

Bond investors need to understand the volatility cycle

✓ **Fixed income markets have become increasingly volatile, a trend that looks set to continue. Investors need to adapt themselves**

The recent surge in bond yields has rocked fixed income investors. Losses on one benchmark bond index from its 2021 highs have already exceeded their near 11 per cent drawdown during the global financial crisis in 2008. What's more, this sort of volatility isn't going away – indeed, it has jumped sharply in recent weeks. Investors will need to learn a different, more active approach to fixed income investing.

An era of unconventional monetary policy – which drove yields to exceptionally low levels – is coming to an end amid a broadly global inflationary surge. This suggests bonds are no longer the safe haven for investors they once were, with particularly significant risks for those holding longer-dated securities, an investment staple for institutional investors with long-term liabilities, such as pension funds.

The roots of this predicament are 30 years in the making. It has been a period of ever-intensifying financial repression, with central banks deliberately holding interest rates below the rate of inflation. The result was not only that yields were artificially compressed, but also that the ups and downs of credit and economic cycles were far less pronounced.

When, in 2006, then-UK Chancellor Gordon Brown claimed to have ended economic 'boom and bust', he was right – to a point. But the side effect of smoothing these cycles through highly interventionist policies was periodic and

severe bouts of volatility.

Another side-effect financial repression is that traditional credit markets have become more highly correlated with equities, shrinking investors' margin for error. Which means future return characteristics of fixed income assets will not be the benign ones of the past four decades. Add in routine spikes in volatility and investors now face difficult periods.

In light of these dramatic changes, how should investors approach fixed income selection and portfolio construction? Investors who can avoid making mistakes – like chasing returns – and yet exploit opportunities that present themselves will tend to succeed.

That's especially true now. The sheer number of credit investors is staggering, not least because of the ever-growing number of passive products that are available. This has increased volatility as an ever-larger number of investors move in and out of the market simultaneously, particularly through exchange traded funds. Meanwhile, there has been a huge accompanying deterioration in the credit quality of company issuing bonds. As a result, investors' risks have grown significantly.

This idea of not chasing returns will inevitably feel alien to investors. Reducing risk when valuations are stretched and taking opportunities to add risk when other investors are fearful is indeed contrarian. Yet, it is this contrarian, value-focused mindset and objective assessment of the state of credit markets that offers the strongest basis on which to navigate these volatility cycles.

The Covid pandemic and the events of March 2020 are salient examples. Many high yield bond investors suffered significant losses during the worst of the crisis. But for those who had previously

taken steps to minimise risk and were therefore well placed to take advantage of the value that was on offer, there were many good quality credit securities available at multiple percentage points below their par values.

Today, interestingly, it is investment grade credit that appears particularly risky. That's because in this part of the market, asset allocation decisions come with very little margin of error and much of the generational high risk previously outlined. In contrast, rising stars within the high yield bond market – sub-investment grade companies whose financial prospects have been improving – offer much better risk-adjusted prospects.

Given how markets have behaved in recent times, it is inevitable that there will be many more bouts of intense bond market volatility, accompanied by severe peak-to-trough declines. Interestingly, bond volatility has spiked even as equity market volatility has remained relatively well behaved, an anomalous condition that few fixed income investors would have been prepared for.

Though we can produce a list of potential risks in store, we can't predict the specific catalyst. What we can do, however, is position ourselves to take advantage of these events when they happen. This means understanding what reflects fair value in asset allocation decisions and then trying to realise as much of the total return available as possible – but without becoming greedy and chasing returns unnecessarily.



✓ **Written by Pictet Asset Management head of investment grade credit, Jon Mawby**

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