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Meeting the challenge of today's fixed income markets

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The new world of fixed-income investing

In today's stressed markets every fixed income asset class carries at least some degree of default risk: investors need to ask themselves if the concept of a 'risk-free' rate still has any credence. Moreover asset class definitions are becoming so blurred as to be meaningless. The changes we are witnessing represent a seismic shift in fixed income market behaviour and this in turn means that conventional approaches to assessing the fixed income universe have become obsolete.

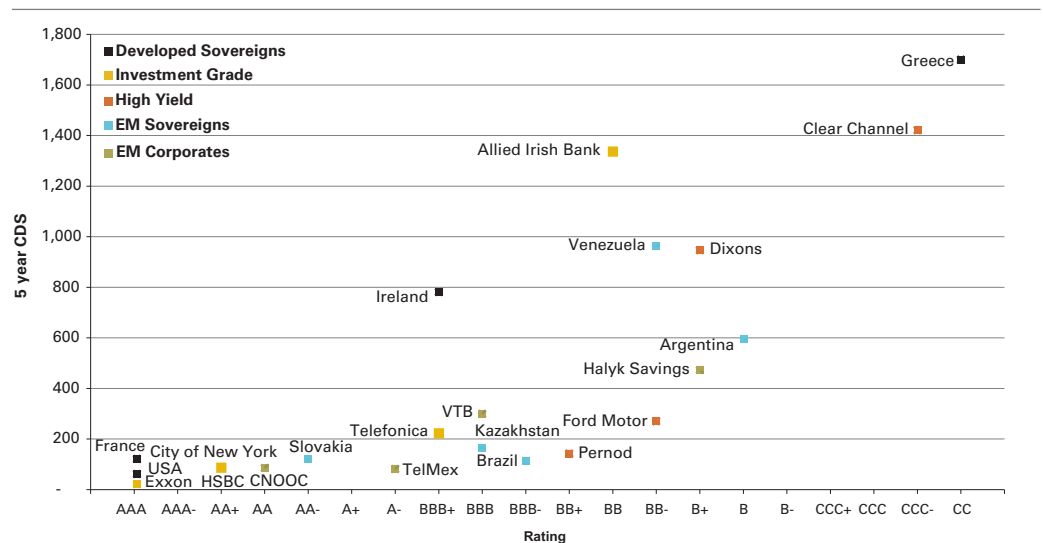
Blurring the lines

The characteristics that once defined fixed income asset classes have become less relevant and less pronounced. The ascendancy of emerging markets has been well documented, as has the deterioration of some developed market economies such as Greece, Ireland and Portugal. These are not short-term occurrences. Many developed nations, following years of growing fiscal imprudence and higher leverage, are now effectively bankrupt. We believe the healing process will be long and arduous, and will have a lasting impact.

The blurring distinctions between fixed income sectors can readily be seen in the chart below. The market-perceived credit risk of a range of issuers is shown plotted against those issuers' credit ratings.

Asset class borders have been torn down

Spreads and Ratings



Source: Bloomberg, as at 31.07. 2011.

For most of the previous three decades, the different asset class categories would have appeared as reasonably tight clusters in this chart. Today the degree of overlap seen is unprecedented, simply knowing the classification an asset resides in offers very little insight into its price.

Seismic shifts

Equally interesting is the extent of dispersion within the various asset classes, which also remains at historically high levels. For example both Greece and Germany are classed as developed markets, but the underlying risk and observed prices have almost nothing in common. If these shifts are permanent, as we believe they are, the conventional framework employed to assess risks has indeed become inadequate.

Threadneedle's approach to managing global fixed income

This analysis is key to the way we manage our global fixed income strategies as well as informing those strategies with a more specific remit.

■ Throw out conventional definitions and focus on risk and return

Threadneedle looks to capture the most attractive risk/return opportunities in the market, irrespective of asset class. Thus by discarding conventional asset class definitions we seek to exploit the dislocations that emerge from traditional approaches to fixed-income investing and capture the rapidly evolving array of global opportunities that emerge as asset classes blur.

■ An investment processes that reflects reality

We analyse assets of different structures, geographies, liquidity and credit risk in a way that aggregates the results into an investable outcome. This could mean for example determining whether Indonesia is attractive relative to assets in other areas such as Irish mortgages or the subordinated debt of a German bank. To achieve this we have developed a rigorous scenario-based analysis process for managing the proliferation of assets and return profiles.

■ Adapting market research to assess market drivers

The pace of globalisation has altered the importance of market drivers. Government and central bank policy, global liquidity and the evolution of large global imbalances have replaced domestic GDP and inflation as the key drivers of fixed income markets. In order to assess the prospects of various asset classes today Threadneedle's has adapted its fixed-income

research capability in order to help us answer key questions such as:

- How the Eurozone crisis will play out?
- Will large debtors like the US, UK and Japan be able to move to fiscally sustainable debt trajectories?
- Can China navigate through accelerating price pressures to deliver sustainable non-inflationary growth?

■ Asset allocation using non-traditional factors

Most fixed income asset classes behave in a way that is more attributable to their risk characteristics than to their categorisation. Beta exposure, momentum, carry and value are four such risk factors that in aggregate explain much more about how a portfolio will perform than does asset allocation. In fact the high degrees of correlation all risky assets have displayed in recent years suggest that asset class definition no longer has much to do with performance.

Threadneedle's investment approach - ideally suited to the new fixed income environment

The shifts we are witnessing today are the culmination of five decades of globalisation. As with all transformations, there will be dislocations that persist. We believe that in order to effectively manage a global fixed income portfolio it is necessary to continually assess relative value across (and within) asset classes and question the appropriate allocation to each of them. This is a challenging but exciting time to be managing fixed-income portfolios and Threadneedle, with its emphasis on sharing and debating investment ideas, together with its highly experienced and extensive fixed income team is well placed to take advantage of the radically new fixed income environment in which we find ourselves.



Find out more

Speak to your usual Threadneedle Investments contact.
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