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Why we're not getting too comfortable in our fixed income risk assessment

Lyle joined the Fixed Income team at PSG Asset Management in 2014. He performs credit and fixed income analysis and serves as the primary money market trader for all PSG funds.

Placing risk first is fundamental to our investment process

At PSG Asset Management, we place a lot of emphasis on the continuous development, refinement and consistent application of our investment processes. Our fixed income process places risk first as we aim to decrease the probability of permanent capital losses for our clients. Our Investment Committee continuously reassesses our investment views, which prevents us from getting too comfortable in our assessment of the risks involved, even when the market may be doing so.

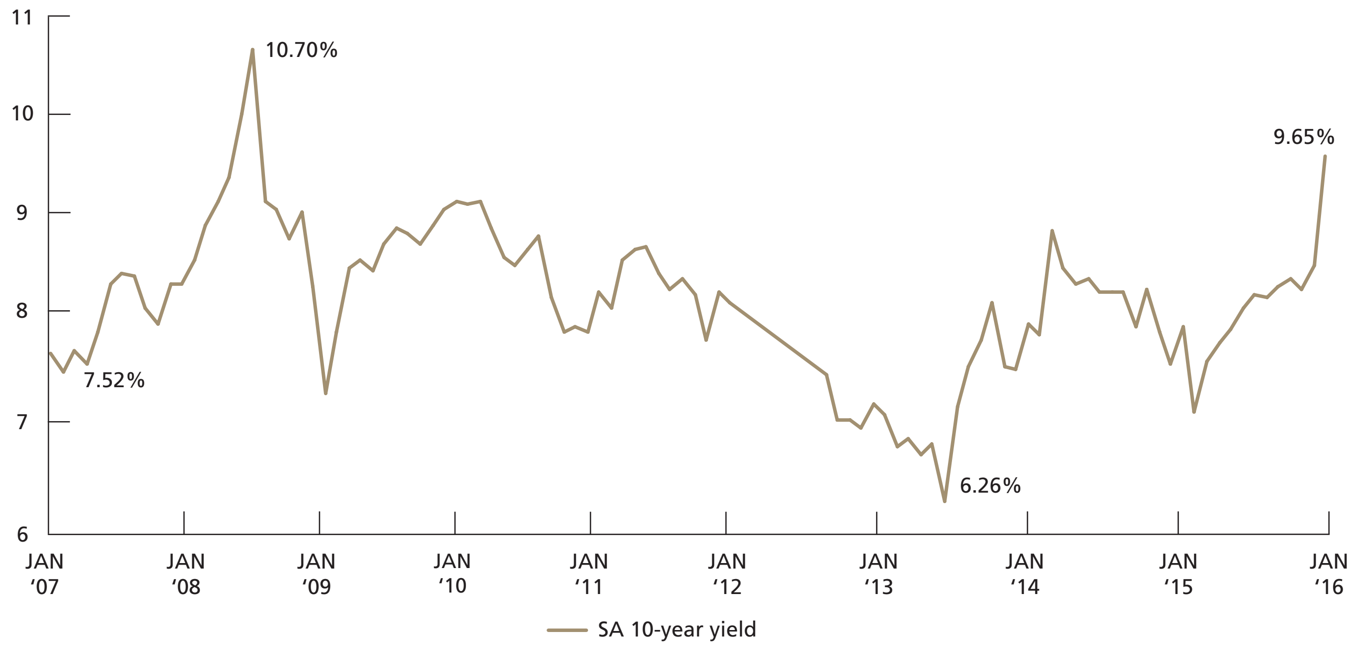
Interest rates have been artificially low for years

The 2008 global financial crisis was in many ways considered the biggest event in financial market history, resulting in the largest downturn in financial markets. This was followed by the start of what was considered relatively unconventional central bank activity, forcing a cycle of low interest rates. Even though almost eight years have passed since the start of the crisis, the effect of this meltdown on the global economy is still evident in the uncertainty of economic recovery.

Fixed income markets – bond yields rose significantly as a result of the crisis

Sovereign bond and currency markets tend to reflect financial distress relatively quickly, due to the depth and liquidity within the markets. During the 2008 crisis, bond yields rose significantly (and bond prices fell) as investors attempted to sell their investments. The distress caused was reflected in both developed and emerging market bond yields, which increased sharply as a result. South African 10-year government bond yields rose by almost 3.0% to a financial crisis high of 10.7%, as shown in Graph 1. For an investor in this bond (albeit 'risk free' for South African investors as an investment in government-issued debt), the potential capital losses at that time were, on average, in excess of 20%.

