FTfm Investing in fixed income

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30 years on, low rates show no signs of yielding

Overview

Markets may be skittish but central banks are pumping liquidity in and fears of economic doom have receded, writes **Richard Milne**

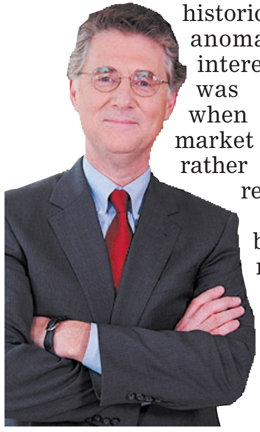
The only way is up,” sang Yazz in the 1980s. It is a feeling that is well known in the government bond markets.

After a relentless 30-year march that has seen US Treasury yields decline with remarkable consistency, interest rates in the big western economies last year reached lows that had not been seen in generations. Calls for the end of this extraordinary run have rung out with regularity in the past few years as investors refuse to believe yields can go any lower.

But with benchmark US, German and UK 10-year rates all around 2 per cent, many investors have stopped singing Yazz and have come round to the view that yields can stay this low for some time to come.

“Of course we are not likely to repeat the rally that bonds have had for the last 30 years but that doesn’t mean that rates are going to [go] back up for the next 30 years,” says Peter Fisher, head of fixed income at BlackRock and a former under-secretary at the US Treasury. He says that, viewed historically, the anomaly for interest rates was in 1982, when the bull market started, rather than currently.

Still, benchmark rates hit lows even by historical standards last autumn. US 10-year yields sunk to 1.67 per cent, their lowest since 1946, while German Bunds hit an all-time trough and UK gilts fell to a level last seen in the 19th century.



Peter Fisher: lessons from history

The reasons why investors believe rates stay low have, however, changed. The end-of-the-world-is-nigh thinking that characterised the markets’ mood at the end of last year has been replaced by a bout of something approaching optimism. The European Central Bank has been instrumental in this change, thanks to its two offers of three-year loans to banks, which has seen a total of €1tn given to the sector.

The European Central Bank has been instrumental in a recent change in investors’ thinking Bloomberg

Investors still worry about growth being moderate across the developed world in the coming years but fears of a eurozone break-up or the US following in Japan’s deflationary footsteps have receded, for the time being at least.

Thanos Bardas, head of global interest rates at Neuberger Berman, sees four big reasons why the US should not suffer from a “Japanisation” effect. First, corporate balance sheets are in a better shape than Japanese companies were in the 1990s. Secondly, banks have largely healed themselves after the crisis. Demographics also count in the favour of the US and, finally, the Federal Reserve has been far more active than its Japanese counterpart in trying to reflate the economy.

“We think the fair value [for bonds] is much higher than where it is,” he says, suggesting US 10-year yields should be at about 2.5 per cent rather than the 2 per cent they traded at last week.

But he sees a limited chance of yields shooting up. He thinks US yields should stay between 1.75 and 2.75 per cent with recent positive good news failing to move bond markets. “Even on good economic data, you don’t see a sell-off because of central banks,” he says.

Low bond yields remain a policy goal of both the Fed and the Bank of England explicitly while the ECB appears implicitly to be using its so-called LTROs, the three-year loans, to influence sovereign rates as well. This stance alone, with a third bout of quantitative easing seen as possible in the US, means yields are unlikely to shoot up any time soon.

‘Core bond markets are liquid and at the end of the day they still yield more than bank deposits’

Shahid Ikram, head of sovereigns at Aviva Investors, says: “We have an incredible amount of liquidity pumped into the system . . . Core bond markets are liquid and at the end of the day they still yield more than bank deposits. The normal supply and demand dynamics are being countered by this excess liquidity.”

Mr Fisher believes central bank intervention was necessary to ensure the banking system did not collapse but that it is a cure for nothing. He says the skittishness of markets is in large part caused by worries about whether the Fed, ECB and Bank of England could be pushing us into the next crisis.

“To a great extent, the risk-on/risk-off environment is caused by the markets’ inability to decide whether the central banks are saviours or lunatics. Mr Market is a bit manic on this point,” he adds.

Government bonds are also in demand as one of the few genuine havens in times of stress. A number of US investors specialising in corporate credit, for instance, say they have a large proportion of Treasuries in their portfolio as their “insurance portfolio”. “It still offers a hedge in the context of diversified portfolios,” says Mr Bardas.

But the number of assets, including government bonds, given a top, triple-A credit rating from agencies such as Standard & Poor’s and Moody’s is shrinking fairly rapidly. That means there is a strong bid for sovereign debt from the likes of Germany and the UK, even if their ratings are under threat.

“You have a limited number of triple-A rated markets left. Rightly or wrongly, they still provide a comfort blanket for investors. So you have probably seen an indiscriminate amount of capital moved into these markets,” says Mr Ikram.

All that said, few investors see government bonds as terribly attractive either compared with equities or just in the fixed income world.

Mike Lillard, chief investment officer at Pramerica, says rates could stay low for the foreseeable future because of a tug of war between competing forces. Arguing for higher yields are big deficits, large refinancing needs and deteriorating credit ratings, but lower yields receive support from high unemployment, moderate inflation, central banks and fiscal tightening.

Mr Lillard says companies are relatively healthier and less likely to see credit rating downgrades than governments. He concludes: “We really think all the value in fixed income is elsewhere.”

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Search for havens boosts corporates

Corporate bonds

Sovereign debt suffers political fallout, writes **Robin Wigglesworth**

Everyone wants a haven during a storm. With governments looking decidedly shakier in many parts of the world, many bankers and investors now argue that high grade corporate bonds are one of the safest asset classes in uncertain times.

As a result, while money has gushed out of equity funds since the financial crisis, investors have rushed to deposit money in funds that focus on investment grade bonds.

"Investment grade corporate credit is an asset class whose time has come," argues Duncan Sankey, head of research at Cheyne Capital, a debt-focused hedge fund. "Not merely has corporate leverage diminished markedly since 2007 but investment grade companies have availed themselves of safe haven seeking bond investors to term out debt."

