



Ian Scott



Buying with a margin of safety in fixed income

Ian joined PSG in 2013 as Head of Fixed Income. He first joined Stanlib in 1999 as a money market dealer, from where he moved to capital markets and was then promoted to Senior Portfolio Manager – Fixed Interest.

Protecting our investors against capital loss is a key element of our investment philosophy

Investing with a margin of safety is a cornerstone of our investment philosophy. It is always important to protect our investors against permanent capital loss. We believe that buying with a margin of safety is non-negotiable in our role as stewards of our clients' money. In the fixed income space, a margin of safety is defined as the spread or yield above inflation. We always want to achieve a yield above inflation (a real yield), adjusted for the level of risk. Yield can be generated in many forms, but it is important to always ask at what level of risk this is being offered.

Fixed income asset prices have changed substantially over the past few years

Opportunities in fixed income arise from the fact that fear and uncertainty are priced into various fixed income assets due to global, economic or political reasons. For example, if we cast our minds back three years to 2013 when global central banks were adding substantial liquidity to markets, risk premiums on bonds declined to all-time lows. As a result, the price for default and inflation risks were negligible in bond yields. At that point, we perceived bond yields to be risky, since yields were low and risks were not priced adequately. We believed the margin of safety was too small (and in some cases non-existent) to justify an allocation in our portfolios.

How has that situation changed over the last three years? Major central banks in the world continue to add liquidity to the global financial system. Yet, the pricing of fixed income assets has changed substantially, especially in emerging markets. In addition, the forces of inflation and deflation are still in the process of playing themselves out, which should continue for a number of years. This has created fear and uncertainty about the valuations of emerging market assets, which were richly valued and easily bought only three years ago. If we think of how Berkshire Hathaway's Charlie Munger might have framed this, we can conclude that South Africans have rarely been this pessimistic about the domestic political situation since the time of our first democratic election in 1994.

Government bonds are currently attractive due to shifts in sovereign risk and inflation premiums

What we have witnessed is a substantial shift in the bond yield curves in various emerging markets. In South Africa, we have seen the 10-year government bond yield trade from a low of 6.5% to the current level of about 9.5%. This is due to price movements in two components that form the basis of bond valuation: the sovereign risk premium (the premium for holding South African assets) and the inflation premium (the risk that inflation may be higher than expected over the long term).

The current sovereign risk price includes a margin of safety

Sovereign risk forms one part of our margin of safety in the pricing calculation for South African sovereign bonds. By applying organised common sense, one can look at how the international market prices risk for larger companies and sovereigns by looking at their credit default swap (CDS) spreads. A CDS is a form of default insurance whereby CDS purchasers insure themselves against a default. The riskier the bond, the higher the spread. If the company or sovereign does default, the purchaser receives the face value and the seller takes possession of the defaulted bond.

Graph 1 shows how South Africa re-rated from trading around the BBB band to the BB band (junk status) in 2013, after the taper tantrums. The average CDS spread for the BB band over the last five years has been 273 basis points, while South Africa's sovereign CDS spread is now trading at a spread in excess of 300 basis points at the time of writing.

If we compare the South African sovereign CDS spread to that of Brazil – which has already been downgraded to 'junk status' – we can see that Standard & Poor's (S&P) has Brazil on a BB rating (two notches below South Africa's current 'investment grade' BBB- rating) with a negative outlook. Brazil's five-year CDS was trading at approximately 340 basis points at the time of writing.

