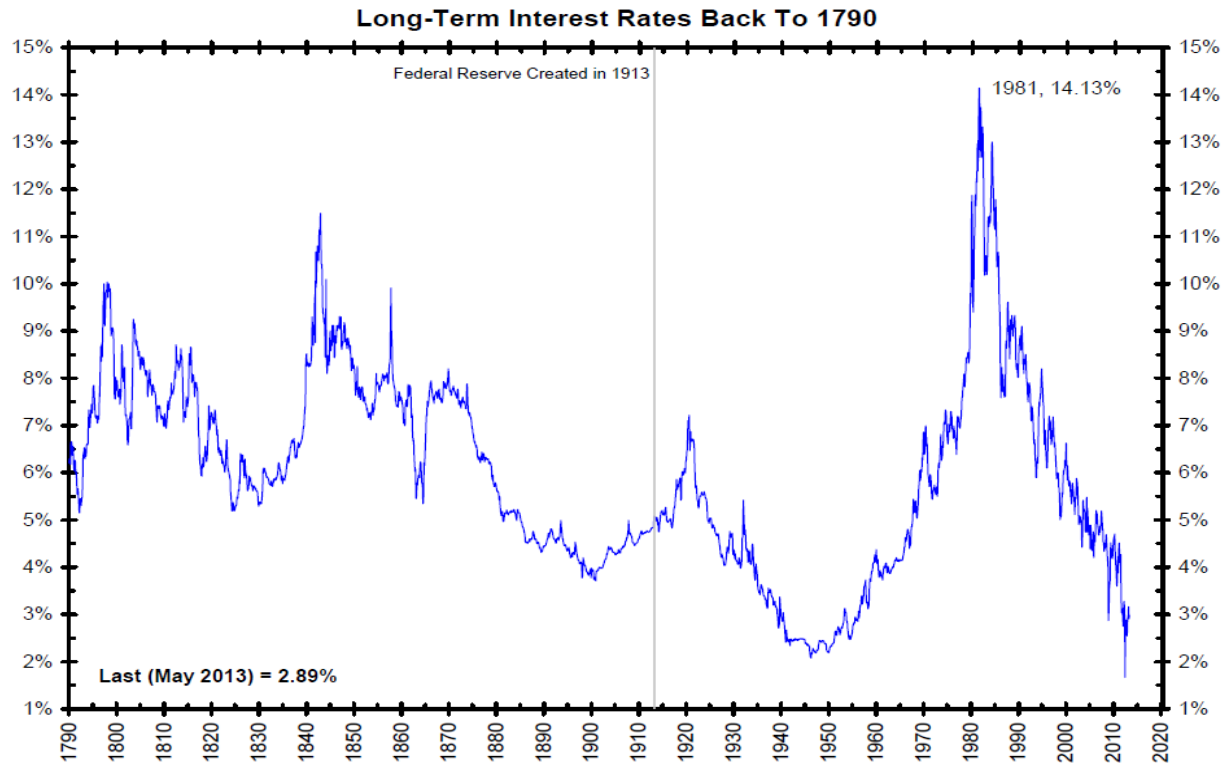
### Is it Becoming a Return-Free Risk ?

- The combination of cheap QE money and low volatility has fuelled risk taking and resulted in financial repression
- This has forced investors to either accept a rate of return on investment below the rate of inflation or realise a negative real return on assets
- Yields are too low to compensate for the increased riskiness of sovereign debt
- Due to the concept of negative real returns, going forward investors are facing a return-free risk

*The Result = traditional fixed income should now be regarded as a risky investment*

