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OPINION

Markets Insight

Bond investing needs a complete rethink

Lessons from the past might be less relevant for current portfolios

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The world is changing. The management of fixed income portfolios has to change with it. Looking forward now from any perspective is very different from times past.

I managed fixed income investments from 1958 until earlier this year, riding one of the greatest bull markets in bonds. Managing any portfolio now requires a complete rethink. There are lessons from the past but their overlap with the present and the future has diminished a lot.

Specifically, the current liquidity level in the bond market is unique. The flow of money seeking a higher current return has narrowed the spreads at which corporate debt trades over government borrowing benchmarks. This has made it possible for companies with marginal credit ratings to both refinance and raise new money on very attractive terms.

The US Federal Reserve is replaying some history. It is supporting the Treasury in "war finance" as the battle against Covid-19 continues. This, along with the speculative attitude in the markets as a result of Fed actions, feeds the liquidity that is likely to stay quite good for a long period of time.

Any major jolt that hits the markets, however, could undo the base for the substantial investor leverage that has made its way into them. It is assumed that leading central banks would race to support markets and that is, in most cases, a valid assumption.

But leverage depends on confidence. Should confidence start to unravel, the excess liquidity would rapidly depart. Central banks are watching this carefully but might not be able to control it.

The other overwhelming factors for forward-looking portfolio management are climate change and geopolitical risks.

Climate change is strongly influencing where and how money is invested. Furthermore, it is changing the viability of investments made. In some cases, past investments are appreciating in value and spurring further investment in the same areas. In others, past investments are sharply depreciating in value. Thus, the need for focused credit research is essential.

All nations must co-operate in fighting global warming. This will be extremely difficult in view of the different methods of government and rising pressures between countries. The possibility of serious conflict between nations is rising.

Many economies also are having to adjust to substantial change in the supply chain. Some of these are due to climate change. Others are due to geopolitical change and Covid-19. The impact on individual industries and companies is substantial and will become more so in the future. Capital flows will obviously be affected.

In addition, government debt around the world is increasing. There will be more pressure for large countries to assist small governments. Overall, government balance sheets will be more difficult to keep in balance. Inflation is very likely to become more difficult to control.

So, what does the bond portfolio manager do? We will have to devote more effort to determining credit risk/reward than in any time past. The same is true for the balance of different maturities of assets in portfolios.

Another major factor for both borrowers and investors to consider are changes in national tax structures.

In the US, for example, it is quite likely that the federal tax rates on investment income and capital gains will rise. Also in the US, a number of states may do the same. Therefore, the comparison of tax-adjusted returns on current income and capital gains or losses will clearly affect relative valuations across the fixed income spectrum.

Unless investors have to meet specific fixed payments in the future, such as for defined benefit pension payments, maturities should be shorter than normal. Further analysis of individual credit risk is very necessary and should have a cautious bias. Liquidity of individual holdings will be increasingly important as we move forward.

The bottom line is to hold the bulk of a fixed income portfolio with a spread of maturities over three to 12 years and a bias towards companies with improving creditworthiness.

Some longer-term investments may be made when unique situations appear with the promise of improving credit and price relative to the market. In a few cases, there may be attractive opportunities in bonds that can convert into equity and other fixed income assets with special features.

The writer is a senior adviser and vice-chairman at Loomis Sayles. He managed mainly bond funds at the company from 1976 to earlier this year.