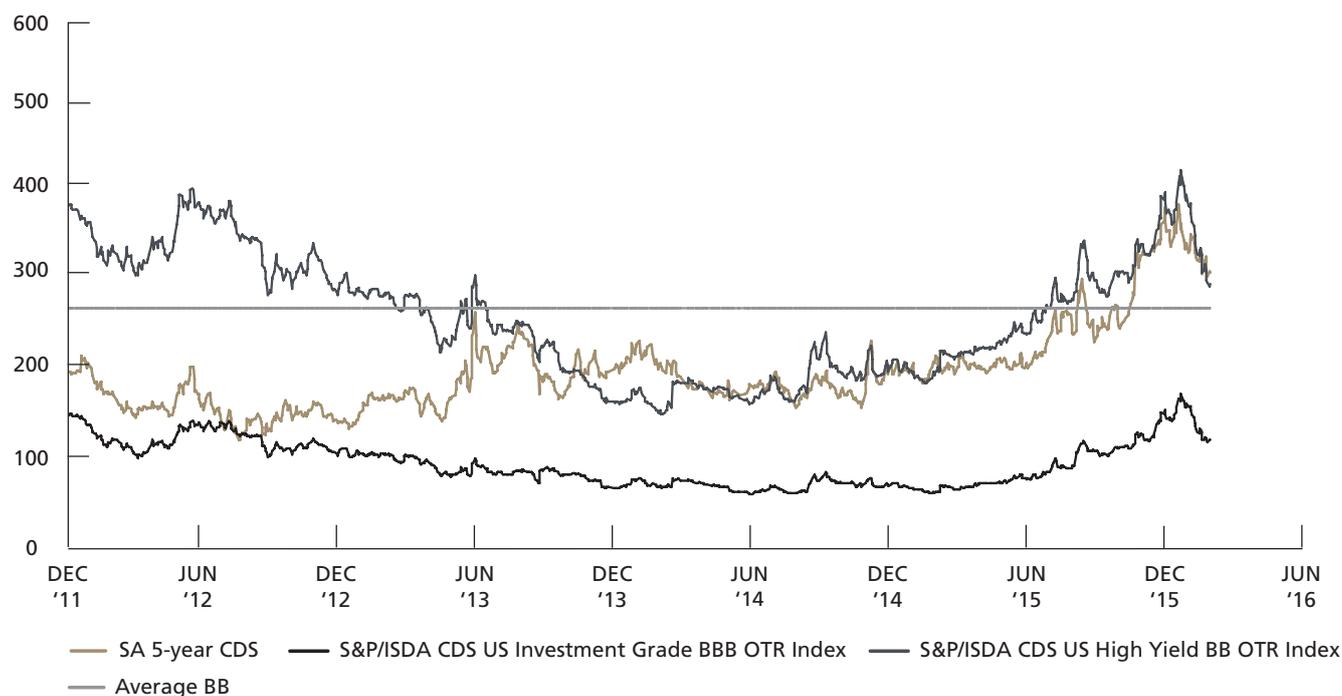
South Africa's five-year CDS is already trading almost 40 basis points wider than the five-year average for the BB band, which means that the CDS is trading well within the junk/BB band rating. This reassures us about the margin of safety for the current sovereign risk price, even if we do get a downgrade from S&P later this year as is being increasingly anticipated.

Local sovereign bonds offer an attractive yield and a measure of protection

The landscape for South African sovereign bonds has therefore been that of a mixed picture. Given the significant sovereign default risks priced into our CDS spreads, these bonds' yields have risen. There are fears that this may continue. Globally, most developed economies are struggling with growth and inflation, and exhibit negative yields in some of their own sovereign bonds. As long-term investors, we have an understanding of long-term economic cycles. We are aware that without developed economies pushing significant growth and inflation, South African sovereign bonds offer an attractive yield. They also offer a measure of protection if the global economy moves deeper into a deflationary-type environment.



Graph 1: South African CDS performance (2011 – 2016)



In South Africa, CDSs are thinly traded for corporate bonds but well traded for sovereign bonds. In the US, corporate CDSs are well traded. South Africa's current sovereign international rating from Standard & Poor's (S&P) is BBB- (foreign currency), and is at risk of being downgraded to BB+. We have therefore used a proxy of the S&P US Corporate Index BB band and BBB band for average CDS spreads over the last five years.

Sources: St Louis Federal Reserve Economic Data, Bloomberg

We construct our portfolios for a range of outcomes

In acknowledging that the deflationary pressure trend is growing from a global perspective, we structure our portfolios for a range of outcomes. In particular, the fixed income allocations of our funds have traditionally been conservative, earning significant real yield for our investors at relatively lower durations (interest rate risk). In implementing our investment views, we prefer to take a balanced, sensible approach in our portfolios. We aim to take advantage of the mispricing noted in our CDS spreads and sovereign bonds to provide us with protection against a deflationary environment.