Fund managers say investment grade credit is particularly attractive at a time when political risks are likely to stalk the government bond markets of many countries in the coming years – particularly in Europe, where the eurozone's debt crisis still spooks investors.

"The attraction is the transparency and certainty," says Richard Dryer, head of global credit at Aberdeen Asset Management. "You're taking a credit risk, but corporates are a lot easier to analyse and evaluate than sovereign debt right now."

With the cost of heading to capital markets falling – thanks both to rock-bottom interest rates in the developed world and blossoming investor demand – and banks still lending only selectively, many companies have started to issue bonds for the first time, or are significantly increasing the bond component of their funding structure.

While bond sales by banks are widely expected to shrink in the coming years, gross debt issuance by investment grade, non-financial companies seeking to reduce their dependence on bank lending will increase by $57bn to $691bn globally this year, according to Joseph Faith, a strategist at Citigroup.

Greek drama: the latest eurozone rescue has failed to reassure investors fully AFP/Getty

Highlighting the appetite for corporate credit, the bonds of large, investment grade companies in the embattled eurozone periphery will often trade at a lower yield than those of their domestic government.

This is the reverse of the custom in developed markets, where corporate bonds have typically traded at a premium, or spread, above the comparable "risk-free" government bond yield. Yet in Italy, Spain, Portugal, Greece, Ireland and even France the debt of blue-chip national champions sometimes returns less than government bonds.

Investors say this could continue for some time, given the companies' diversified, global revenues, and the swirling uncertainty around the eurozone.

"To my mind it's wrong, but it will probably continue," says Arif Husain, head of European credit at AllianceBernstein. "Not a lot of people like sovereign debt these days, while companies have mostly got their balance sheets in order, so a lot of money is chasing corporate bonds."

Indeed, some fund managers argue that the sheer amount of money now chasing investment grade bonds has dented the asset class's attraction.

Triple-A rated US corporate bonds have returned almost 6 per cent to investors over the past 12 months, according to Barclays Capital's aggregate credit indices.

In Europe, triple-A companies have returned a hefty 11 per cent over the same period, as investors have fled peripheral sovereign and bank debt and piled into the safest corporate paper.

"The only problem is that it's a crowded trade, and the returns aren't great in the top names," Aberdeen's Mr Dryer says. "I was positive at the start of the year, but less so now."

If investors start pulling back from high-grade corporate bonds, it could cause some problems.

"The risk is that when you have a lot of money chasing assets it pushes the market up, but if some of that money tries to leave, the exit door can be quite narrow, and that can cause some pain," Mr Husain warns.

Nonetheless, most expect problems to crop up mostly at the lower-rated end of the credit curve.

Although US economic growth seems to be strengthening, and Europe's prospects look somewhat brighter than they did late last year, pressures from bank deleveraging, regulatory changes that penalise lower-rated company debt and continuing sluggish growth could trip up some smaller or indebted companies.

These challenges are particularly acute in Europe. Although the European Central Bank's offer of unlimited, cheap loans to banks has buoyed sentiment dramatically, the latest eurozone rescue of Greece has failed to comfort investors fully.

"Right now it's a battle between technicals and fundamentals," argues Claus Skrumsager, head of European debt capital markets at Morgan Stanley. "The technicals are incredibly favourable for bond markets, but Europe's economic fundamentals are still weak.

"The market isn't pricing in an Armageddon scenario any more, but Europe still clearly has problems."

Right and wrong places to hedge with linkers

Inflation protection

Brian Bollen asks whether this is a good time to invest in the asset class

While economists debate whether the world faces an inflationary or deflationary environment in the short- to medium-term, investment professionals say there is still a place for "linkers" or inflation-linked bonds.

Experts warn that the cost of hedging against inflation in a number of the world's most developed economies has risen so much in recent times that putting such hedges in place will inevitably result in wealth destruction rather than wealth enhancement. Yet in other situations, especially developing countries, linkers are still worth considering.

Pimco sees inflation falling in the US, UK and Europe in the short-term, says Berdibek Ahmedov, its real return product manager. "Looking out further we think inflation will be a risk especially in the US and the UK where the central banks are hellbent on reflating the economy via [quantitative easing] and other stimuli."

Michael D Billy, managing partner at Florida-based Econophy Capital Advisors, agrees that inflation lurks just around the corner, for essentially the same reasons. He also concedes that the wholesale destruction of liquidity in recent years represents a significant counterbalance to this threat.

"It could go either way, depending on the European sovereign outcome," says Laurens Swinkels, a portfolio strategist in the investment solutions department at Robeco Investments in the Netherlands. "For what it's worth, we expect inflation of around 3 per cent a year over the next five years, and we would suggest that around 5 to 20 per cent of a pension fund's portfolio should be in linkers to help compensate."

In a forthcoming research paper for the Rotterdam-based Erasmus Research Institute of Management, Mr Swinkels challenges, inter alia, the view that linkers have become less important in recent years, and comes down strongly in favour of investment in them as one of the few assets that provide direct protection against inflation.

The results of his research indicate that for most countries, inflation-linked bonds expand the "mean-variance efficient frontier" for investors that hold nominal bonds and equities, he says. Hence, investors should allocate part of their investment portfolio to inflation-linked bonds. This result holds in a nominal framework with a monthly holding period.

> 'You have to take your hat off to treasuries and banks for selling inflation protection that doesn't protect against inflation

"We also indicate that inflation-linked bonds are better hedges against realised inflation than nominal bonds," says Mr Swinkels. "Hence, for long-term investors with goals in real terms, inflation-linked bonds would likely be even more attractive. Our results also suggest that governments that have not issued inflation-linked bonds may consider doing so in order to provide a valuable asset class to investors."

Alessandro Ghidini, in-house inflation-linked bonds specialist at Swiss & Global Asset Management, identifies three key questions to ask when assessing the attractiveness of the asset class.

The first focuses on the economic fundamentals of the country in which it is proposed to invest, in particular its debt profile and how that is likely to develop over the next few years. The second is on valuation; asking whether likely positive developments have already been priced in. The third is to assess what protection the bonds in question provide against inflation.

