Strategic bond investing: Solutions for the new bond world

Bonds play a vital role in all diversified portfolios, helping to provide a regular income and to promote more stable, less volatile returns. However, in the current challenging market environment investors may need to re-evaluate their bond investments.

UK Gilts, for so long the staples of most bond portfolios, appear to offer little long-term value at current levels, with ten-year Gilt yields recently hitting their lowest point since the 1890s.

In contrast emerging market debt and corporate bonds, which have traditionally played a more marginal role in most portfolios, increasingly offer more attractive options for investors looking for attractive income options and the potential for long-term capital gains.

To take advantage of opportunities across global bond markets, investors may wish to consider a strategic bond fund investment, which has the flexibility to adapt its holdings depending on the prevailing economic environment so that your bond portfolio is always optimally positioned.

You should remember, of course, that currency returns may impact the value of global bond investments, while emerging market bonds and corporate bonds carry a higher level of default risk than Gilts.

Nasty economy is no friend to Gilts

Gilt yields are being pushed lower by the threat of a double dip recession and by risk aversion as investors seek out safe havens from the eurozone debt crisis. For bond investors, this weak growth environment and the continued flight to quality has been positive for returns in recent years.

However, there is now a major risk to this benign backdrop – namely stagflation. Stagflation's combination of weak growth and high inflation presents one of the worst possible scenarios for bond investors. Economies function best when they are growing at a moderate pace, with modest inflation. This was the case in much of the western world from the mid 1990s through until the mid 2000s – a period that Bank of England governor Mervyn King has referred to as the 'Nice' decade (non inflationary, consistently expansionary).

Today the developed economies are seeing a much more elevated rate of inflation, but economic growth has dropped below trend. The Nice decade has vanished to be replaced, as Financial Times columnist Martin Wolf has put it, by something much more 'Nasty' (nightmare of austere and stagflationary years). This Nasty combination of high inflation and low growth is the enemy of fixed income investors, as it erodes the future value of a bond's interest payments and its maturity value.

On the face of it, the outlook therefore does not look favourable for developed bond markets, which are confronted by high headline inflation and low nominal rates of growth. Fortunately, the global fixed income markets are broad and diverse. Even though some developed economies are at risk from stagflation, there is still considerable value to be found for bond investors..

Avoid cash and government bonds

In the current environment, cash deposits and developed world government bonds do not look attractive. Record-low interest rates and rising inflation mean the real interest rate available for cash deposits in the US, UK and eurozone is negative. When adjusted for inflation, bank deposit holders are seeing the value of their money gradually eroded.

Government bonds also appear to offer little value. Using a combination of real GDP growth expectations and inflation forecasts to work out a theoretical yield suggests that current yields for US, UK, German and Japanese government bonds are significantly lower than would be expected. Added to this, bond issuance is still high, despite austerity measures to cut fiscal deficits, while the investors also face uncertainty over the unwinding of quantitative easing measures implemented in the US, UK and Japan.

Three to consider – investment grade credit, high yield and emerging market debt

In this new bond world, opportunities in investment grade credit, high yield and emerging markets look attractive for bond investors. High yield bonds, for example, offer a high coupon, averaging around 7% per annum, which gives good inflation protection. Also, default rates are continuing to fall as companies strengthen their balance sheets and benefit from rising profitability. As default rates fall, the spread over US Treasuries (a measure of high yield risk) should continue to tighten in the long run. Investors should be prepared for some volatility, as high yield bonds have a high correlation to equities and so will be likely to experience bouts of volatility when equity markets correct. But given the strong fundamental valuations we would see any market weaknesses as a buying opportunity.

Investment grade credit spreads ballooned out during the financial crisis of 2008/09, providing a once-in-a-generation opportunity for investors to buy investment grade bonds at extreme valuations. Spreads have contracted a lot since then, producing significant gains for investors. Although they remain above the pre-crisis levels of 2007, it’s unlikely that spreads will reach those levels soon given the different capital requirements that now exist for corporations. However, for investors with the credit research abilities to seek them out, there are many attractive stock-specific opportunities within the investment grade space. Therefore, investors should look to access this sector using a manager with strong credit analyst resources that are able to hunt out value and mitigate against default risk.

