In association with

PICTET 1805 Asset Management

CHAIR

**PAUL WHELAN**
**Fixed Income Manager Researcher of the Year, Aon**

Paul is UK head of fixed income manager researcher for Aon. He is responsible for covering the full spectrum of fixed income asset classes and is an active member of the UK fixed income views team, working to expand the breadth of the team's output, formulating appropriate scheme hedging levels and informing the advice we give to clients on managing their liabilities.

**ANDRES SANCHEZ BALCAZAR**
**Head of Global Bonds, Pictet Asset Management**

Andres joined Pictet Asset Management's fixed income team in 2011. Before joining Pictet, he was a senior portfolio manager for Western Asset Management Company Ltd for six years. During his tenure he was responsible for global, European and absolute return fixed income portfolios. Prior to that, he worked for Merrill Lynch Investment Managers.

**TOM BALAAM**
**Investment Manager, MS Amlin**

Tom joined MS Amlin in September 2013 from Lloyd's of London, where he helped manage fixed income portfolios. Starting from an analyst role, Tom is now an investment manager in the multi-asset portfolio management team at MS Amlin. His responsibilities include asset allocation, macroeconomic analysis and portfolio construction.

**IAN COULMAN**
**CIO, Pool Re**

As chief investment officer, Ian is responsible for the development and implementation of investment strategy, strategic asset allocation and the monitoring of the range of managers through whom Pool Re invests. Prior to joining Pool Re, Ian was managing director of Butterfield Asset Management, a wholly owned subsidiary of Butterfield Bank.

**CLARENCE ER**
**Senior Life Consultant, Hymans Robertson**

Clarence is a senior consultant in the life and financial services practice at Hymans Robertson, specialising in the fields of insurance investment and risk & capital management. He is a life actuary with over eight years of experience across industry and consulting. Clarence has also worked on insurance models used to value various illiquid asset classes.

**NEIL PARRY**
**Portfolio Manager, Beazley**

Neil joined Beazley in 2014 and is responsible for the management of the investment grade fixed income portfolio and the selection and oversight of external fixed income managers. Prior to that he worked in a similar capacity for Beazley subsidiary Falcon Money Management. Before this, he was a trader in credit derivatives at CQS, a London based hedge fund.

# DEMYSTIFYING ABSOLUTE RETURN FIXED INCOME

**CHAIR**: Where do you see markets at the moment, and what are your views on fixed income?

**BALCAZAR**: We've been through what we would qualify as a risk on year. A lot of people are calling it the FOMO rally, because not a lot of people are convinced that this is the right time in the cycle to actually have such a stern rally in risk assets. We tend to believe that actually, right now, we are in a sweet spot for our markets, mainly because Central Banks across the board have moved away from the position they were at the beginning of last year. We also have the added potentiator that the Chinese Central Banks and the Chinese Government, are very much engaged in to achieving higher growth in China. From a policy perspective of the markets, it is a very constructive feeling at the moment. From a growth perspective, it is probably less so. I think from a fixed income perspective, having mediocre growth and mediocre inflation, is actually also a pretty good situation to be in. We like things to be stable, growth to be not too hot, not too cold, and inflation low, even though you could argue that you may have some rises in certain areas. From a fundamental perspective, there is also a fairly benign set of conditions, where probably there are some concerns round the more idiosyncratic stories, in particular in the emerging markets, and obviously everybody still quotes Brexit, the trade war, and so on as potential risks.

The risks have not changed a lot over the last year however. We do believe that one of the consequences of this risk rally, is that volatility seems to be too low for this stage of the cycle. We tend to deploy our hedges more on the tail risk side. We try to run a fairly balanced portfolio, so we do still like some of the duration markets on the risk off side and the US is one of these. Not because we think the US is going into recession, but because we've been through a rate hiking cycle already in the US. The Central Bank is signalling that they're pretty much done for the moment. The risk for us, is that obviously if we are to be constructive on risk, that the growth falters and therefore the Central Bank could need to cut rates. It's quite instructive to see that the Fed is telling everybody that they're happy to incorporate external factors into the rate decision mechanism. This Fed doesn't want to cut too quickly, they want to stay on hold for as long as possible. The lesser conviction we have is in the dollar. If somebody put a gun to my head I would probably be in long dollars. Why? Because everybody wants to be short, and it seems like the easy decision to make. People forget that usually the dollar tends to do very well when global growth underperforms. If your risk is as we said before that global growth underperforms, I think the contrarian should be looking to increase a dollar position not decrease it, which is very counterintuitive given that the dollar has already done very well over the last year or so. But, currencies tend to deviate for a very, very long time around central value measures, and they tend to follow the flow of money more. In terms of spread sectors, we like US long duration credit and we like parts of the emerging market credit. We'd still like to have some allocation to hard currency in emerging market sovereign, acknowledging that it has done extremely well right from the beginning of the year.