"What is the real yield?" he says. "If you can buy inflation protection, how much will you pay for it? In the US and the UK, for example, investors are even accepting negative long-term yields, which can lead to wealth destruction. The real yield is too low."

Econophy's Mr Billy concurs. "You have to take your hat off to treasuries and banks for selling protection against inflation that doesn't protect you against inflation," he says.

Conversely, Mr Ghidini concludes that inflation-linked bonds in emerging markets can offer a compelling opportunity for financial institutions. Fundamentals are strong, the debt profile looks good and real yields of around 3.5 per cent are available.

"That is a very powerful combination that you don't currently see in the developed world," he says. "Markets are not pricing in excess levels of inflation over the next few years in the emerging market world; this is the best part of the cycle to buy inflation protection there."

Daniel Loughney, portfolio manager, fixed income, at AllianceBernstein, says that, by historical standards, inflation-linked bonds look expensive when the deflation/inflation debate remains so stubbornly unresolved.

Against this backdrop, current forecasts also suggest that the premium for inflation protection looks expensive.

But, he suggests, there is a reasonable risk that the authorities in certain countries will overplay their hand and that inflation could accelerate meaningfully.

"If that happens, you might want to have bought some," Mr Loughney concludes drily.

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Safety warning for investors as old certainties disappear

Government bonds

Fund managers can no longer rely on the so-called 'risk-free' rich countries' debt, says **David Oakley**

Government bond investors are in a dilemma. On the one hand, they have been encouraged to switch into government bonds by new regulations as these assets are deemed safer than equities. On the other, there are fewer and fewer government bond markets that are still considered risk-free.

"In the old days, it was simple. If you wanted safe assets, you bought government bonds. But now there are not many government bond markets that are safe," says Alan Wilde, head of fixed income and currencies at Barings, It means fund managers have been presented with a trickier task in satisfying regulators that want them to opt for caution, while at the same time trying to provide clients with strong returns that outperform the main government bond benchmarks.

It has also sparked a fierce debate over whether a fund manager should play it safe and buy debt that is still considered risk-free or take a chance on higher-yielding bonds and equities.

Many fund managers have taken the safe option and have offloaded eurozone government bonds, leaving them underweight in markets such as Spain and Italy.

Some have taken an even more extreme position with the small, peripheral government bond markets of Greece, Ireland and Portugal, which they are now completely avoiding.

For these managers, the safe assets of governments they think are certain to pay them back, such as the US, the UK, Germany and Japan, are the only option.

Yet, there may be risks in buying this debt too.

Mr Wilde cautions against buying the so-called safe bonds of gilts, for example. He warns that they offer low returns, with the risk that investors may decide to sell because they have become so expensive. That could cause yields suddenly to shoot higher and prices to fall, leaving other investors nursing losses on gilts.

> There is a fierce debate on whether fund managers should opt for higher-yielding bonds and equities

Others agree that buying gilts and other "risk-free" bonds of the US, Germany and Japan present dangers, because the yields, which have an inverse relationship with prices, are too low. The market has gone too far and is due a correction, in their opinion.

For these investors, a better option is Spain or Italy. Even though yields on these government bonds have fallen sharply since the European Central Bank announced plans for three-year loans, they still offer much higher returns than US, UK, German or Japanese bonds.

Other investors go further, saying that Portugal, despite its status as a risky, small eurozone peripheral, is a good buy because its yields are so much higher than those from Italy and Spain and even Ireland, another small peripheral.

Buying peripheral bonds because of high yields may also be a good option because of the continuing support the ECB's emergency liquidity provisions are giving the markets. The central bank's three-year loan tenders have helped to drive yields lower.

One senior investor at a US fund says: "As a fixed income investor, it is now all about the price – whether the price offers value. Gilts, US Treasuries, Bunds and Japanese government bonds are too expensive.

"Safe havens such as gilts are vulnerable to a turn in the market. Fiscal performance is in doubt and Germany has huge contingent liabilities. Any re-emergence of global inflation could hit the four safe havens and see yields rise sharply."

Although the US fund investor concedes there is no sign of that yet, he still prefers the riskier government bonds such as those of Portugal. This is because inflationary pressure can take markets by surprise, particularly if it is driven by oil, which can be volatile due to unexpected events in places such as Iran or the Gulf.

He also likes the bonds of Poland, Slovakia, Slovenia and Russia. There are risks with these bonds, however, because there is no guarantee that principal payments will be met at the end of the maturity term. But he argues that in a world of diminishing risk-free assets, they offer better prospects.

This is a key point.

Even the US, the world's biggest economy, no longer has a top-notch triple-A rating from all the agencies. For many investors, there are risks with holding US debt as well as the triple-A of the UK, Germany and Japan. The US is extremely unlikely to default, but the risks are considered high enough that yields could suddenly lurch higher. The dangers are arguably higher for German debt because of the problems in the eurozone.

In short, it is not as it was before the financial crisis when all eurozone government bonds traded at similar yields with little volatility. Those days, say investors, are gone, probably for good. It is unlikely, for instance, that Greek yields will fall below those of Germany, as they occasionally did before the crisis.

It means an investor may be better off opting for equities or riskier bonds, which offer higher yields and returns. Indeed, some global companies, such as the fast-food chain McDonald's, are safer than the most highly rated industrialised countries.

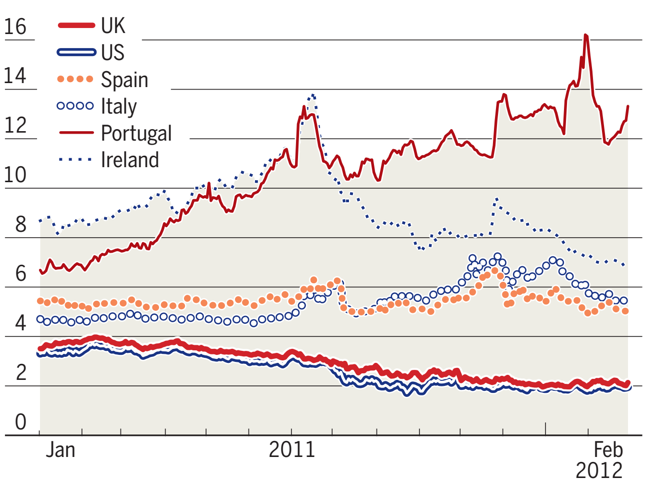
"There is arguably no such thing as a risk-free rate or bond any more. There are risks with gilts and Bunds too," says Mr Wilde.

