Close Brothers Asset Management

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Fixed Income Opportunities

Much has been made of the challenging backdrop for equity markets in 2022, but bond markets have endured an equally torrid time with yields rising substantially. The highest inflation for decades has certainly challenged investors across all asset classes – particularly where correlations have increased and the benefits of diversification reduced. Following the recent selloff, however, the rewards on offer from fixed income securities are significantly more attractive than they have been for some time, with Investment Grade bonds now offering yields of c. 5% and High Yield bonds offering yields of 7-9%. Given these more attractive valuations, our outlook for fixed income is significantly more positive.

That said, bonds remain a fundamentally different beast to equities, offering contrasting risk and return opportunities. First and foremost, the fact that yields have risen should mathematically mean better future returns are achievable for the discerning active investor. As long as a bond issuer does not default, a conventional bond will deliver a return equal to the yield at purchase if held to maturity. Developed market sovereign bonds such as UK government bonds, or gilts, are sometimes referred to as 'risk-free' investments - somewhat of a misnomer as no investment is free of risk. Nevertheless, it is true that the chances of the UK government defaulting on its debt obligations are negligible. Therefore, a 10 year UK gilt now offering more than 2% of 'risk-free' return must, by definition, be more attractive than it was when offering a yield of just 0.5% as recently as the summer of 2021.

For bond investors more broadly, this move higher in gilt yields, coupled with a widening in credit spreads (the additional yield available from corporate bonds above that of an equivalent government bond), means that investors are now seeing some of the most attractive yields for many years, across many different fixed income sectors.

One can also argue that bonds now offer greater capital protection benefits to investors as well. Central banks like the Bank of England (BoE) and the US Federal Reserve (Fed) are currently increasing interest rates in response to rising inflation, which is a challenging environment for bonds, with prices driven down and yields forced up, year-to-date. Should central banks further increase interest rates and do so quicker, and / or to a higher level, than the market is currently anticipating, bond yields could rise further still. However, the dramatic move in yields already this year offers not only the chance of better returns, but should also reduce the chances of suffering significant further losses.

By the same token, should central banks continue to prioritise controlling inflation over employment levels, then the economic outlook could well remain uncertain. If recessionary risks remain elevated, then higher bond allocations within portfolios could be an approach investors take to hedge against the possibility of an economic downturn. If interest rates eventually need to be cut again to stimulate economic activity, bond investors could enjoy strong price returns based on prevailing yields.

On the other hand, given that central banks face an acute conundrum in terms of balancing price stability with economic growth and employment, there is a chance that the market is expecting monetary policy to be more aggressive than policy makers think necessary. Interest rates may not need to rise by as much as the market is currently factoring in, and this could also provide opportunities for active fixed income investors.

Fixed income markets have not been a comfortable place to be invested in 2022, but investors are likely to be well advised not to lose their nerve and allow recent losses to make them too cautious where bond allocations are concerned. Rationally, bonds are safer now that yields are higher and investors receive more meaningful risk compensation in the form of significantly better prospective returns.

As ever with financial markets, timing movements exactly right is nigh on impossible. The likely paths for inflation, central bank action and the macroeconomic backdrop remain particularly difficult to call. However, now that fixed income as an asset class is much more attractively valued it should be well-placed for most scenarios: in a 'middling' economic environment attractive bond yields will simply deliver an attractive income; in a weak / recessionary economic environment, bonds will likely outperform as central banks reverse course and cut rates; and in a strong economic environment, higher yields act as a cushion against potential losses – and corporate bonds in particular should perform well.

Patience will be required, but there is plenty to pique investors' interests. Within the Close Select Fixed Income Fund (which sits within the Investment Association Sterling Strategic Bond Sector), the fund managers have found sufficient risk-adjusted opportunities to reduce the cash position from a high of 15% in December 2021 to just 2% by the end of May this year. As a result of trades locking in higher yields, they have boosted the portfolio's yield-to-expected call to 6.6% (June 2022), having been 2.8% in December 2021 (its yield to maturity is slightly higher still, but the lower figure is likely to be a more accurate measure of yield). The fund managers' patient, active and nimble strategy has enabled the fund to negotiate the recent challenging market backdrop successfully, outperforming the Investment Association peer group by c.1.3% over the first five months of

2022. As well as careful security selection, a short duration position (keeping portfolio sensitivity to rising interest rates low) has been key to delivering strong relative performance.

For the time being, we believe that it continues to pay to remain short duration, but the fund managers stand ready to buy longer-dated bonds if conditions are right. Underpinning our conviction in the Close Select Fixed Income Fund's strategy is the ultimate belief that a flexible approach to fixed income can deliver attractive risk-adjusted returns over an economic cycle.

The flexibility of the IA Sterling Strategic Bond Sector allows fund managers to access a broad range of fixed income assets, from sovereign bonds to high yield and unrated bonds. Furthermore, there are a number of market inefficiencies which a nimble and dynamic bond fund can look to exploit: liability matching on the part of institutional investors, and passive funds having to hold those bonds which form part of the index, mean there are a number of forced buyers in the market. Obtaining credit ratings is expensive, so unrated bonds may also offer opportunities. And being truly active may set the fund apart from the very large bond funds in the sector, which often have to maintain hundreds of individual positons for liquidity reasons, meaning each individually selected idea might ultimately add little value even if it does perform strongly. The Close Select Fixed Income Fund addresses this by adopting high 'active' positions in 50-70 high-conviction ideas with a long term perspective, while a 'bottom-up' stock selection approach and in-depth research underpin these ideas. The fund managers are also experienced investors in unrated bond analysis, and their proprietary rating assessment can uncover excellent risk-reward trade-offs, often providing 'upgrade' alpha if such bond ideas do eventually acquire a formal credit rating.

Bond markets have undoubtedly been tricky. However, it is great to see value appearing again for both multi-asset and bond-only investors. We continue to work tirelessly across all of our funds and services to identify the right opportunities at the right time.

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