# Fixed Income in the New World

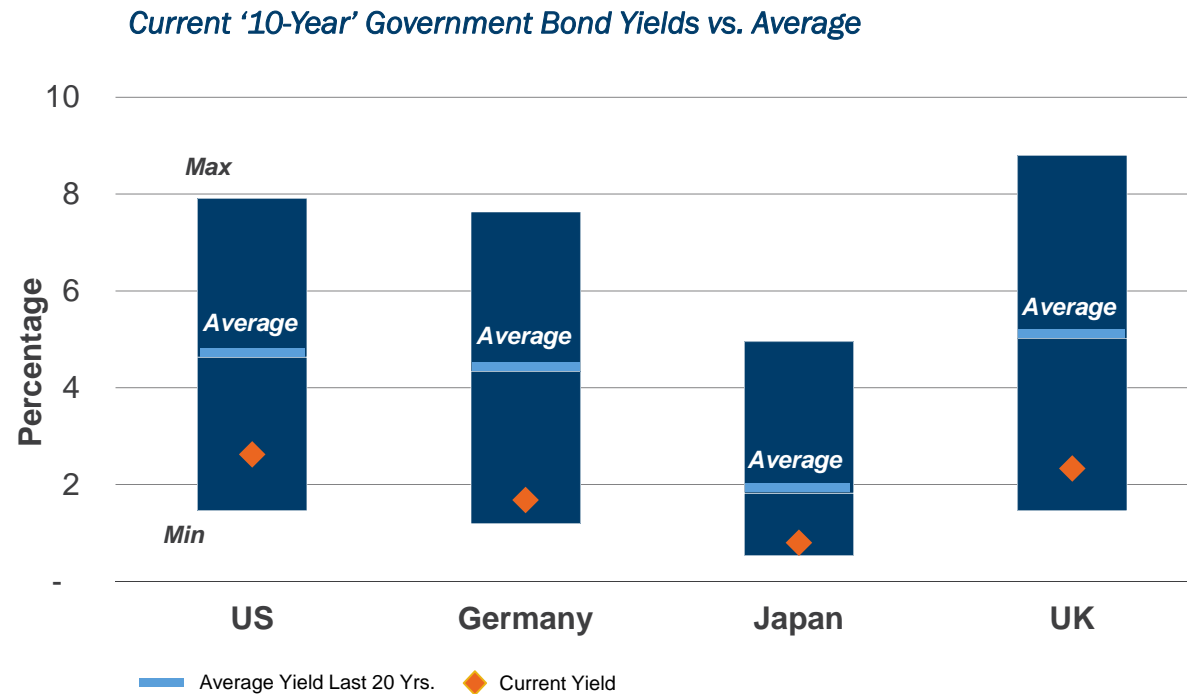
## Interest Rates - The Only Way is Up...