Peter Schaffrik, head of European rates strategy at RBC Capital Markets, says: "We live in a more complex world. Investors have to be more discerning about what they buy – there are no longer the old certainties. Arguably, no bonds are truly risk-free in this new environment."

Lisbon skyline: Portugal is risky but high yielding Dreamstime

European government bonds

10-year yields (%)



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West's woes prompt rethink on risk

Emerging markets

Investors redirect cash from weaker eurozone holdings, writes **Robin Wigglesworth**

Thriller in Manila: the Philippines is benefiting from increased interest in emerging market debt Colin Beere

The financial crisis has shattered many market shibboleths, but one of the most dramatic is the perception of emerging market risk. While investors fret over the indebted west, they are pouring money into emerging market bonds.

Indonesia and the Philippines now enjoy markedly lower borrowing costs than Spain and Italy, despite the recent rally in the latter's bonds this year. Hong Kong and Singapore can borrow more cheaply than France, and Colombian bonds yield less than Belgium's.

"There is a lot of money interested in emerging market debt these days, and the Philippines is benefiting from that," Roberto Tan, the treasurer of the Philippines finance ministry, told the FT at a recent European roadshow to meet fund managers.

Those managers say their own investors' appetite for emerging market debt has been reignited.

"This is our time," says Simon Lue-Fong, head of emerging market debt at Pictet. "We used to have a more difficult time convincing investors about the merits of emerging market debt. People were very cynical. But there's been a seismic change in perception in recent years."

Indeed, the net asset value of dedicated emerging market bond funds tracked by EPFR Global, a data provider, has climbed from $34bn at the end of 2004 to more than $180bn today.

This still severely understates the amount of money being allocated to emerging markets by many pension funds, insurers, family offices, sovereign wealth funds and central banks that do not report their figures to EPFR.

This stream of money has helped to shelter the bonds of developing countries and their companies from the market turmoil emanating from the eurozone.

The overall blended yield of JPMorgan's EMBI Global Diversified index of dollar-denominated emerging market sovereign and corporate debt remains near an all-time low of 5.6 per cent. At the peak of the financial crisis in 2008 the gauge hit 12.3 per cent, but last year it touched a record low of 5.2 per cent.

Falling borrowing costs have lured many emerging market entities to the debt market for the first time. While global debt issuance, including sovereign, sovereign-linked entities, financial institutions and companies, dipped 6 per cent last year, emerging market debt issuance climbed 11 per cent to a record $849bn, according to Dealogic.

Developing markets accounted for 15 per cent of the global total – another record – and the bond sale rush has continued this year.

Pablo Goldberg, head of emerging market research at HSBC, argues that the financial crisis has accelerated an existing trend of investors reappraising the riskiness of developed and emerging market bonds.

"Europe's fundamentals have deteriorated, so clients have pulled money out of developed markets and put it into emerging markets, where the fundamentals are still improving," says Hakan Sofuoglu, co-head of emerging market credit trading at Citigroup.

Local emerging debt markets denominated in the domestic currency have flourished

Many investors and strategists argue that the trend towards increasing asset allocations to emerging market debt will be supportive for the asset class for some time to come.

"The interest is broad-based – from pension funds, insurers, sovereign wealth funds, endowments, central banks, family offices, everyone really," Mr Lue-Fong says. "But we're probably only a third of the way to what the emerging market debt allocation should really be for most investors."

Encouragingly, emerging debt markets have also matured and developed significantly in recent years. Once dominated by international dollar-denominated government bonds, the market now spans a wide range of assets.

"Emerging market debt now has many more facets to it," says Brett Diment, head of emerging market debt at Aberdeen Asset Management.

Most of all, local debt markets denominated in the domestic currency have flourished. International institutions have increasingly started to target local currency emerging market bonds – once the preserve of local banks and investors – hoping to capitalise on both the higher returns on offer and strengthening currencies.

Inflation can erode returns of local bonds, and emerging market currencies are often volatile – as seen last year, when the resurgent eurozone crisis hammered many emerging market currencies and hurt demand for local currency debt.

Some analysts also caution that the big gains in emerging market debt have already been made, and returns could be less than in the past, when the asset class was still considered more parochial.

Yet fund managers argue that the longer-term trend of emerging market currency appreciation against the dollar and the euro is still intact, and will continue to attract investors searching for extra returns.

"Local currency debt is more volatile, but the returns were pretty respectable even last year. That has reinforced the fact that emerging market credit fundamentals are improving," argues Mr Diment. "Emerging market currencies will continue to appreciate against the dollar in the longer run."

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Sub-inflation gilt returns fuel derisking debate

Pensions

David Rowley looks at new strategies to help fill the yield gap

Pension funds are traditionally conservative investors but the sub-inflation returns of government bonds are encouraging change.

In theory, a 15-year gilt with returns that match expectations of liabilities is an ideal investment. However, heavy demand for haven assets and a fair amount of quantitative easing by governments has pushed real yields into negative territory for the first time in living memory.

As a result, only the most desperate pension funds are currently adopting such a strategy.

Alasdair MacDonald, head of investment strategy at Towers Watson, which advises many of the UK's largest private sector schemes, says: "The high potential cost of derisking at the current time must be set against the risk of further short term deterioration. For very risk averse funds such as those with a weak sponsor and poor solvency level it may still be attractive. However, for many this is no longer the case and so the pace of derisking has slowed."

For those that can afford to wait, he is seeing some sell high performing equities and purchase non-matching bonds such as short-dated index-linked gilts. This protects against spikes in inflation, but retains the option to reinvest at higher potential yields when the bonds mature.

Another wait and see approach is the trigger-based buying of gilts. Here, purchases are triggered whenever a scheme's funding reaches an acceptable level or when yields hit acceptable levels.