Graph 1: South African 10-year government bond yields (January 2007 – January 2016)



Source: Bloomberg

Central banks drove interest rates to traditional lows
Following the financial crisis, the global economy was by and large deep in economic recession, requiring action to support economic recovery. Traditionally, lowering benchmark interest rates (in South Africa, the repo rate) and bond yields lowers the cost of lending, theoretically creating cheaper money that can be used to increase consumer spending and economic activity.

The enormity of the damage done, however, required central banks to adopt unconventional monetary policies. The US introduced quantitative easing (QE), which constituted an irregular example of central bank influence. The essence of QE involves a central bank buying the bonds of their own government. The intention is to make these bonds less attractive in comparison to stocks and other risky assets, lowering the yield on these bonds and increasing the price. This mechanism directly introduces cheap money into the global economy and, at the same time, levers down the cost of lending. The US injected roughly $3.5 trillion into the global economy since the announcement of the QE programme in November 2008. To put this into perspective, the US not only dropped the US benchmark rate to almost 0%, but also injected enough dollars into the financial system to cover South Africa's GDP (in US dollars) roughly 10 times over.

The result of such stimulus was that government bonds globally fell consistently since the peaks of the 2008 financial crisis. US treasury bonds are a large driver of sovereign bonds globally and therefore South African bonds swiftly followed suit. With developed market bond yields providing low real investment returns over this period, the investment opportunities in South Africa offering above-inflation yields resulted in large capital inflow. These factors contributed significantly to the drop in bond yields. Graph 1 shows that the 10-year bond yield dropped from a 10.7% high to a low of 6.2%, accumulating significant returns for bond investors over the period. With yields at these levels, the bond market became a relatively unattractive investment space.

Government bond yields have re-priced since 2012

Understanding the key drivers and risks of South African government bond yields is key to our fixed income investment process. In theory, sovereign bond yields are driven by perceived credit (default) risk and expectations of growth and inflation in South Africa. An investor would require compensation for all these factors – an expectation of higher sovereign risk (credit), inflation or growth would result in an investor requiring a higher yield (lower bond price) as compensation. With government bonds at traditional lows and relatively expensive, a prudent investment process allows a deeper understanding of the likelihood of bond yields rising and causing capital losses for our investors.

The unwinding of easy money should lead to a rise in sovereign bond yields
The US, as the leader of accommodative monetary policy since the 2008 financial crisis, commenced talks about an end to the QE programme and an eventual normalisation of their benchmark interest rate, the Federal funds rate, in late 2013. The effect of an increase in interest rates in developed markets in its simplest form is expected to draw capital flows from riskier emerging markets. The result is a rise in sovereign bond yields (and a fall in price) brought about by increased selling by foreign investors.