**CHAIR**: When you discuss those views against the backdrop of volatility

**FRANÇOIS JOLLY**
**Senior Investment Manager, Lloyds of London**
François's primary responsibility is managing fixed income investments across the Lloyd's capital structure; Central Fund, Premium Trust Funds and Funds at Lloyds. He is also responsible for all Foreign Exchange trading activity at Lloyd's. François has over 15 years' experience in trading and investment management roles.

which is lower than one might expect towards the end of the never-ending cycle, what sort of timeframes do you look to operate the views that you have mentioned, and has that timeframe shortened compared to where you typically would be on your investment horizons?

**BALCAZAR**: I think, given what's going on in markets, there's a tendency probably to shorten your time horizon and we want to fight that and remain focused essentially on a 3-5 years time horizon. We want to just remain steady in terms of how far ahead we look. In particular, we've just been through the end of the rate hiking cycle in the US. There's this natural tendency to try to predict the timing of the next cut or next hike, which I think is a losing game. If you stay with a focus on the long term, you realise that obviously what we are seeing is no different from what we have seen over the last 15 or 20 years, with the Fed consistently underperforming the expectations that the market has set, in terms of how much hiking they can actually deliver. It's mainly for structural reasons that this is happening.

I think one of the areas of concern longer term then, becomes that the priority is no longer for governments to reduce their levels of debt. If anything, it's the opposite. How can we ease fiscal policy further? So now you get the likes of the modern monetary policy theory coming in.

I think that's a good debate to have, but it has to remain on the longer timeframe. We're trying to avoid the temptation to try to forecast too much what's going to happen near term. We don't believe that you can have a repeatable edge in trying to forecast what the next quarter GDP number will be, but what I can tell you longer term is on average that GDP is going to underperform the estimates that people have around GDP trends in the world. That's one long term consideration, the size of government balance sheets is another one.

**CHAIR**: So the key points of investing in this environment are around capital preservation and liquidity, enhanced returns irrespective of the market cycle but to deploy those techniques, any absolute return strategy must involve a longer term philosophy.

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**BALCAZAR**: That's a very fair summation, I think. One clarification I would just make, is when you say 'go anywhere, do anything' under an absolute return strategy, people assume that the strategy will perform well in whatever market scenario it is faced with. That's a bit pretentious from my perspective. If you say we're going to do well in every single market scenario, it's a very tall order. What we're prepared to do, is to say to our clients, that we're going to give the, downside protection during difficult fixed income years, and last year is a good example of this. We had positive returns of 1.5%. We did underperform cash last year, but during the more positive years like this one, we can deliver higher than target returns for our clients. So on average, over the longer run, I would say cash plus three. It's important to note that when you call it absolute return, there needs to be that embedded notion of what you call capital preservation and the downside protection around the strategy. For the future survival of these type of strategies, there needs to be a notion that the client is getting a good value proposition mainly from the downside protection, and obviously when the beta is doing well, then close to beta returns during those more favourable years.

**CHAIR**: There are some strategists that think they can deliver positive terms every single day and have 300% to 400% turnover per year, versus others such as yourselves which work around more longer-term thematics.

**BALAAM**: We are an investor in absolute return fixed income. Our portfolios have short duration liabilities, so the need for liquidity is high. We already have fairly large allocations to Treasuries, short fixed income and short credit portfolios. We use our allocation here to increase portfolio diversification. We find within the absolute return space, you can construct portfolios with relatively low correlation to interest rate and credit risk.

**PARRY**: What we have found particularly in the volatility controlled strategies which potentially is what you're offering, is that they are inherently more correlated to our existing exposure to front end rates, and the front end of the credit market than other strategies. Other strategies aren't as effective so much on the downside. We're more willing to look at absolute return, that is completely agnostic to where it goes, and may have quite material exposures if you take them individually, and could potentially underperform on the downside in a bad year, but then would catch up more on the upside in good years.

