First State Investments

EXPECTING THE UNEXPECTED: THE '03 SUMMER OF RISING YIELDS

- Global bond markets have a torrid two months, starting in Japan
- Yields rocket but remain contained within bonds and mortgages
- Lesson learned: 'Defensive' assets can prove themselves wrong

The First State Diversified Growth Fund borrows part of its wisdom from history, using times where markets have suffered significant falls in asset prices to enable fund manager Andrew Harman – part of First State's £12bn multi–asset team – to 'replay' past stress scenarios to test the impact on today's portfolio.

We extend our insights from history by also 'replaying' broader macroeconomic shifts. By looking at risks factors embedded in equities, fixed income, and commodities, where the portfolio invests - for example shifting interest rates, the widening of spreads or volatile currencies - Andrew and his team can prepare the portfolio for the worst in order to meet an important short-term objective of protecting investor's capital on the downside.

Let's look to an example: the summer of 2003. Harry Potter was in the midst of its magical march towards global literary dominance with the launch of its fifth book; Twenty20 cricket had just got under way with its first official matches; and supersonic Concorde, which captured the imagination of many at its launch in the late 60s, made its final flight due to safety concerns following the Paris Air Disaster.

Unfortunately trouble was also brewing in the global bond market, and the summer ushered in its worst sell-off since 1994. June kicked-off with investors poorly receiving a 20-year Japanese Government Bond (JGBs) sale, forcing yields to rise as Japanese banks and hedge funds moved to unwind their positions. US data also proved better than expected, adding to the selling of JGBs and dollar treasuries, with dollar bond investors also becoming spooked by Fed policy signals from unexpected interest rate moves.

Mortgages further exacerbated selling, particularly in the mortgage backed securities (MBS) market. As interest rate expectations began to change so did the durations on MBSs. Investors rushed to manage their exposures to rate changes - as is usual in the MBS market – hedging by selling treasuries, swaps and related derivatives. Because the hedges reached into a variety of segments in the fixed income market, changes in MBS durations therefore affected the whole FI market.

It was an uncomfortable time for investors with an important lesson to be learnt from the volatile summer: defensive assets, in this case bonds and mortgages, will not always act as such under certain market conditions.

Our testing of these scenarios in today's portfolio has led us to consider carefully how defensive assets are deployed.

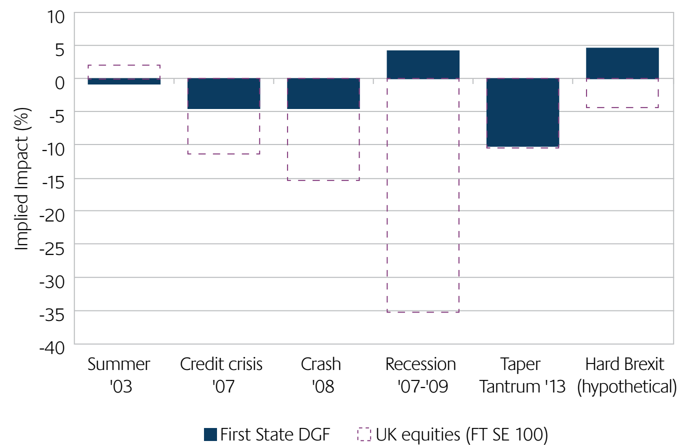
Looking to an example, a classic defensive asset for a portfolio would be government bonds, but presently we see a need for caution in investing here: a seeming end to the 20-yr bond bull-run. Rising short- and long-dated yields demonstrate this, as evident in US 10-yr treasuries breaking through the 3% level; but there's also the bigger concern of inflation pushing higher than it has done for years.

Seeing waning value and a pathway to higher yields, our approach has been to invest in inflation protection to counterbalance the portfolio, currently taking up positions in Australian, UK and US inflation-linked bonds. This, we feel, is an attractive 'inflation compensation' versus nominal bonds. We have no allocation to corporate credit.

We also use non-correlated positions in both equity and bond markets to generate returns. This approach, we believe, balances the risk/reward proposition and minimises our reliance on 'safe' assets.

In the portfolio today we hold fixed income, commodities and equities, and add balance by investing in foreign currencies. This varies considerably over time, with historic net allocations spanning from 45% to almost 0% of the portfolio, and we will look to all manner of developed market and emerging market currencies to generate returns and/or reduce risk.

Here is how our portfolio performed during the stress test:



In the next article we will continue to explore the lessons of history with a look at the liquidity squeeze of 07/08. For more information about the First State Diversified Growth Fund please click here.

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