

Short and Sweet

Weekly Digest

22 January 2018

– Alex Harvey, CFA

Risk can be defined in many different ways but is usually unique to the individual appraising that risk. What one person may consider risky may to another person be quite ordinary. When it comes to investing, true risk at the investor level is the probability of not achieving the original investment objective. For that reason, variability of future returns from an asset (i.e. volatility) means less certainty of reaching your desired outcome.

Active equity strategies are often constructed with a style tilt; an underlying bias to one or more of the commonly cited equity factors such as value, momentum, quality, size and low volatility. ‘Smart Beta’ strategies look to replicate these factor returns in a more pure and systematic way. As a growing field of research it is likely we will see more product come to market exploiting fixed income factor strategies. It is the OTC (over-the-counter) nature of fixed income trading (meaning that data is harder to obtain), and the costs of that trading, that has, I think held back research and product in this area to date.

From a fixed income perspective we can draw together the themes of risk and factor investing by theorizing that a lower volatility bond portfolio with a high probability of hitting its objective should be preferable to a higher vol strategy which is more likely to under (or over) perform on its investment objective. The lower vol strategy – which has better long term risk adjusted returns – might be expected to trade at a premium. The reality though is that capital constraints on the unleveraged investor leads them to

allocate more capital to higher yielding (market duration) credit strategies, leaving short duration bonds trading at wider spreads than the core market. Sector and issuer considerations aside, this is the low volatility factor being played out in credit and in certain markets you might earn the bulk of your risk premium going onto the credit curve, not necessarily going along it (e.g. some emerging markets).

For high yield bonds it is true that it is an inherently low duration asset class. This is a criticism often levelled at short duration funds - that high yield bonds have only limited sensitivity to interest rates. This misses the point. The reason we favour allocating to short duration bonds today is that they have a lower spread duration – lower sensitivity to credit spreads - which makes their risk adjusted returns look attractive in all but the worst scenarios.

It is true that credit spreads in some markets are at their lowest post crisis levels. We don’t however expect a sell off. The global economy appears in rude health (albeit not stellar growth projections, but that suits credit) and credit fundamentals on the whole look fair. As mentioned at the start of this piece though, we want to offer more certainty of outcome to our investors. When we are not paid enough to carry the risk of an asset – and can earn a more reliable return from a lower volatility variant of that asset – then it makes sense to allocate to the more certain outcome. Using an active manager can further mitigate downside risk, but most of the benefit comes from the short duration decision itself. Sometimes less is more.

The Marketplace

- US government enters federal shutdown
- German SPD party vote in favour of coalition talks
- UK headline CPI fell to 3.0% in December
- China Q4 GDP growth beats expectations

Market Focus

US

- The US government entered federal shutdown on Saturday, after a bill to provide short-term funding to government funded operations failed to pass the Senate. Essential government services will remain in operation.
- US equities ended the week up 0.9%, while Treasuries fell 0.4%.

UK

- Headline CPI fell to 3.0% in December from 3.1% in November, the first fall in six months.
- UK equities fell 0.6% during the week, while Gilts flat lined.

Europe

- German government coalition negotiations took a step forward on Sunday after 56.4% of SPD delegates voted in favour of pursuing talks with Angela Merkel's CDU/CSU.
- The final reading for December Eurozone headline CPI was unrevised at 1.4% year-on-year.
- Continental European equities rose 0.9%, while Emerging Europe rose 1.2% in the week.

Asia

- In China, Q4 year-on-year GDP growth beat expectations at 6.8% versus 6.7% expected. For 2017 GDP growth was 6.9%, up from 6.7% in 2016, the first rise in annual GDP growth in seven years.
- The Japanese seasonally adjusted Purchasing Managers' Index hit a near four-year high in December, rising to 54.0.
- The Bank of Canada hiked its overnight lending rate by 25 basis points to 1.25%, a move that was widely flagged.
- South African equities outperformed during the week in US Dollar terms, rising 4.1%.