**ER**: From an insurance company perspective, demand is likely to depend on the type of insurer and liability. For annuity liabilities, assets are held directly on the balance sheet and there is a focus on sourcing long-dated fixed income and long-dated inflation-linked assets to back their long-dated liabilities. Then we've got with-profit funds, many of which have a high allocation to equities. They may consider strategies like absolute return fixed income for the non-equity portion of their portfolios, but the suitability will vary from fund to fund - for example some are more mature than others, and some are better capitalised than others- and their investment decisions will need to reflect policyholder expectations and commitments. As we've just discussed, some non-life insurers have already invested in absolute return fixed income strategies. Here, liquidity is a key consideration, and also portfolio durations are shorter than we typically see for life insurers. The extent of overlap with what the firm is currently investing will also need to be taken into account. One final thought is that life insurers may be looking for suitable assets to back their 'surplus assets'.

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Similar considerations may apply here in terms of liquidity, duration and diversification. Regardless of which type of insurer and which type of liability class, some key challenges will include understanding the underlying risks of the investment and, of course, being able to model it.

**COULMAN**: We don't invest specifically in absolute return fixed income, but in a roundabout way we do have exposure to different strategies underlying this. I'm a little bit sceptical because absolute return strategies are almost too broad in nature. It's almost 'go anywhere' in fixed income markets to try and capture that value.

**JOLLY**: From our point of view, we actually put money towards absolute return fixed income this year, but the strategies ranged quite significantly. At the end of the day, we actually went with a manager who had less correlation to what we do already. Some of the more credit focused absolute return funds had too much correlation like to what we already do.

I do think there is a case for absolute return fixed income strategies, given

we are seeing equity markets again achieving all-time highs. Credit spreads are again nearing post global financial crisis lows. Personally, I hate the name of absolute return though. It reminds me of a LIBOR plus 100, plus 200, plus 300 and so forth. I see this allocation as I see hedge fund allocation. It's all on the manager.

**BALCAZAR**: If the absolute return portfolio turns out to be a lower beta version of your traditional portfolio, I don't think we are doing our job properly. I think for a good absolute return manager you need to be very aware of correlation and actively manage the correlation risk. I think a manager who's not aware of correlation, and isn't actively managing that correlation, is probably not going to give you the downside protection. You also need to be very aware of how that volatility is priced in the market.

The complexity point is a very good one. It's all about a process in this portfolio. How do you reassure the client what kind of risks they're taking? How do you know that the risk that you're taking is exactly what it says on the tin? I think that's why we make a lot of reference to the structural themes in our case. We are very clear that if the client doesn't understand what's driving the returns in their specific absolute return fixed income portfolio, then they're very unlikely to renew this with you. You need to be almost systematic about the way you take risks, and very, very disciplined in your investment process. Even in periods where you might think your investment process may not work, that credibility is far more important. I think that's absolutely key. Somebody who has a strong process, who's reputable, who can actually show with evidence that they have followed the process is particularly important.

**COULMAN**: Do you think the development of machine trading is going to reduce the opportunity set for absolute return fixed income managers?

**BALCAZAR**: In a way, yes, because it makes it the barriers to entry in that ecosystem harder. With the amount of technology and machine learning that is out there, it would be very pretentious for somebody who's starting from scratch to say that in three years we'll have a high frequency trading activity. I think that the differences in skills and technology there are massive. It goes from not only the algos, and obviously the computer and brainpower that you have, but it goes to the access to the markets that you have. That's why we made our very conscientious decision about how we are not going to compete in that space. In a way,

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the opportunity has been created because there is a vacuum that has been created from the trading, where there is a lot less capital for trading activities. That vacuum has been somehow filled by the asset managers and insurance companies who can provide liquidity to the market at those times.

**PARRY**: You said you really like long-dated credit, and the credit curve is steep, looking ahead beyond five years from now. How do you capture that given the lack of liquidity, and do you use ETFs to do it?

**BALCAZAR**: We cannot use ETFs in our absolute return strategy. We wanted to make it as transparent as possible. One thing is the ETFs are equities so we say we cannot do that. If you think what has happened over the last 15 years in the market, there's this massive growth in the ETF business and the passive business. In a way, it's actually a good thing for active managers. It actually makes your job easier because there's less competition for those active strategies that really work. For me, it's actually a bit of a blessing in disguise. Yes, of course my fees are going down, and I'm losing assets to passive investors, but I actually, as an active investor, think there are more opportunities now, than what there were before the global financial crisis when everything was arbitraged. Going back to your question on how you exploit that long duration credit, the thing the additional complexity is to make the clients understand that that's how you separate your decisions. You use derivatives to separate your spread decision from your rate decision, from your currency decision.