## Fixed Income in the New World

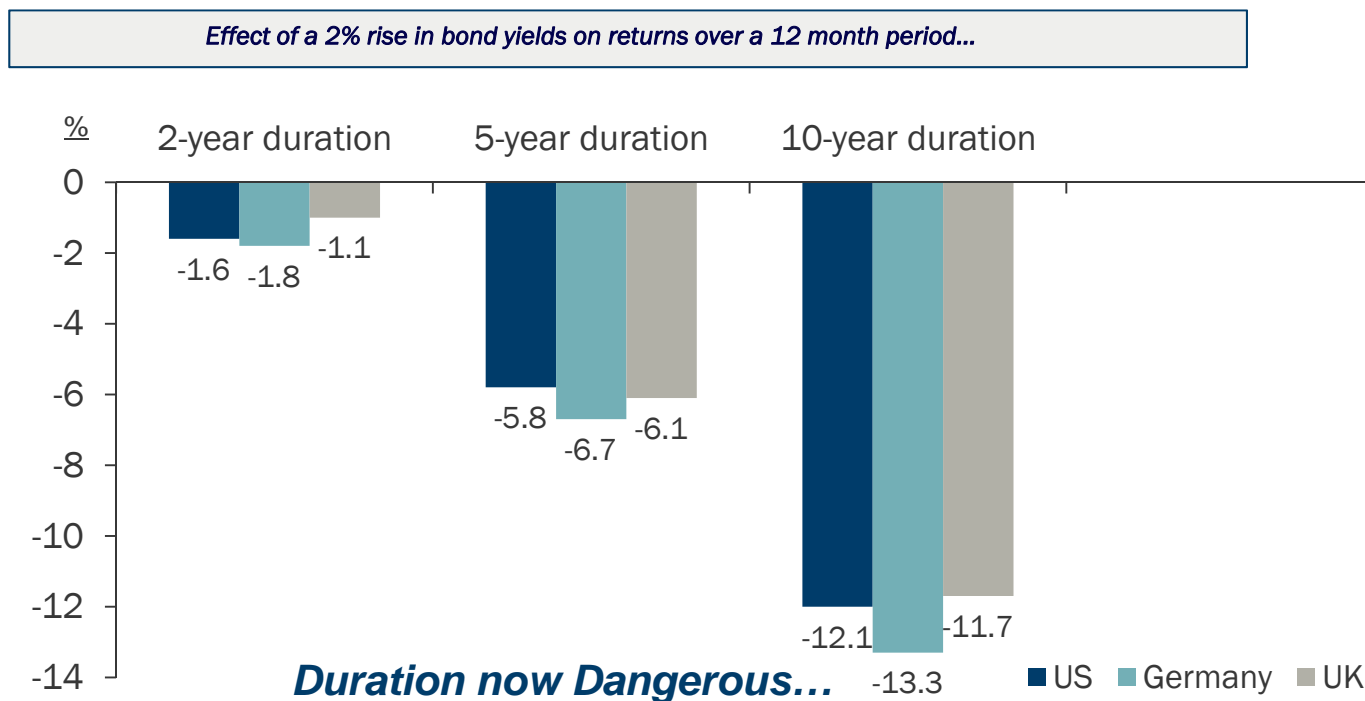
### Rates significantly below 20-year averages



# Fixed Income in the New World

## The Danger of Duration

During a cycle of rising bond yields, any duration exposure can cause heavy losses