John Dewey, managing director in BlackRock's multi-asset team, says that, if yields remain low, schemes will take some pain by reanchoring their yield triggers closer to current levels. However, trigger frameworks have helped some of his clients to profit from market opportunities this year.

"Plans have grasped the opportunities to add value as a result of movements in inflation breakevens and differentials between inflation markets so far in 2012," he says.

In common with many fund managers Mr Dewey advises the use of derivatives wherever a scheme cannot afford to sell growth assets. Here he favours gilt total-return swaps or repurchase agreements on gilts (repos).

The use of derivatives is an area many trustees have shied away from, but there is no shortage of advisers advocating change.

Pfaroe, asset liability modelling software which is accessed online, has recently been offered free to all clients of the mid-tier consultancy Punter Southall – a first for the industry.

The software illustrates to schemes how conventional assets rarely offer smooth expected returns that match promises to pay pensions. It also offers interest rate and inflation swap modelling that shows how derivatives can fill this gap.

John Belgrove, senior investment manager for AonHewitt, agrees. "Synthetic bonds structured correctly allow investors (or fund managers) to be more precise, more flexible, more capital efficient and to profit from occasional market anomalies," he says.

One derivatives-based approach is described by Craig Inches, a government bond manager at RLAM. In this higher risk strategy a scheme will buy corporate bonds instead and put an inflation swap on top.

The use of derivatives is avoided by many trustees but there is no shortage of advisers advocating change

"You are basically buying into a real yield of 1.5-2 per cent, which is something schemes find more palatable than locking into real yields of zero at the long end."

"The problem is it brings in another risk factor which is credit risk as opposed to inflation risk. You take your choice, if you are comfortable with that risk you take that instead of inflation hedging."

Another approach has been the creation of patchwork or synthetic gilts, where the duration curve of a 15-year gilt with an attractive yield is recreated from many parts.

In the specialised, liability driven pooled funds offered by F&C Investments to help keep the cost of such strategies down for small to medium sized schemes, a combination of gilts, interest rate swaps, inflation swaps, gilt futures and repos are used.

Julian Lyne, managing director of institutional at F&C, explains: "You can make an incremental return by being in the most efficient instrument for hedging across the curve. It is still a hedge, but using the highest yielding instrument at each maturity."

Ironically, the evolution of such strategies has come about not just because gilt yields have slipped, but also, says Mr Lyne, as a recognition that swaps no longer reliably yield more than gilts the way they did before 2008.

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Low yields fail to stem flow of funds into munis

US municipal bonds

Continuing low interest rates drive income seekers away from cash, reports **Nicole Bullock**

US municipal bonds, which states, cities and other public bodies use to raise money, defied fears of broad defaults to emerge as a leading investment in 2011.

That stellar run has prompted a flood of cash at the start of this year from investors chasing those returns. But unlike last year, investors in 2012 are buying "munis" at record low yields.

Even Illinois, which is arguably the most troubled of the 50 US states, was able this year to borrow at the lowest rates in its recent history. That has left investors sceptical about the prospects for large returns this year.

"We now have yield levels that are not that appetising," says Richard Ciccarone, managing director of McDonnell Investment Management. "To some extent, the rally has moved some prices higher than they deserve."

Expectations are that the best munis can do this year is to earn their coupons.

But last year, US municipal bonds returned 10.7 per cent, according to a Barclays Capital index. By comparison, US Treasuries returned 9.8 per cent, investment-grade corporate bonds about 8 per cent and junk bonds about 5 per cent.

Lured by those gains, muni funds have taken in $8.6bn already this year, including three individual weeks when net inflows topped $1bn, according to Lipper, the fund tracker. Those inflows also come as income-seeking investors have been aggressively buying assets, such as munis, that offer any kind of incremental yield to cash, which is earning next to nothing. The Federal Reserve has pledged to keep interest rates near zero until at least 2014.

Last year's rally in municipal bonds followed a dramatic sell-off that began at the end of 2010. Concerns mounted at rising defaults after the US recession resulted in several years of ballooning budget deficits.

At the same time, the US economy was picking up steam and some economists were predicting higher rates, which erode the value of fixed income assets such as muni bonds.

In 29 straight weeks from November 2010 to June 2011, investors – largely wealthy individuals who benefit from tax breaks on this type of debt – withdrew nearly $50bn net from mutual and exchange traded funds that buy muni bonds. Muni bonds lost 4.2 per cent in the fourth quarter of 2010.

Munis might face selling pressure if the economy brightens enough for yields on US Treasury bonds to rise

But the default fears have yet to materialise. Instead of rising, yields on US Treasury bonds actually fell to historic lows, bringing the yields on state and local debt with them. Because munis had performed so badly, they rebounded sharply.

Yields on triple-A-rated 10-year municipal bonds dropped to a low of 1.67 per cent this year, according to an index from Thomson Reuters Municipal Market Data, which has been tracking these figures since 1981.

In spite of the low yields, some areas continue to struggle, and analysts now warn this could lead to some renewed selling. Mr Ciccarone also says munis might face some selling pressure if the outlook for the economy brightens enough for yields on US Treasury bonds to rise.

Illinois, for example, is still languishing amid its financial problems.

Moody's this year cut Illinois' credit rating to A2, its lowest for any of the 50 states, criticising the state for not taking steps toward long-term solutions for its severely underfunded pensions and chronic delays in paying its bills.