**PARRY**: Do you hedge your duration?

**BALCAZAR**: Yes, but again, there goes an extra layer of hedging because if you hedge the bond on a one-by-one basis on duration-by-duration basis, you're actually taking a pretty active beta - spread beta decision. It depends on the correlation between the spread and the rates which is not always stable and not always positive. That's why I said at the beginning, the manager that is very aware of correlation would know that.

**CHAIR**: Looking at alternatives, whether it's direct lending or real estate debt, where does that fit into your portfolio just from an insurance perspective if at all, and how does that compete versus some more higher octane absolute return fixed income?

Balaam: In terms of alternatives we have an allocation to global property. In terms of other alternatives, we've looked at the space in terms of direct lending etcetera but you're just upping your liquidity risk. We have property which is illiquid in the capital portfolios. How does it fit in with these strategies? I mentioned before we used that as part of our liquid part of our portfolio. In terms of going down the route of higher-octane fixed income, that's not what we are looking for in our absolute return fixed income allocation. We have equities if we want to increase risk levels rather than do this via the fixed income allocation.

**PARRY**: We absolutely invest in alternatives. Again, we have a bucket of illiquidity where we're willing to allow funds to be locked up for longer and that's a mix of hedge funds and some direct lending strategies. Particularly direct lending, I don't think it's as advantageous now as it was maybe three or four years ago. It seems like those returns are getting much lower much more quickly. I think there is a lot of capital that is looking at that, and I think that some of those funds are levering further to get the same return as they would previously earn with less or no leverage.

**ER**: We've seen growing interest from firms in recent years to support them with strategic asset allocation. There are many reasons for this - the low yield environment, competitive markets, and also more focus on investments now that Solvency is embedded. For the bulk annuity market, 2018 was a record-breaking year and 2019 looks set to be another big one, so there is a big demand for alternative, long-dated assets - we've seen firms investing in infrastructure debt, real estate debt and equity release mortgages. Elsewhere we have seen firms investing into areas such as high yield, private equity and emerging markets - although in some cases holdings in these asset classes are still small relative to traditional asset classes.

**COULMAN**: Obviously the alternative risk premium is quite liquid, but there are other areas that we've either considered or continue to monitor. This has included real estate debt, infrastructure debt, private equity, private debt and trade finance. A number of different areas there. What is always critical from our point of view is the liquidity side of things. We have thought about real estate in the past as to whether we move directly into real estate and property, or through REITs. REITS typically are too correlated to equities.

We have talked about being close to the end of the cycle and it having been extended. Is it really the right time to be taking on additional risk?

**JOLLY**: I still have nightmares about selling illiquid assets in the 2008 financial crisis, and so I'm much more liquidity driven.

Balcazar: I think of course from the absolute return perspective, liquidity is one of the priorities. On the other side, what's amazing is on all the areas as much as we can say in terms of the stage of cycle we're in, is how much money is actually chasing so few returns.

**CHAIR**: Is there any other questions panellists want to raise, or topics they want to bring up?

**JOLLY**: I think my issue with asset returns is it's very difficult to benchmark. For example, there are a lot of Absolute asset return funds that have a benchmark of cash plus 100 basis points.

**BALCAZAR**: I think the benchmark being brought into question is an interesting one. I think we need to be very aware of where beta is. On your question regarding how do we tackle, let's say, the asymmetry of the client reaction, I think for us it's very clear. If we're underperforming, and if the client even before talking to you, already knows the answer that's a good sign. The calls you hate to answer is, hold on, I thought you would be doing well in this type of environment. How come you're not? So you know your communication was poor from the outset, or you're actually not doing

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what you said you would do, which is even more serious. I think there, the trust bond is broken and trust is a very, very important concept. You don't have a benchmark, you don't have a way of guiding; you just have what you say you will do, and that's it. For the survival of the asset class or the sector, I think managers need to be very aware that 'go anywhere' doesn't really mean 'do anything' in the absolute return fixed income space.

**PARRY**: The other problem is that the track record is short with lots of these funds because the asset class itself is just new. If you look at a bond index you can go back 50 say- or however many years you want. With absolute return fixed income the track record is short.

**BALCAZAR**: I think 2018 was a very good test for managers in this field in general. I think the market has been very quick and taken out some of the competitors, sometimes very quickly. I think we're in the middle stage of the development of the asset class. One of the reasons why we decided to go there at Pictet as some of you who know is that we try to be niche players in some areas, rather than just being everything for everybody. We identified that as one of the niche areas that we would want to develop. This is skilled, and not everybody has the capabilities or the skillset to do so.