Weekly Manager Views – 26 March 2014

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Long Only and Absolute Return Fixed Income

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GAM Star Absolute Return Bond, GAM Absolute Return Bond Fund, GAM Star Dynamic Global Bond, GAM Star Absolute Global Portfolio

- Since around mid-February, we have seen some pronounced movements in the US yield curve, with the short end increasing in yield, while the yield on the long end at 30-years has declined. We have seen similar moves in Germany and in the UK, but much less marked. Meanwhile, the opposite is the case in Japan, which is what the authorities had intended.
- In emerging markets, the yield curves of Mexico and Brazil as well as the South African rand have all rallied somewhat, while high yield bond spreads have contracted. Investment grade spreads were broadly unchanged, while global equities have seen mixed fortunes since mid-February. Overall, the environment has been challenging. In particular, the fast-moving Crimean crisis has sparked risk aversion and volatility. We currently have no net exposure to Russia, although it is interesting to note that the rouble is recovering, while bonds have stopped falling.
- What is of even greater significance for core fixed income markets is the Fed's strategy. Following the latest meeting, the question now is the precise definition of a "considerable period". So far, the approach of the Fed has been 'slow and low' – a slow rate of interest rate hikes and a low terminal value. It might not be quite as slow in the future, although the terminal value should still be low. As a response, we have focused on investing some cash into US 3-year bonds, where the spread over Bunds is rather wide, while currency hedging costs are minimal.
- The instrument of choice for interest rate hedging used to be bond futures, but we have recently started to use swaps. This approach allows us to be short interest rates also at bank level. Swap spreads have started to widen slightly since November, but this has not yet had an effect on our portfolios.
- High-yield bonds and convertibles share some of the same characteristics, but we clearly prefer convertibles in an environment of rising interest rates. Our analysis shows that historically convertibles outperformed high yield in that environment. Hence, we have now actively started to cut our credit exposure, particularly in high yield, while we previously had simply allocated fewer inflows to the asset class. On top of that, we are seeing select bonds that trade below par being called by the issuer, which shows that our stock selection process is working as planned. Interestingly, we are still seeing market participants buying into high yield bonds offering yields below 3%, which is the rate that we are selling our bonds at, since that is simply no longer reflective of the risk inherent in the asset class. Our suspicion is that once liquidity seizes, it will be such a rapid switch that investors will then no longer be able to sell. Another indication that the market is overheating is that new issues are no longer outperforming.
- Looking at emerging markets, yield curves in numerous local bond markets, such as Mexico and South Africa, have steepened or moved upwards since April 2013. The steeper curve in Mexico has benefited our forward-starting positions that are focused on the long end. In South Africa, the fear of rate hikes has also caused the short end to sell off, pushing 4-year bond yields up to 8%. If the central bank hikes rates by less than the market expects, yields will come down, which is what we anticipate. We have therefore added to our position in this area.

Global Convertible Bonds

Jonathan Stanford
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GAM Star (Lux) – Convertible Alpha

- Following several years of offering cheap bonds on good valuations, the convertible market is now becoming more expensive in reaction to strong demand. However, regional disparity remains, with the US market proving the most expensive, followed by Europe, while Asia and Japan offer considerably better value. However, we believe these more elevated valuations will remain steady, particularly in the investment grade sector, sustained by strong demand from Europe and a significant amount of upcoming maturities and redemptions in Asia.
- Asset inflows year-to-date into convertibles have been significant, building on the momentum generated during 2013 as investors began to switch out of the high-yield market following tapering concerns. Following the Fed's latest update on its tapering policy, US Treasuries could become more sensitive to any positive data releases and economic growth updates. With rates having moved sideways since last summer, the safe-haven status of Treasuries could be weakened and subsequently impact bond prices, particularly if the geopolitical situation in the Ukraine cools. For investors who fear interest rates rises, convertible bonds pose as a very sensible alternative to government issues.
- The high valuations of investment grade convertibles are reflective of their scarcity. Of all 27 new issues in the US market year-to-date, none have been of investment grade and only two have had any rating at all. Bearing in mind that some 30% of this year's redemptions and maturities in the US have been of investment grade bonds, it is easy to see how demand is becoming inflated. In Europe, the situation is a little better, as close to 40% of 2014 issuance has been of or close to investment grade level.