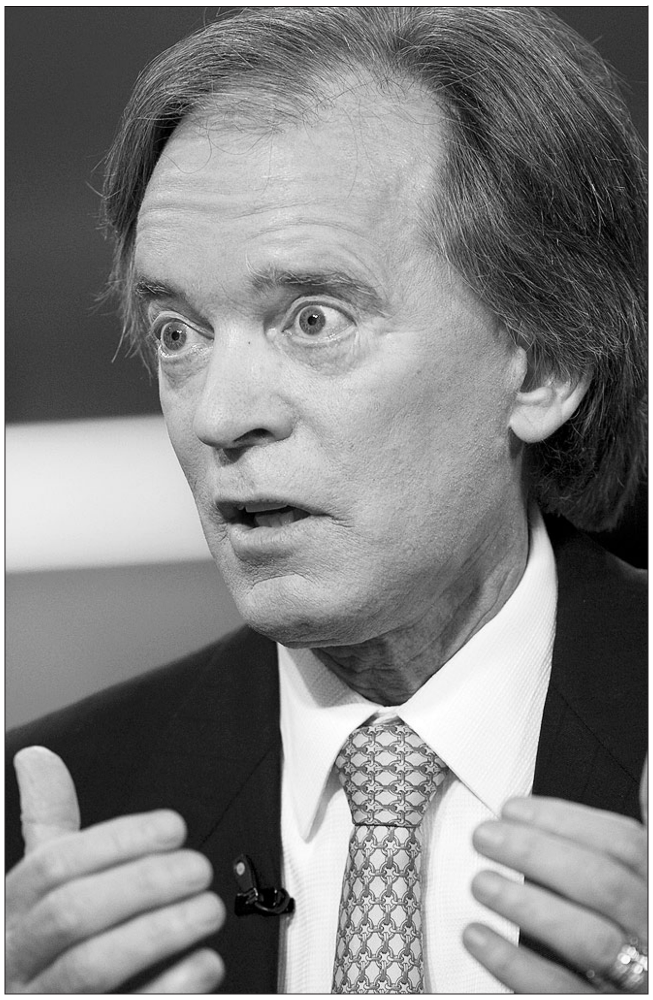
Pat Quinn, governor of Illinois, says the state needs to face its "rendezvous with reality" and to tackle its budgetary problems.

Elsewhere, the struggling city of Stockton in northern California recently decided to suspend payments to some of its creditors and take steps that pave the way for an eventual bankruptcy. With a population of 292,000, Stockton would be the largest city in at least 30 years to seek bankruptcy protection, according to James Spiotto, a partner at Chapman and Cutler, the law firm.

"There are still problems, but these do not seem to have deterred investors," says Marilyn Cohen, the founder of Envision Capital Management, which manages fixed income portfolios for individuals.

"The appetite continues to be voracious. People don't know what else to do with their money because rates are so low."

Spotlight shines on new stars in ETP universe



Fixed income ETPs recently overtook BIll Gross's mutual fund blockbuster in terms of assets Bloomberg

Index investing

Pimco's launch will focus attention on actively-managed ETFs and fixed income ETPs, says **Baptiste Aboulian**

If the popularity of the Pimco Total Return fund is anything to go by, assets in fixed income exchange traded products could be about to reach new highs.

The launch last week of the ETF version of the world's largest bond fund, run by Bill Gross, is one of this year's big events in the US investment industry.

The replica of the $250bn fund will bring a lot of attention to actively managed ETFs, which are still in their infancy, but will also probably draw comparison with the fast-growing fixed income ETP sector.

It is a telling sign that fixed income ETPs recently overtook Mr Gross's mutual fund blockbuster in terms of assets, after they grew 24.4 per cent last year to a total of $258bn, according to BlackRock.

In January, inflows into fixed income ETPs continued, setting a new global monthly record with $9bn of net new assets. In the ETP universe, fixed income gained 3 percentage points of market share to 17 per cent of total assets last year, when the asset class also provided three of the 10 best-selling ETFs.

These figures suggest that ETPs are settling in the fixed income landscape, albeit not in all geographies or asset categories. Last year's expansion was driven by US products, with European fixed income ETFs suffering outflows due to the eurozone crisis and concerns over bank debt.

With political headlines able to quickly influence markets, the ability to allocate funds tactically is one of fixed income ETFs' main advantages, says Alex Claringbull, a senior portfolio manager at iShares.

ETFs trade on exchanges continuously, and provide direct access to what happens in a given market.

Mr Claringbull says: "Investors are less thinking active versus passive or funds versus bonds, but they ask: 'Which fixed income asset exposure do I want?'

"Once you decide which asset class you want to invest in, then the choice of instruments is quite straightforward. You can buy a corporate bond but you need a view on the company, you can also buy a fund, but then you need a view on the fund manager, or you can access directly with an ETF."

Eleanor Hope-Bell, head of State Street Global Advisors' intermediary sales for the UK, says ETFs' ability to play fixed income characteristics such as duration or credit has led to their growing use by US fund managers.

Passive products are seeing steady inflows in categories where it is difficult to own assets directly

In Europe, the market has been slower to take off, which she attributes to structural inefficiencies.

ETF flows are meagre in liquid fixed income asset categories such as government bonds, but the passive products are seeing steady inflows in categories where it is difficult to own assets directly, such as in high yield. iShares iBoxx $ High Yield Corporate bond fund was the most popular fixed income ETF last year with $3.5bn of net new money.

Nizam Hamid, deputy head of Lyxor ETFs, says: "[Fixed income ETFs] are marginal in terms of the core portfolio, but if we want to add an element of credit, triple-A, or a German government call, it may be easier to access them with ETFs.

"Those exposures are far easier to manage in ETFs essentially because of the lack of transparency in the underlying market. "

Not everybody agrees, however, that ETFs are the right tools to get exposure to fixed income. Aymeric Poizot, managing director in Fitch's fund and asset manager ratings group, says: "Liquidity in high yield is difficult to replicate in the world of ETFs, while picking the right bonds is a management skill.

"There is a logic from investors that they should not venture into this space."

Noël Amenc, director of Edhec-Risk Institute, says there are big problems with transparency, especially as fixed income issuance mostly takes place over the counter and investors have no visibility on the construction of the ETFs.

"We don't know where prices come from," Mr Amenc says.

Mr Hamid admits underlying liquidity remains a question for ETF providers, but says that an overlay is added to ensure the products are easily tradable.

He says: "We discuss [liquidity] with the index provider. Clients realise that a broad benchmark cannot be broadly investible. They want a benchmark that they can track."

Tim Gardener, global head of consultant relations at Axa Investment Managers, adds that an issue with fixed income ETFs is that they are mostly based on capitalisation weighted indexes.

They are not an "intelligent way" of diversifying a basket of bonds, as "they pile into companies that are the most indebted", he says.

