

What are the greatest risks for fixed income investors?

The 40-year bull market ended over a year ago



Ian Williams of Charteris

Ian Williams 18 OCTOBER 2017

Fixed income investors face an increasing risk of a significant decline in asset prices in the years ahead, writes Charteris' Ian Williams.

Our long-cycle analysis, as I have previously warned, [flagged the end of the 40-year bull market in bonds more than a year ago](#) as interest rates reached a 300-year low.

Since then, the US has begun raising rates to normalise its monetary policy amid low unemployment and growing economic activity.

With major commodity prices - an early indicator of inflation - also hitting multi-year highs, the Bank of Canada has followed suit and could soon be joined by the Bank of England in raising rates as it grapples with above-target inflation.

[What's the biggest risk to owning corporate bonds?](#)

Completing the bearish picture for bond investors is the looming prospect of the end of quantitative easing (QE) by the European Central Bank, while its counterparts plan to go further by introducing reverse QE measures to normalise their balance sheets - a move that would be potentially very negative for bonds.

If central banks start selling their vast portfolio of bonds, it remains to be seen who will step up to buy the hundreds of billions of these bonds at prevailing yields.

With zero value baked into prices at current levels, bonds carry a massive asymmetric risk relative to any likely reward.

Yet asset managers face a dilemma as the regulatory regime virtually mandates heavy exposure to this sector, especially for clients with low- to medium-risk profiles.

So what should UK investors do if they wish to preserve capital and generate more than 'quasi-cash' returns?

JPMAM's Mandel: Why holding duration is not the shock-absorber it once was

The greatest risks they face are duration risk and liquidity. To mitigate, they need to focus on a mix of assets including high quality floating rate notes (FRNs), short duration government bonds and where permissible, some exposure to blue-chip, high-yield equities.

The much-touted alternatives, such as high-yield junk paper, are a potential disaster area if a full-scale bear market develops. This is because liquidity (never great even in a bull market) will dry up and such assets become virtually impossible to sell.

Many of these junk bonds also have long duration, which is where the greatest losses will occur.

Ian Williams is chairman and chief investment officer of Charteris Treasury Portfolio Managers

Bull Points

- Gilts will always be liquid and can be actively traded
- Higher rates favour FRNs and shorter rather than longer duration bonds

Bear Points

- All bonds, especially index-linked, are grotesquely overvalued
- Long duration bonds face added risk of capital erosion due to inflation

(IA) £ Corporate Bond: Over three years

	3yr % chg	Rank	Vol monthly	Fund size (£m)	Morningstar rating™
Top 5					
F&C Institutional Lng Dated Corp Bd	27.35	1	310	4090	★★★★★
Schroder Instl Long Dated Corp Bd	27.33	2	328	39338	★★★★★
Fidelity Instl UK Lng Corp Bd	25.95	3	274	48228	★★★★★
PIMCO GIS UK Long Term Corp Bd	24.55	4	287	40964	★★★★★
Henderson Inst Long Dated Crdt	24.05	5	346	47322	★★★★★
Bottom 5					
Threadneedle Stlg SD Corp Bd	8.08	75	0.42	999.21	★
M&G Short Dated Corp Bd	7.35	76	0.52	481.14	★
Vanguard U.K. Shrt-Term IG Bd	6.70	77	0.42	1686.50	★
AXA Sterling Crdt Shrt Dura Bd	5.45	78	0.34	762.78	
SVS Brown Shipley Sterling Bond	4.47	79	1.03	50.82	★★
SECTOR AVERAGE	16.57		1.64	847.94	

Performances calculated bid to bid, net income re-invested, GBP to 15/10/17. Source: © 2017 Morningstar.