- In the primary market, we have seen 17 European issues this year, totalling just under EUR 5 billion. In the US, the 27 issues to-date total just under USD 10 billion, with the bigger deals including Tesla, Herbalife and Jardine.
- Credit spreads are very tight and also volatile, and are likely to remain so unless we see suggestions of increased default rates coming through – which is unlikely in the current environment of easy monetary policy. In Europe, the strength of the euro is causing some concern regarding companies' earnings power, which could also impact the credit markets.
- Our positioning remains very defensive – we currently have a 10% cash position and a 27% delta exposure in GAM Star (Lux) – Convertible Alpha, reflecting both the current geopolitical concerns as well as elevated equity multiples, particularly in Europe. We believe these multiples require a pick-up in earnings in order to become justified. The fund's Rho is around -0.9. To enhance our defensive positioning, we are moving out of high delta names, these typically being bonds we bought when they were balanced, and that have subsequently gone deep into the money with strongly negative yields. We are looking to replace these positions with new issues. These adjustments also help to keep the fund's yield-to-maturity figure above zero, although this is becoming increasingly difficult to achieve.
- Year-to-date, the US dollar class of the fund is up 1.2% (to 25 March). Our average credit spread now is approximately 205 bps, contracting from around 235 bps at the beginning of the year. Realised volatility is approximately 3% on a 365-day measure. The average yield to maturity is 0.4% with an average coupon of 1.6%. Geographically, we have approximately 55% of our exposure in Europe and 25% in the US, with the remainder spread across the emerging markets of Eastern Europe, Latin America and Asia.
- Reflecting the uptick in valuations, we are avoiding French investment grade names, which tend to trade extremely rich. Instead, we favour new issues. Our nimble fund size works to our advantage here, as even a small allocation can have a significant impact on our positioning.

Discretionary Fund Management

Charles Hepworth
Investment Director, GAM

GAM Star Global Equity, GAM Star Growth, GAM Star Balanced, GAM Star Cautious, GAM Star Defensive

- March has been a challenging month for markets. Across our five models, the only notable areas that have yielded positive performance have been our US exposures, thanks to the dollar strengthening against sterling, and emerging market plays.
- Being positioned overweight Japan has been a key theme for us since summer 2013. After a strong run, the Japanese market started to weaken in January, and our exposure is down around 4.5% on the month, reflecting the anxiety around the upcoming consumption tax hike. However, our expectation for the market is the continuation of further economic stimulus, hence we believe the position will recover in due course.
- Looking at cyclical plays, our positioning is performing well on a global basis. One of our most recently purchased positions is focused on profiting from the global recovery. The manager sees increasing value in the emerging markets (EM). This is a view that we echo, and we are looking at increasing our EM exposure during the second quarter.
- Our long-standing private equity exposure continues to be a positive contributor to the models.
- In our absolute return positioning, we adjusted our exposure to favour a more long bias to equities across the second half of 2013. One of the strongest performers within the category since purchase has been a global macro fund, which can take tactical positions in all asset classes, although it has a predominant equity bias. The manager has been exploiting his tactical abilities year-to-date – adjusting from a 0% net long equity exposure in January to an 83% exposure in February before reducing this to around 32% now. These adjustments are reflective of the manager's macro expectations, namely: only a modest impact of the 'fragile five' problems on global growth; steady growth in China, as opposed to a hard landing; and solid economic growth in the US, driven by consumer spending. The manager is also long Portuguese 30-year bonds and the Indian rupee, and has delivered 2.1% year-to-date.
- In our fixed income portfolio, the only recent activity has been the sale of one position as the fund size had become very small. We replaced the holding with an absolute return bond fund, which has a directional, relative value approach. The manager is positive on US and UK growth, and broadly positive on the EU with the caveat of lacklustre growth, while recently turning neutral on Japanese government bonds. They currently have a short emerging market bias and are positioned for this with a short on the Australian dollar.
- Following the disposal of all of our emerging market fixed income exposures during the course of last year, we are monitoring the asset class closely, looking to possibly rebuild some exposure in the near future.

Source: GAM