Asset Class/Region	Currency	Currency returns			
		Week ending 19 Jan. 2018	Month to date	YTD 2018	12 months
Developed Market Equities					
United States	USD	0.9%	5.2%	5.2%	25.9%
United Kingdom	GBP	-0.6%	0.6%	0.6%	11.3%
Continental Europe	EUR	0.9%	3.7%	3.7%	14.9%
Japan	JPY	0.7%	4.0%	4.0%	26.3%
Asia Pacific (ex Japan)	USD	1.5%	5.1%	5.1%	37.7%
Australia	AUD	-1.1%	-1.0%	-1.0%	10.2%
Global	USD	1.0%	5.0%	5.0%	26.6%
Emerging markets equities					
Emerging Europe	USD	1.2%	7.6%	7.6%	30.6%
Emerging Asia	USD	1.8%	6.3%	6.3%	45.7%
Emerging Latin America	USD	2.9%	8.7%	8.7%	29.7%
BRICs	USD	1.9%	8.5%	8.5%	47.1%
MENA countries	USD	1.9%	4.9%	4.9%	5.4%
South Africa	USD	4.1%	2.7%	2.7%	35.0%
India	USD	1.6%	3.5%	3.5%	39.7%
Global emerging markets	USD	2.0%	6.4%	6.4%	40.8%
Bonds					
US Treasuries	USD	-0.4%	-1.1%	-1.1%	1.3%
US Treasuries (inflation protected)	USD	-0.1%	-0.7%	-0.7%	2.0%
US Corporate (investment grade)	USD	-0.5%	-1.0%	-1.0%	5.2%
US High Yield	USD	-0.1%	0.6%	0.6%	6.9%
UK Gilts	GBP	0.0%	-1.1%	-1.1%	2.7%
UK Corporate (investment grade)	GBP	0.3%	-0.3%	-0.3%	5.6%
Euro Government Bonds	EUR	0.2%	0.0%	0.0%	1.3%
Euro Corporate (investment grade)	EUR	0.3%	0.1%	0.1%	2.9%
Euro High Yield	EUR	0.2%	0.6%	0.6%	6.8%
Japanese Government	JPY	0.0%	-0.2%	-0.2%	0.3%
Australian Government	AUD	-0.6%	-0.9%	-0.9%	2.5%
Global Government Bonds	USD	0.3%	0.5%	0.5%	7.4%
Global Bonds	USD	0.2%	0.4%	0.4%	7.8%
Global Convertible Bonds	USD	0.4%	3.1%	3.1%	11.8%
Emerging Market Bonds	USD	-0.5%	-0.6%	-0.6%	6.5%

Asset Class/Region	Currency	Currency returns			
		Week ending 19 Jan. 2018	Month to date	YTD 2018	12 months
Property					
US Property Securities	USD	0.1%	-5.1%	-5.1%	-1.6%
Australian Property Securities	AUD	-0.5%	-3.4%	-3.4%	2.0%
Asia Property Securities	USD	0.7%	6.9%	6.9%	30.9%
Global Property Securities	USD	0.1%	-0.5%	-0.5%	15.1%
Currencies					
Euro	USD	0.8%	1.8%	1.8%	14.7%
UK Pound Sterling	USD	1.2%	2.5%	2.5%	12.3%
Japanese Yen	USD	0.6%	1.8%	1.8%	3.8%
Australian Dollar	USD	1.4%	2.4%	2.4%	5.8%
South African Rand	USD	1.7%	1.4%	1.4%	11.0%
Swiss Franc	USD	1.0%	1.2%	1.2%	4.6%
Chinese Yuan	USD	0.9%	1.7%	1.7%	7.5%
Commodities & Alternatives					
Commodities	USD	-0.2%	1.9%	1.9%	6.2%
Agricultural Commodities	USD	1.0%	1.0%	1.0%	-6.9%
Oil	USD	-1.8%	2.6%	2.6%	26.7%
Gold	USD	0.2%	2.1%	2.1%	10.7%
Hedge funds	USD	0.2%	1.9%	1.9%	7.5%

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