We view our investments in sovereign bonds as longer-term insurance against a deflationary environment

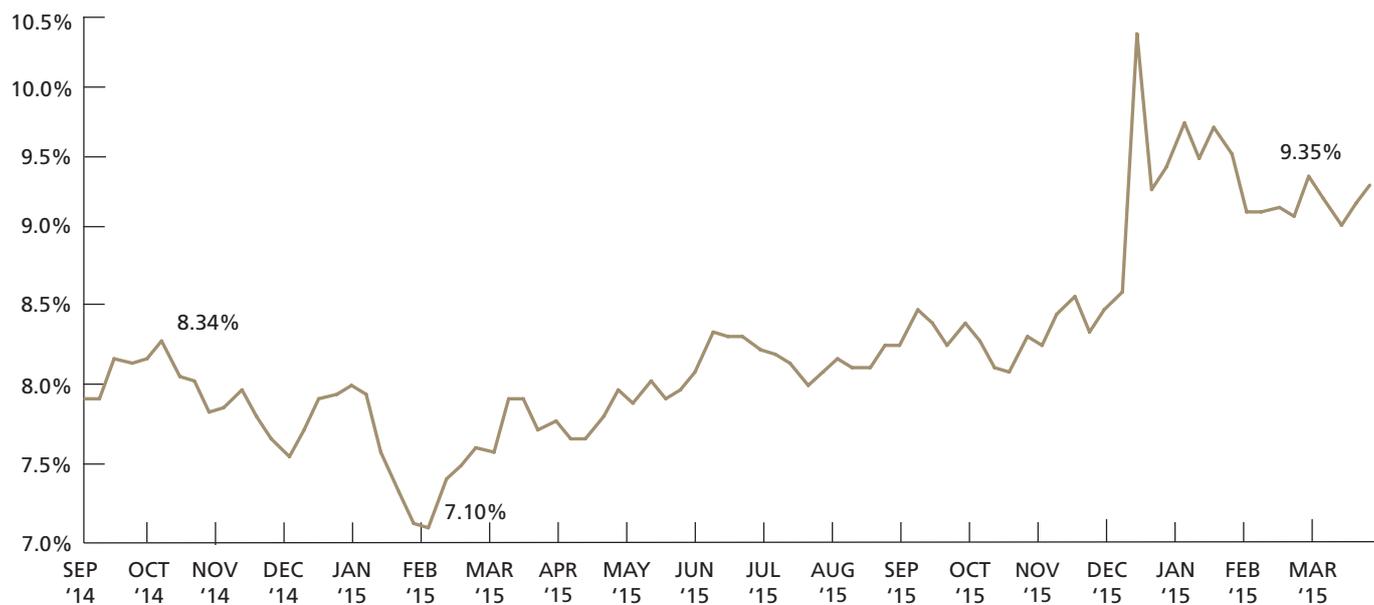
A global deflationary shock could result in a significant decrease in our sovereign yields over a short time, accumulating significant returns for investors who are appropriately positioned. In early 2015, the global economy experienced such a deflationary shock when the Brent Crude oil price fell significantly. Graph 2 illustrates how sharply the yield on the R186 (the South African 10-year government bond) fell – a drop of almost 1.40% from 8.34% in October 2014 to about 7.10% by February 2015. As a basic measure, the capital returns alone would have been roughly 10% (a duration of 7.7 at that time).

As long-term investors, we will always examine the economic cycle to identify the global forces that are driving our economy. On the back of the increased margin of safety in sovereign bonds and an increasing sense that global growth will remain slow, we have added measuredly to our holdings in sovereign bonds where we have seen market fears. We view this as long-term insurance against a deflationary environment.

As mentioned in Anet Ahern's PSG Angle of December 2015, diversification is the only free lunch available to investors. The way in which our portfolios are structured offer this margin of safety. Over time, we have invested in attractive cash options with less interest rate risk for our clients as rates have risen. We believe that the appropriate margin of safety is now in place to allocate appropriate cash reserves in an organised way using common sense.



Graph 2: South African 10-year government bond yields from September 2014 to March 2016



Source: Bloomberg