WANTED – BOND CHAMPIONS

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WHY IT PAYS TO BE A FIXED INCOME INVESTOR

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Phil Annen, Baillie Gifford Managed Fund

BAILLIE GIFFORD

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Annual Past Performance to 31 March Each Year (net %)

	2016	2017	2018	2019	2020
Baillie Gifford Managed Fund	0.5	22.0	6.3	8.4	0.2
IA Mixed Investment 40–85% Shares	-3.4	17.7	1.4	4.5	-7.8

Source: StatPro. Managed Fund B Inc. Sterling. Net of Fees.
*IA Mixed Invested 40%-85% Shares Sector Median (Net)

The manager believes an appropriate comparison for this fund is the Investment Association Shares sector median given the investment policy of the fund and the approach taken by the manager when investing.

Past performance is not a guide to future returns.

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ABOUT THE AUTHOR

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Phil Annen manages the Rates and Currencies portfolio for the Baillie Gifford Managed Fund. He works closely with Steven Hay who has overall responsibility for the fixed income portion of the fund. He joined Baillie Gifford in 1999 and worked in the Risk Department before becoming a Fixed Income Investment Manager in 2002. Phil graduated MSc in Physics from the University of Bern in 1997 and MSc in Financial Maths from the University of Edinburgh in 1998.

APRIL 2020

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Yields at low or even negative rates have prompted questions about the relevance of investing in bonds. Phil Annen remains a fan. And he explains why, insisting this is an asset class that can still form a key part of an actively-managed, balanced portfolio and offer attractive returns.

“So, why would anybody buy bonds, and especially now with yields so low or even negative?”. It’s a fair question. My answer is usually that it’s because they still offer attractive returns and provide diversification. But let me elaborate.

The main reason for holding around a quarter of the Managed Fund in bonds and cash is to offer diversification against the equity holdings. This lowers the overall return volatility of the portfolio, while still adding to returns. Of course, it is true that bonds have generally moved together with equities over the past several decades. Initially, this was largely on the back of falling inflation supporting both asset classes, and more recently has been as a result of monetary easing by central banks. That has directly supported bonds, and indirectly been good for equities. We think this environment, with supportive central banks, will remain in place for some time, and hence should continue to benefit both asset classes.

But in times of market stress, bonds remain negatively correlated with equities. We only have to look at how bonds and equities reacted to the Covid-19 pandemic to see that this relationship still holds. But it has also been true many times in the past. The bursting of the tech bubble in 2001 saw positive bond returns, as did the great recession in 2008. Smaller equity market corrections such as the one at the end of 2018 on the back of global trade war worries also saw bond yields fall, and hence bond prices move higher. We have no reason to believe that this relationship has broken down. Investors typically flee to the safety of government bonds in times of uncertainty, regardless of how expensive those bonds might appear relative to the past.

It is true that substantial parts of government bond markets are zero or negative yielding. Currently the figure is around $10 trillion, or 20 per cent of the global developed market government bonds outstanding. However, the fund doesn't hold any negative yielding bonds. Admittedly, this is partly because a large part of the allocation is in higher yielding corporate bonds, and another part is in emerging market bonds. These asset classes have seen yields rise during the pandemic crisis as investors have raced for the safety of sovereign bonds. However, we believe our holdings in these sectors are resilient to the pandemic impact and that yields will fall from here. A good example currently is the portfolio's bond holdings from Asian countries including Thailand and Indonesia. They are sensibly managed economies and the bonds offer attractive yields. Once lockdown is over and economies return to normal, these countries' bonds are well-placed to rally.

But the fact that the fund doesn't hold any negative yielding bonds is also a reflection of our active selection which allows us to buy bonds where we see good return opportunities. For example, we like the peripheral European bonds of Spain and Greece, which offer positive yields and should appreciate with continued quantitative easing by the European Central Bank (ECB). And we are excited about Australian bonds, where a very sound fiscal stance should guarantee decent yields with a high rating. Among our corporate bond holdings, we see attractive combinations of value and resilience in the likes of Enviva Partners and Graham Holdings. Enviva is a global leader in the supply of wood pellets for electricity generation, which is displacing dirtier coal-fired generation. The focus of Graham Holdings has evolved from ownership of the *Washington Post* to a more diversified portfolio of media, entertainment and industrial businesses.