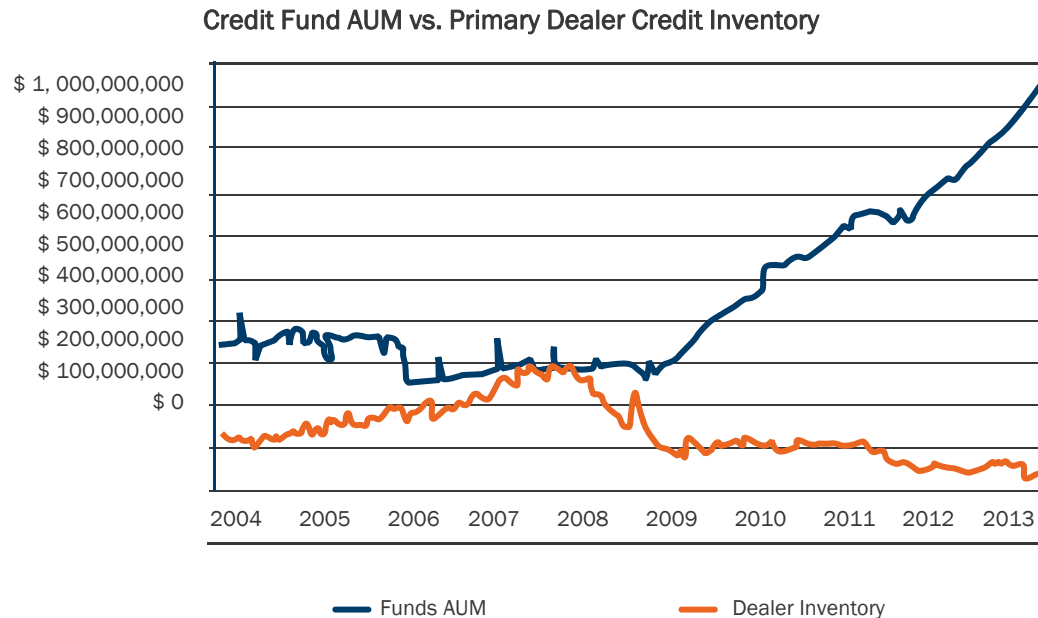


**QE WAS POSITIVE FOR RISKY  
ASSETS. WILL QE REMOVAL BE  
NEGATIVE FOR RISKY ASSETS?**



# Fixed Income in the New World

## Mind the GAP



*Liquidity of Credit also now Dangerous*

Source: Federal Reserve Bank of NY, AMG, EPFR. Data as at July 2013



## Fixed Income in the New World

### I-Shares Emerging Markets Local Currency Bond ETF



## Fixed Income in the New World

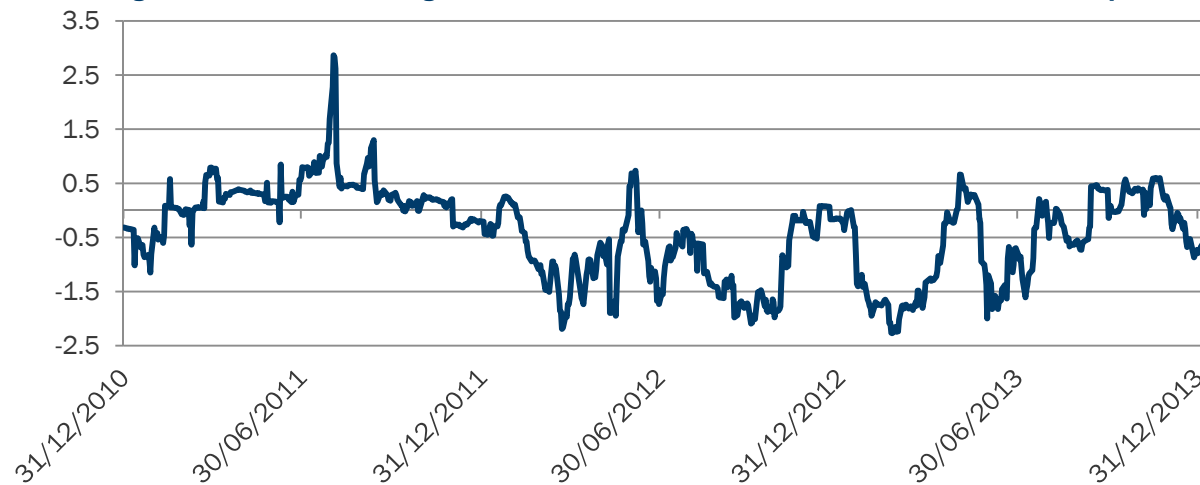
### The Challenges

- We expect greater volatility in the next 18mths-36mths. A good active manager welcomes volatility as an opportunity to add value for clients.
- This increased volatility (and changes in central bank stances) will provide openings for specialist managers versus traditional generalist managers.
- Multiple uncorrelated sources of active returns has been shown to lead to better risk-adjusted returns and better information ratio's.
- Fixed Income in New World means the end of the 30-year bond bull market and a period of rising bond yields.
- As pension fund investors and advisors, this presents us with a challenge –  
**What Do We Do Now?**

## Fixed Income in the New World The Solution

Implement an Absolute Return Bond strategy that is uncorrelated to duration that has the ability to generate returns in all market conditions

**Eg. Duration Positioning of Pioneer Absolute Return Bond Fund Since Inception**



## Fixed Income in the New World

### How to construct a winning Absolute Return Bond strategy?

#### Must have four key characteristics :

- A cash benchmark as opposed to being benchmark-constrained
- The ability to run negative interest rate and credit spread duration positions
- A return which is derived from several well-diversified, lowly correlated sources of alpha rather than having one or two big bets dominating performance
- Strong & disciplined risk management techniques

*'Caveat Emptor'....*

*Be **ABSOLUTELY** sure it does what it purports to do.....*