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Knowledge Transfer Program
Module 2 - Back to Fixed Income

Is it time for investors to revisit their fixed income allocations?

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Opportunities in fixed income

- Despite the challenges we are experiencing in fixed income, we also see some opportunities going forward. That's why we think that it is very important for institutions who have exposure to this asset class to really think closely about their asset allocation and to position themselves for the opportunities that we think are out there.
- In the world of sovereign institutions, we deal with different investor profiles with different investment needs. We develop model portfolios to reflect their different requirements and these are reflected in two main categories. The first category we call the 'liquidity tranche', which is subdivided into a 'central bank working capital portfolio' and a 'stabilization portfolio', while the 'investment tranche' incorporates the 'savings portfolio', which are typical of long-term investors with a much broader investment allocation who invest in both traditional and alternative asset classes.
- When we model sample portfolios, we always start with government bond portfolios. It's fair to say that what has happened in government bond markets is unprecedented, at least in terms of the magnitude of the losses that fixed income investors have suffered in 2022, year-to-date.
- Looking at a hypothetical global government bond portfolio, split across the leading advanced economies, in a long duration portfolio, YTD losses are running at around -8%. This portfolio last suffered losses in 2013 at the time of the Fed's 'taper tantrum' and the European fiscal crisis and also in 2009, after the GFC.
- What is unprecedented are the losses experienced by investors in short duration global government bond portfolios. Negative performance started during the final quarter of 2021 when the market began pricing in higher interest rates and this continued in 2022, with losses that we estimate at around 2% YTD for a hypothetical portfolio.

Diversification improves returns

- Within global sovereign markets, we model different portfolios. For central banks, we have five model portfolios, ranging from CB1, which is a very liquid and a very conservative portfolio, to CB5, which is a more diversified portfolio, and includes equity as an asset class.
- When we look at the stabilization funds, again we have three types of model portfolios (Stab1-3), which are very much focused on liquid and high grade government bonds, but with a longer duration to boost returns, while some also allocate to equity and real estate.
- We also have three portfolios typical of sovereign wealth funds, Sav1-3. Sav1 is very similar to the Norwegian pension fund, which is largely public markets oriented with a high allocation to equity. Sav2 is a portfolio very similar to the Singapore GIC, where you have a higher allocation to alternatives. And Sav3 is a portfolio that we describe as an endowment model portfolio, which has an allocation to alternatives that is higher than 50%.
- From a historical perspective, diversification within fixed income or by adding equities has been shown to boost returns while keeping risk/return relationships relatively stable. For the CB1-5 model portfolios,

looking at returns against standard deviation since 2002 to end of July 2022, the portfolios have performed in line with their risk exposure, with CB1 showing the lowest return with the lowest standard deviation, while CB5 has the highest return and the highest standard deviation.
- Looking at the Sav1-3 and Stab1-3 portfolios, from an historical perspective they have also been generating very good returns, of between 3% - 4% for the stabilization funds and rising to close to 8% for the savings funds, which have a higher allocation to equity and alternative asset classes.
- This compares, for example, to the so-called balanced portfolio, (60/40 equity/fixed income split) that generated a return close to 6%.

Are things different today?
- We think very hard about future economic scenarios and we have modelled four different scenarios. The first is a 'soft landing', which is a benign scenario, where over the next five years inflation comes down towards the target of 2%. We also have the 'stagnation' scenario where the rise in interest rates will not prevent the global economy from going into recession and where inflation drops very quickly to target and interest rates fall from current levels.
- We also have two inflationary scenarios. One is 'stagflation', where we see low growth and high inflation. The increase in interest rates is substantial as central banks attempt to lower inflation expectations. The other is the 'growth and inflation' environment, where growth picks up very strongly, while inflation remains high, and interest rates also rise.
- We take these scenarios and apply them to our model portfolios. Today, are we moving into a completely new regime given what's happening on both the inflation and on the economic sides? Jonathan Gregory will explore that question in the next presentation.

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