Junk bond ETFs attract surge of cash

High yield bonds

Growth is part of a broad rally as US economc recovery hopes rise, writes **Nicole Bullock**

Exchange traded funds have become a favourite of many investors for stocks, commodities and other areas of the financial markets over the years and now they are rising in prominence in another spot: junk bonds.

ETFs are a type of fund usually based on an index and that trades on an exchange like a stock.

Junk bond ETFs have surged recently. Annualised growth has gone from 68 per cent in the last 12 months to 244 per cent in the last three, according to Barclays Capital. That includes the cash intake and market returns.

This year has included a record inflow to US junk bond ETFs of more than $1bn in a single week, while net cash inflows surpassed those of mutual funds that also buy low-rated corporate debt in five out of the last eight weeks, according to data from Lipper, a fund tracker.

"We are seeing pretty significant interest in high-yield," says Matthew Tucker, head of fixed income strategy at iShares, who adds that the firm's junk bond ETF is its fastest growing fixed income product. "We have seen a lot of investors get comfortable with ETFs through equities and then look at their portfolio and think about how to incorporate them elsewhere."

The outsized growth is part of a broad rally in junk bonds this year. Since the start of 2012, investors have sought the highest yielding assets as they focus on mounting evidence of a US economic recovery and play down risks of contagion from Europe's debt crisis. The Federal Reserve has also pledged to keep US interest rates near zero until 2014, which means cash investments will offer meagre returns.

But the same low rates are drawing investors to low-cost investments such as ETFs. Average annual expenses paid by investors on junk bond ETFs are about 59 basis points versus 1.16 per cent for high-yield mutual funds, according to Morningstar, the fund tracker.

At the same time, the ability to quickly and easily trade their investments, another feature of ETFs, has also become a priority for many investors.

"When you have had such volatile markets over the last few years, the value of that liquidity is higher for investors," says Brad Rogoff, head of global credit strategy research at Barclays Capital. "You can get in and out [of ETFs] as quickly as you want."

This feature has created a debate over whether the increasing presence of ETFs in the market will also only increase that volatility. Some portfolio managers say the junk bond market is not suited to ETFs.

"The nature of the product is encouraging shorter-term trading in a market that is not a large and deep market like you have in equities and most commodities," says Greg Hopper, senior portfolio manager at Artio Global Advisors.

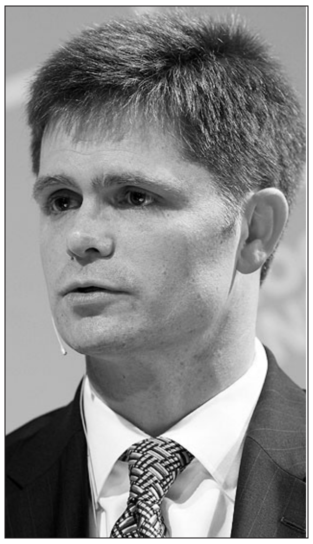
Mr Hopper says that concentrates trading in the bonds of a set of companies that are in the indexes the ETFs use as reference. This in turn increases volatility specifically in those bonds as investors trade in and out of the ETFs.

'The nature of the product is encouraging shorter-term trading'

Mr Tucker at iShares says the ETF industry is still too small to move the needle. He estimates that ETFs represent only 3 per cent of the overall US high-yield market, which is just under $1tn. He also argues that ETFs just make it easier to see volatility because they trade on public exchanges.

"ETFs get a lot of attention because they are so visible," Mr Tucker says. "ETFs are not driving volatility, but just providing a way for investors to view shifts in volatility that have always been occurring."

Complicating the debate is a sharp reduction in what is known as dealer inventories that has coincided with the rise in ETFs, says Chris Taggert, an analyst at CreditSights.



Matthew Tucker: ETFs 'are not driving volatility'

Large Wall Street dealers traditionally have held inventories of bonds to facilitate trading for their clients. These inventories have dropped sharply ahead of tighter restrictions on risk-taking expected from regulatory and banking reforms around the world.

"Any trading activity now leaves a bigger footprint," says Mr Taggert.

Lending a hand as banks pull back

Shadow finance

Chris Newlands explains why some asset managers are offering companies alternative funding

The news last month that Axa Investment Managers is to dip its toes into the previously bank-dominated waters of corporate lending would have come as little surprise to many.

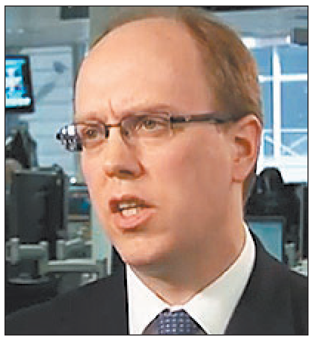
In Europe, around 70 per cent of funding for companies has traditionally come from banks, but regulation and worries over sovereign debt are putting lenders under intense pressure to shrink their balance sheets. As a result, alternative funding sources, such as that of asset managers, are emerging.

Laurent Gueunier, head of structured finance at Axa IM, said in February that there was "a lot of appetite for its corporate lending project", adding that with its new fund it wanted to "be the link" between banks, investors and mid-sized companies, which currently have little access to the financial markets.

The French asset manager says it wants to raise "several billion euros" to finance mid-sized companies in Europe and expects a lot of interest in the vehicle from pension funds and other insurers.

"Our role as asset manager is to invest in asset classes that meet our clients' objectives and needs in terms of credit exposure, risk/return and diversification," says Mr Gueunier.

"Investing in mid-cap European corporate debt allows us to offer our [pension fund] clients a way to diversify their credit exposures with an efficient risk return profile. Furthermore, mid-cap European companies lack diversification in their financing sources and are much too dependent upon banks, which cannot meet the global financing demand in the current environment.



William Nicoll: sees bigger role for non-bank lending

"We are offering these companies the financing flexibility they need."

Shiv Taneja, managing director at Cerulli Associates, expects to see other investment managers follow Axa into the corporate lending market – although he is not convinced it will be a wholesale move.