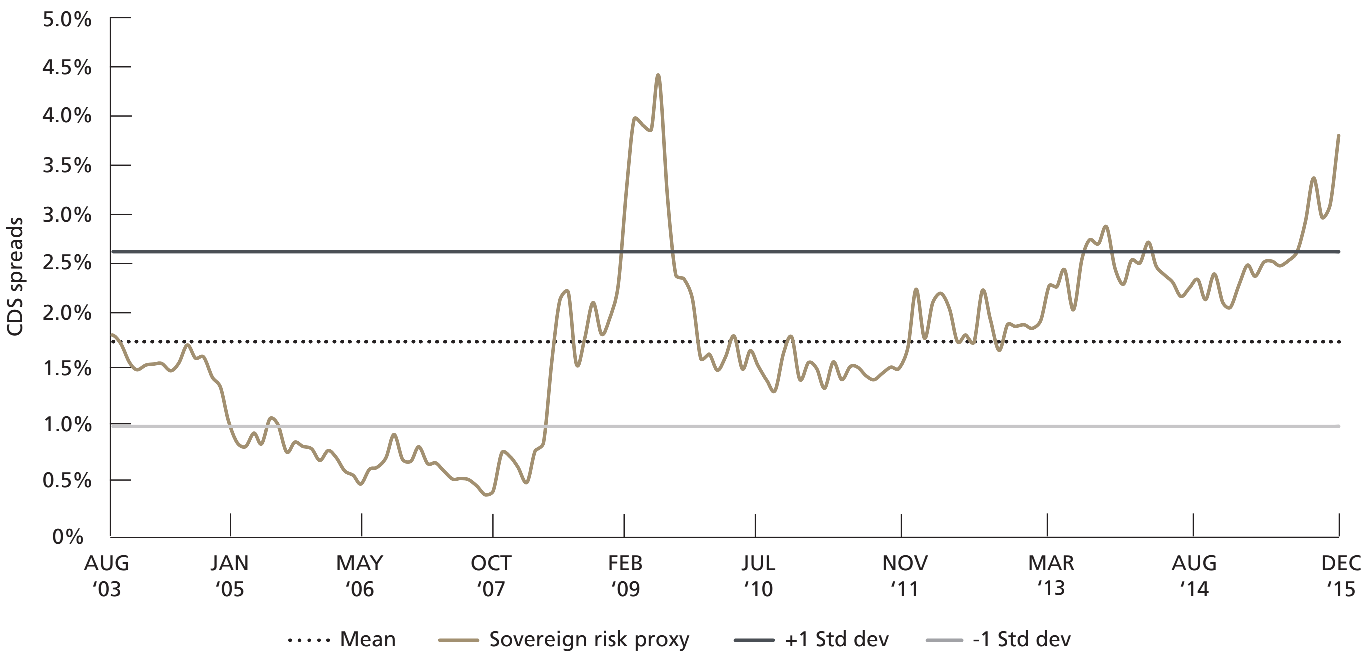
The local sovereign bond risk premium has increased
In January 2012, South Africa's outlook and investment rating suffered the first of a series of downgrades, with all three major rating agencies (Fitch, Moody's and Standard & Poor's) initiating downgrades to their view on South Africa. Significant issues noted were declining government institutional strength, socio-economic stress and declining confidence in South Africa's ability to manage its competitiveness and growth. Infrastructure shortfalls, high labour costs and unemployment furthermore increased political risks in the country. These are largely the problems we still see currently.

The effect of these factors increases the risk premium associated with South African government debt, as an investor requires additional compensation through a higher yield. Graph 2 reflects a market measure of the perceived credit risk associated with South Africa over a five-year period, known as the five-year credit default swap (CDS) spread. The CDS is essentially the cost an investor would pay to insure their investment in South African government bonds against a South African investment default. Fear in emerging markets and deteriorating outlooks resulted in the South African five-year CDS spread rising significantly from 2012 onward, as shown in the graph. This feeds directly into a valuation-based approach to government bond yield fair valuation, as discussed below. In Graph 1, we can see the effects of this rising risk premium on the yield of the 10-year government bond.

Our valuation-based investment approach provides a reasonable estimate of local yields

The fixed income investment process at PSG Asset Management encompasses a bottom-up valuation-based approach combined with views on the global macroeconomic environment. One of the valuation models used to estimate a fair value yield on South African government bonds is to base an expectation of a fair yield off the US 10-year government bond, typically viewed as the global risk-free rate. The method adjusts a long-term view of the US 10-year yield by adding a long-term view of the US-South Africa inflation differential and adds a sovereign risk premium (a long-term view of the South African CDS spread). This measure provides a rough but reasonable expectation for local and foreign investors of South African yields and allows us a long-term through-the-cycle view of what fair compensation should be for our clients.

Graph 2: The South African 10-year credit default swap (CDS) spread



Sources: Bloomberg, PSG Asset Management

Yields have risen, but are they at fair value?

In assessing the rise in South African government bond yields discussed above, a key consideration is whether the current yields reflect the risks inherent in the security. In a South African context, growth and global economic competitiveness have further deteriorated since 2012 and it is evident that consumer demand and commodity prices are unlikely to drive inflation expectations much higher. As a result, the key risk for South African bond yields rising further relates to sovereign risk from a rating downgrade perspective and rising fear of emerging market distress.

With yields at subdued levels for significant periods, it is easy to become comfortable with the repricing in yields that has taken place since 2012. This is the type of scenario we like to avoid at PSG Asset Management, specifically getting too comfortable in applying our investment thinking.