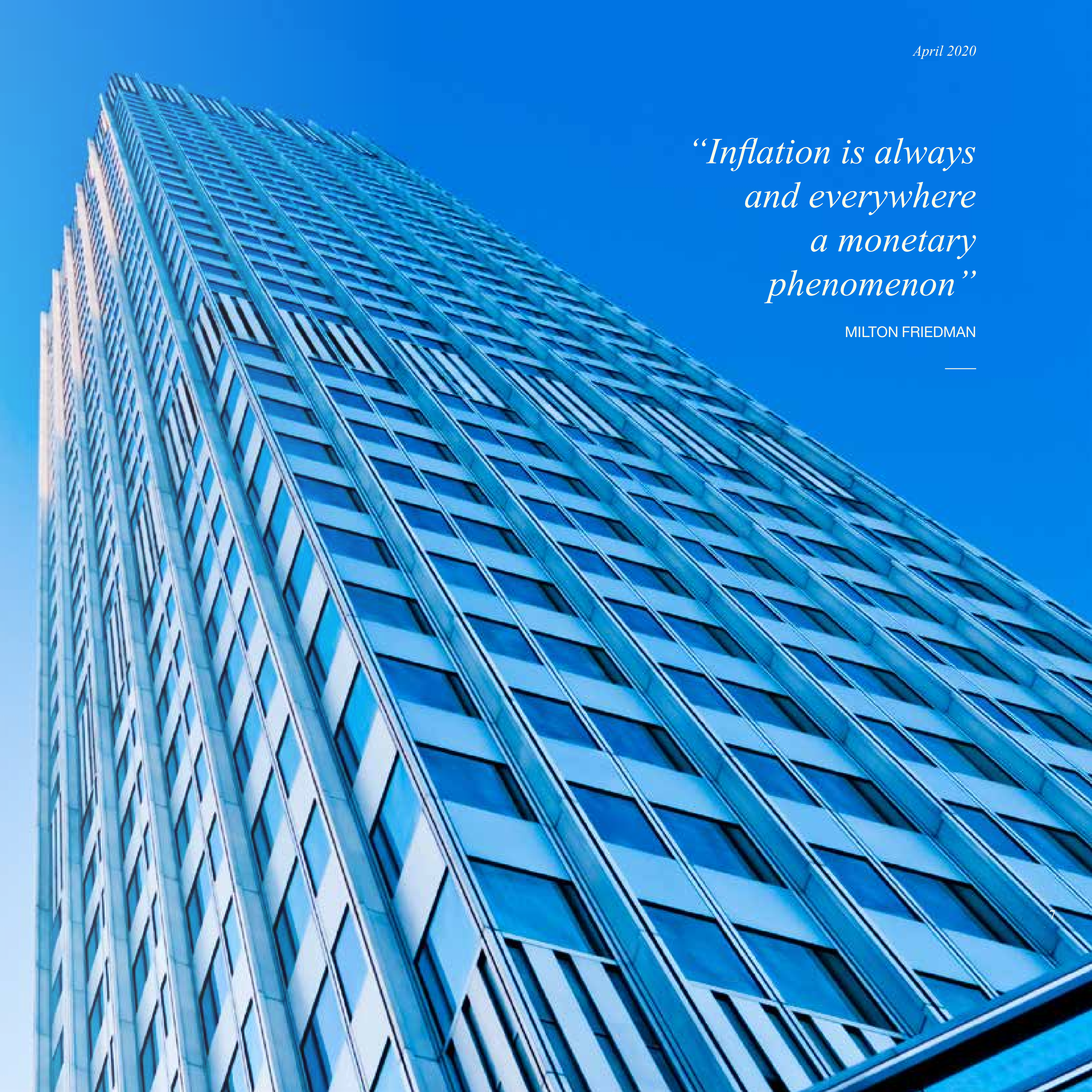
Christine Lagarde, president of the European Central Bank.
© Source TBC.

There are usually two objections to our positive medium-term view on bonds. First, people would say 'surely the massive increase in fiscal spending in response to Covid-19 and hence higher bond issuance will result in higher yields?'. However, this narrow view on supply misses the demand side. Increased regulation has meant that more bonds need to be bought for liquidity management, for asset-liability matching, for currency management, or to lower risk weightings in banks. On top of this, a new buyer emerged in the last decade, which rivals all others in size: central banks. Together, the major central banks hold a combined $14 trillion of government bonds through their quantitative easing programmes, and the number is rising. It's no surprise then that even with a record amount of debt outstanding, yields are lower today than they've ever been. Finally, lower bond yields might also lead to higher demand, as savers need to buy more because they require a given level of overall return/ income. There is some evidence of that happening, especially in countries with ageing populations.

The second objection is more credible. Many people ask whether quantitative easing will ultimately create inflation, especially when it is used in combination with fiscal expansion. This angst over inflation stems from the currently popular narrative of a move away from monetary policy, which is seen as becoming ever less potent, to fiscal policy. That is an area where there is still room to take action after many years of austerity. After all, even central bankers are calling for more fiscal expansion – the new head of the ECB, Christine Lagarde, being a prime example. And if loose fiscal policy were to be financed by printing money through extensive quantitative easing programmes, something some of the more radical proponents of modern monetary theory advocate, then it seems certain that inflation would rise and, consequently, bond valuations should fall.

We wouldn't necessarily disagree with this view. After all, a famous economist once said: "inflation is always and everywhere a monetary phenomenon". For us, the critical question for Milton Friedman's quote is when that would happen. We think it is a long way off. The reasons for mediocre growth and low inflation seem structural, and hence won't reverse quickly. This is a great environment for bonds. And just in case inflation were to surprise to the upside, the portfolio does hold some US and Japanese inflation linked bonds, plus some in several emerging market countries.

We believe it is this active bond selection that benefits the fixed income part of the Managed Fund, and confirms the important role it plays of providing balance to the portfolio while also adding to returns.



April 2020

"Inflation is always and everywhere a monetary phenomenon"

MILTON FRIEDMAN

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