Finally, emerging market debt continues to look attractive as a selective opportunity. Credit metrics are much more attractive in the emerging world than the developed world. Emerging markets have lower debt-to-Gross Domestic Product (GDP) levels and much higher economic growth rates, which means they have the resources to repay lenders. This is reflected by the credit rating agencies, with many emerging markets being upgraded while developed economies are seeing downgrades. Emerging markets, however, face rising inflationary pressures, which mean investors need to look closely at real yields to see if they are being compensated to take on inflation risk.

JPM Strategic Bond Fund: Release the constraints to capitalise on bond opportunities

You can capitalise on the opportunities presented by today’s complex global bond markets by replacing rigid bond benchmarks with cash and taking a strategic view across global bond markets

and sectors. Such a flexible, international approach can help improve diversification and boost risk-adjusted returns.

By allocating flexibly across global bond markets and sectors, investors can access a huge global opportunity set and position themselves wherever the greatest opportunities lie in this new bond world.

The JPM Strategic Bond Fund is a low volatility bond fund, which targets returns of cash plus 3% net of fees over the interest rate cycle (three to five years). The fund emphasises capital preservation and low volatility returns, which makes it ideal for clients looking for a stable bond fund at the heart of their portfolio.

1. **Benefits from a flexible, unconstrained approach**
   Unconstrained portfolio construction and flexible allocations across the global bond spectrum help to reduce volatility across the economic cycle.

2. **Tap into a strong performance record**
   Investors have enjoyed very competitive returns since the fund launched in May 2009, with low volatility and minimal currency risk. Please remember however that past performance is not a guide to the future.

3. **Outsource your fixed income asset allocation**
   Experienced fund managers choose your optimal bond allocations, backed by the research from our extensive teams of credit analysts and dedicated bond sector specialists.

4. **Enjoy the backing of an integrated global investment process**
   Our investment decisions incorporate research from all global fixed income sectors, including government bonds, investment grade, mortgage-backed securities, emerging market debt, high yield and currency.

5. **Invest with one of the world's largest fixed income managers**
   Fixed income is our largest asset class and is crucial to our business. We have nearly USD 795 billion[1] in fixed income assets under management and over 600 investment professionals dedicated to bond investing.

Points to remember Investors should also remember:

- The value of investments and the income from them may fall as well as rise and investors may not get back the full amount invested.
- Bond funds may not behave like direct investments in the underlying bonds themselves. By investing in bond funds, the certainty of receiving a regular fixed amount of income for a defined period of time with the prospect of a future known return of capital is lost.
- Bond prices can fluctuate significantly depending not only on the global economic and interest rate conditions but also on the general credit market environment and the creditworthiness of the issuer.
- The credit quality of high yield bonds is below investment grade and they usually offer higher yields to compensate for the reduced creditworthiness and the increased risk of default relative to investment grade bonds.

[1] Source J.P. Morgan. Assets under management as at 31 March 2011 stood at USD 1,329 billion: Equities USD 369 billion, fixed income USD 795 billion, balanced USD 52 billion, other USD 114 billion.

- Bonds with a lower credit rating may have a higher risk of defaulting which may in turn have an adverse effect on the performance of Funds which invest in them.
- The investment policy of the Fund permits the use of derivatives and/or forward transactions for investment purposes. As a result the Fund may sometimes be leveraged, potentially increasing the volatility and therefore risk of the Fund.
- The Fund may have a significant exposure to asset and mortgage backed securities (ABS and MBS). Owing to the nature of some ABS and MBS, the exact timing and size of cashflows paid by the securities may not be fully assured.
- Bond funds will normally distribute a combination of coupon and the expected discount/premium on the securities. Therefore, a Fund's distribution will comprise income received and an element of projected capital gains or losses. This could result in an element of capital gain being taxed as income in the hands of an investor.

The Fund may suit investors who are seeking to maximise returns in a higher risk environment through a combination of capital growth and income through investment in bonds. Investors should have at least a five-year investment horizon.