In November 2015, government bond yields rose in anticipation of further credit rating downgrades and impending interest rate hikes by the US. The five-year CDS increased to almost 3.5%, well above the long-term average. This was fully reflected in South African government bond yields, with the 5- and 10-year yields at 8.13% and 8.58% respectively.

It is at these points in the bond cycle where deep questioning of the investment opportunity and potential risks is more important than ever. While government bonds began to offer real yield for investors, the risks of rising yields remained evident. While the market was buying, we chose to remain cautious as the risks of yields rising further (and bringing about capital losses) have remained prevalent. At 31 December 2015, South African 5- and 10-year government bond yields had risen to 9.43% and 9.80% on the back of rating downgrades and political instability.

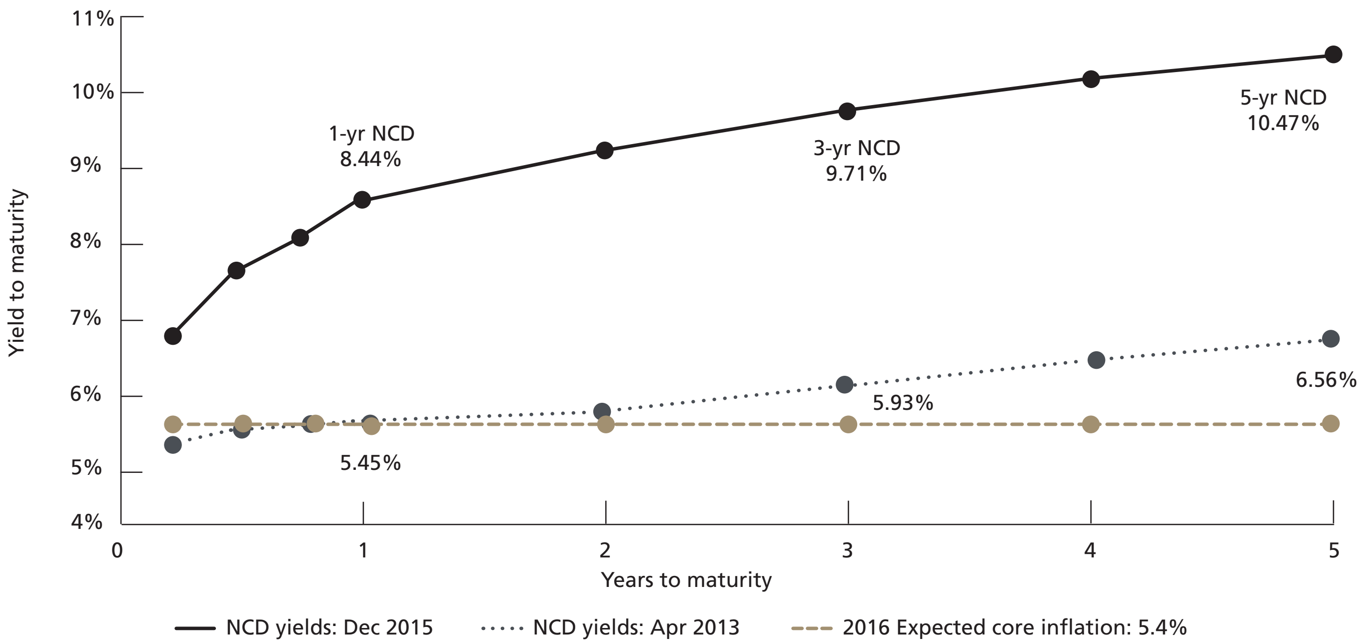
It is always important in any process to acknowledge that not all risks can be foreseen, but a focused approach of risk analysis can limit greed when yields appear to be more attractive.

We identified an opportunity that offers real returns and a sufficient margin of safety

Our funds have been invested in long-term fixed negotiable certificates of deposit (NCDs), which we view as quasi cash instruments with liquidity and minimal credit risk (see the article on cash by Paul Bosman in the second quarter 2015 edition of *Angles & Perspectives*). NCD yields over the past three years have risen significantly. Major factors driving the rise in yield reflect increased sovereign risk and the effects of regulatory developments of BASEL III regulation, which requires South African banks to have additional long-term funding to meet the required capital ratios. The South African Reserve Bank had also increased the repo rate four times since January 2014, by 125 basis points in total.