"The obvious reason [managers are moving into this market] is that banks are pulling back some of their lending to the corporate sector, especially to smaller companies," he says. "That demand is now being filled by asset managers, who feel this is a better bet than investing in the markets.

"But I am not sure it is going to become a mainstream trend," he adds. "I think it's quite a specialised area and one that requires risk management systems that most asset managers may not have. It's also not core to what they do."

M&G Investments has been active in the corporate lending market for what it calls "a very long time" and its UK Companies Financing Fund has made 10 loans since it was launched in July 2009, including £100m to housebuilder Taylor Wimpey in November 2010 and £100m to vehicle hire company Northgate in April last year.

> 'It requires risk management systems that most asset managers may not have'

William Nicoll, director of fixed income at M&G Investments, is convinced non-bank lending will again become a bigger portion of institutional investors' fixed income portfolios.

"Pension funds and insurance companies used to provide long term capital to UK companies and other essential parts of the economy for years before banking deregulation in 1986. But between then and the 2008 collapse of Lehman Brothers, banks priced institutions out of many long-term lending markets.

"However, banks' own cost of funding has risen above the interest rates at which they used to lend money and new regulations are making it more difficult for them to offer long term loans. With competition reduced, institutional investors may want to take back their place as providers of long term debt capital."

Asset managers are being helped in this by the lending initiatives of various governments, which are desperate to breathe life back into their economies.

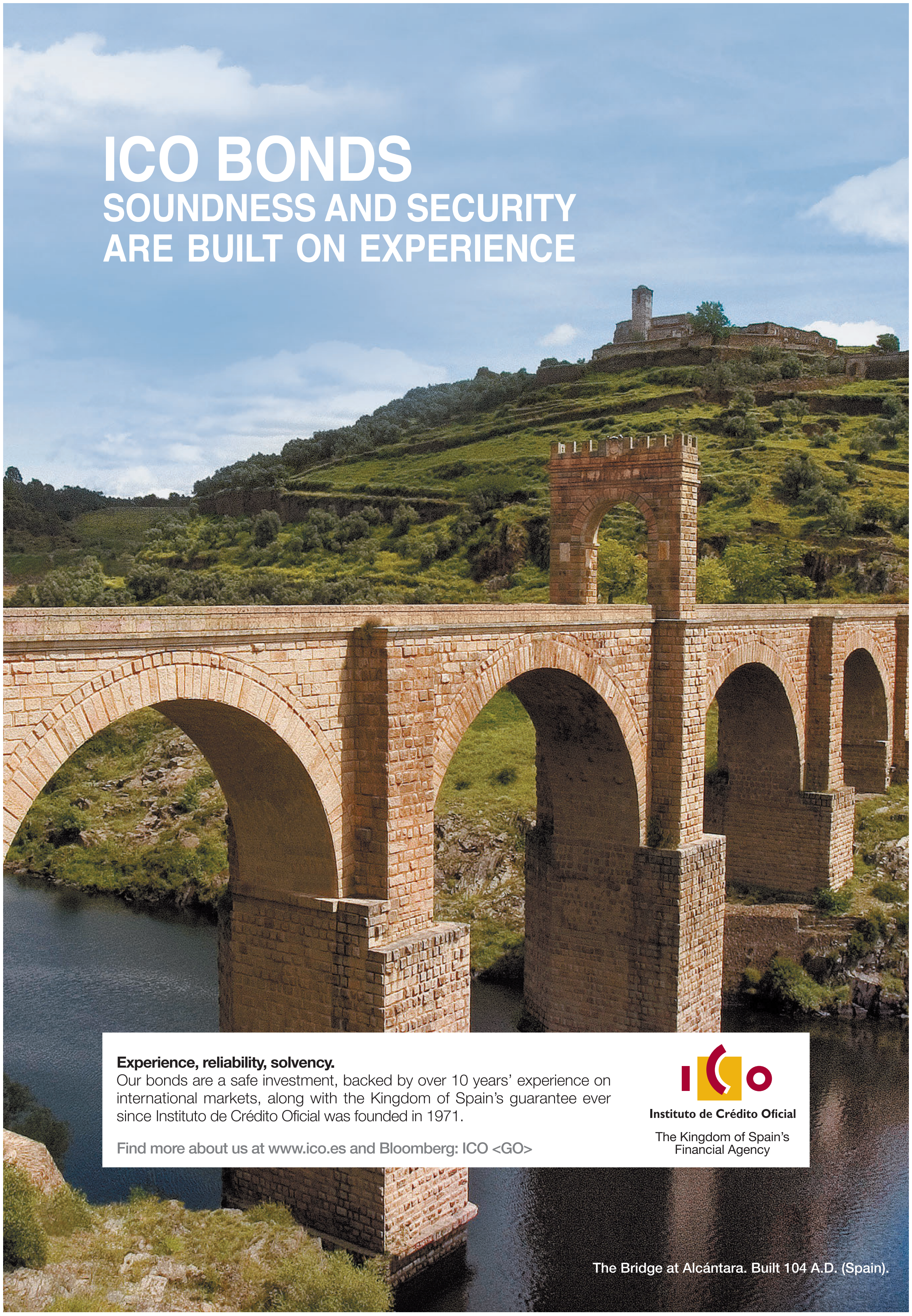
The UK government, for example, announced in November that it would launch a £21bn package of measures aimed at easing the flow of credit to UK businesses, and as part of that it confirmed that it intends to invest up to £1bn, alongside private sector investors, in managed funds that lend directly to mid-sized companies.

At the end of January it consequently issued a request for proposals to fund managers wanting to run that money.

"This is an interesting part of the market right now," says Mr Nicoll.

"As a part of its credit easing policy, the UK government [among others] is looking to encourage non-bank lending to small and medium sized enterprises. Furthermore, it is quite likely that banks' portfolios of infrastructure debt and commercial mortgage loans will come up for sale as new regulations bite. It looks like there will be some good opportunities for pension funds and insurance companies."

The returns for investors can be compared to corporate bonds "with an equivalent" credit rating and term, says Mr Nicoll, but the real advantage is that non-bank lenders write their own terms and conditions – "a powerful tool not available in the public credit markets", he says.



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