NCD instruments represented an investment opportunity for our funds because they met our investment criteria for providing a sufficient margin of safety and real risk-adjusted yield for our clients. This has also provided us with flexibility in cash to take advantage of opportunities in riskier asset classes. Graph 3 indicates the significant rise in NCD rates over the past three years.

Graph 3: The rise in negotiable certificates of deposit (NCD) rates



Sources: Bloomberg, PSG Asset Management

Our fixed income investments attributed to the significant increase in yields in our income and multi-asset class funds

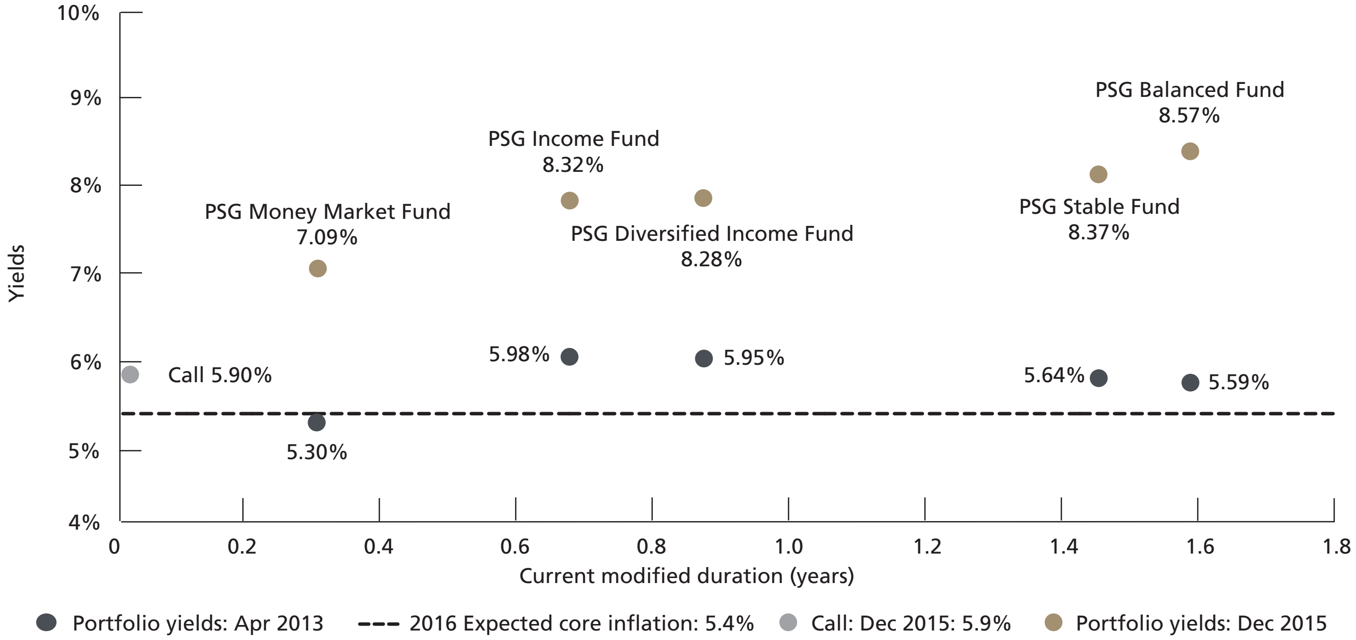
Graph 4 indicates the significant increase in yield offered by our funds since 2013. This reflects our fixed income investment team's best views on NCDs, floating rate credit and fixed rate credit that have met our stringent criteria for qualifying as an opportunity for our clients.

Our funds offer an opportunity for long-term saving

While market factors have driven yields higher across fixed income instruments, the higher yields in our funds provide evidence of our risk-first approach. Our funds' yields have risen while undertaking minimal interest rate risk (the risk of yields rising, resulting in capital losses) as measured by the low modified durations of our funds.

At PSG Asset Management, we view ourselves as partners of the counterparties we invest in. For an investor willing to partner with a diligent investment team for the longer term, our fixed income and multi-asset funds offer an opportunity to earn a real yield appropriate for the risks undertaken.

Graph 4: Increase in the yields of the fixed income portions of the PSG income and multi-asset class funds since 2013



Sources: Bloomberg, PSG Asset Management