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Portfolio Management in the New Normal

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The key questions to ask your Fixed Income Manager

Chamath De Silva, BetaShares

BetaShares

The key questions to ask your fixed income manager

Chamath De Silva
BetaShares Senior Portfolio Analyst

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Speaker

Chamath De Silva

Senior Portfolio Manager,
BetaShares

Agenda

1. Role of fixed income in defensive portfolios (in a low interest rate environment)
2. Pitfalls of existing and new fixed income strategies (passive & active)
3. Product solutions - how to invest in fixed income (pros & cons)?
4. What are the key questions to ask your fixed income manager?

1. Role of fixed income in defensive portfolios (in a low interest rate environment)

Introduction to fixed income

Fixed income and “defensive assets” should be a bespoke solution

Fixed income exposures should be assessed on how well they serve the overall portfolio

The amount of equities and the type of equities held can make a big difference to the effectiveness of fixed income

Investors are paid for bearing duration and credit risk vs cash over the long run

	US$ Fixed Income Excess Return over Cash				Excess Return over Govt	
	1-10y Govt	10y+ Govt	1-10y Corp	10y+ Corp	1-10y Corp	10y+ Corp
2010s	+1.9%	+6.5%	+4.0%	+7.4%	+2.1%	+1.0%
2000s	+2.6%	+4.7%	+3.5%	+4.5%	+0.9%	-0.2%
1990s	+1.9%	+3.4%	+2.7%	+3.5%	+0.8%	+0.1%
1980s	+2.3%	+3.3%	+3.0%	+3.9%	+0.7%	+0.6%
1970s*	-0.3%	-1.8%	-0.5%	-2.0%	-0.2%	-0.2%
Long-Run	+1.8%	+3.5%	+2.7%	+3.7%	+0.9%	+0.3%

Sources: Bloomberg, Betashares. Data current as at December 2020. Returns based on Bloomberg Barclays US Intermediate Treasury Index, Bloomberg Barclays Long Treasury Index, Bloomberg Barclays Intermediate Corporate Index, Bloomberg Barclays Long Corporate Index and Bloomberg Barclays US Treasury Bill Index returns. Past performance is not indicative of future performance. *Data available from March 1973.

With cash rates at the zero lower bound

- Fixed income can still produce excess returns over cash from carry and rolldown from steep segments of the yield curve

- Can still diversify equity risk, in the case of government and high grade bonds

- Can provide liquidity in size to take advantage of corrections, crashes and dislocations in risk assets

2. Pitfalls of existing and new fixed income strategies (passive & active)

Fixed Income: Being efficient in defence

Problems with fixed income benchmarks

Liability weighting

- Issuers can set their own weight in the index
- Issuer preferences determine risk profile of the index

Unstable risk profiles

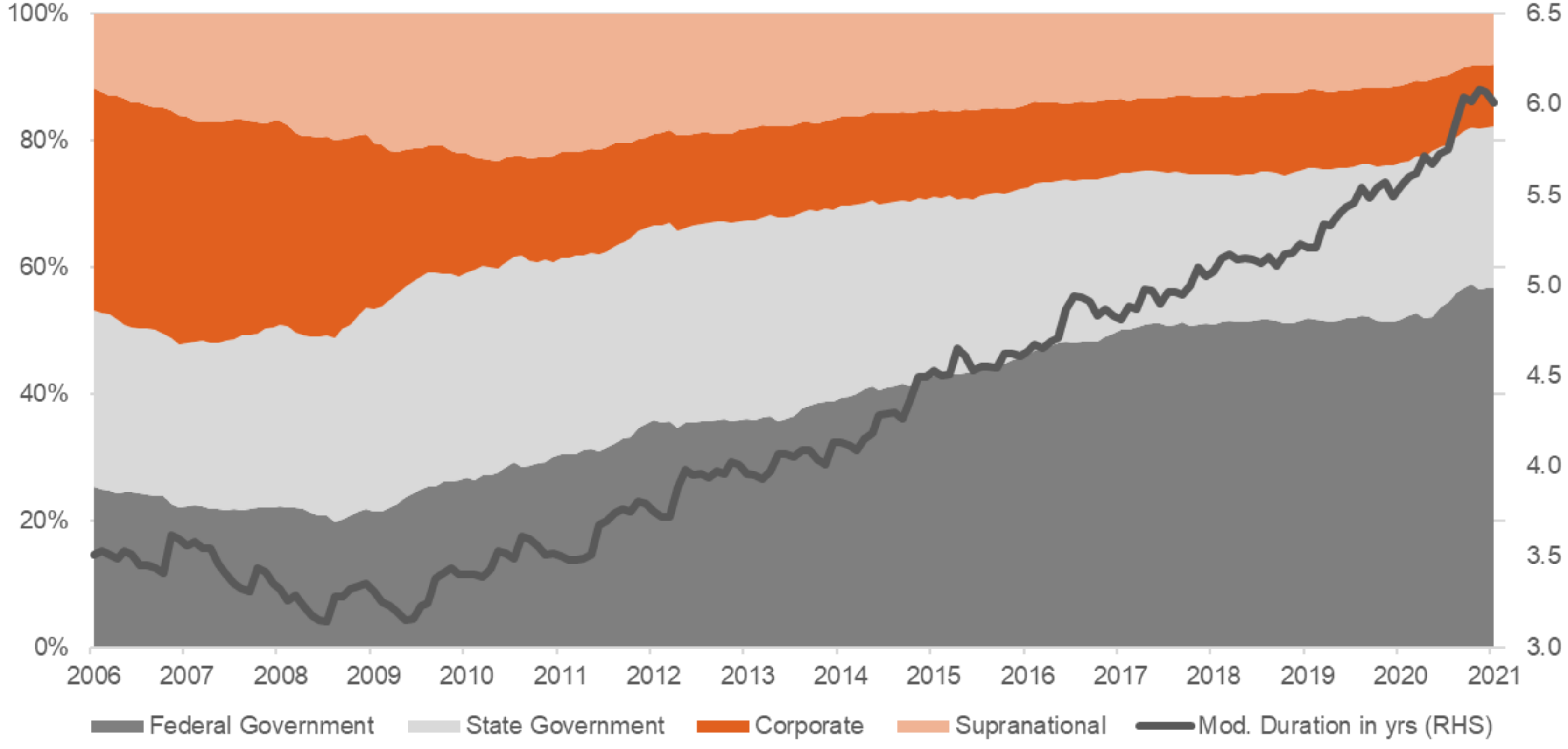
- Duration creep
- Segment creep

Inefficient

- Current monetary policy has impacted potential returns and capacity to provide meaningful diversification benefits

Segment creep of benchmarks

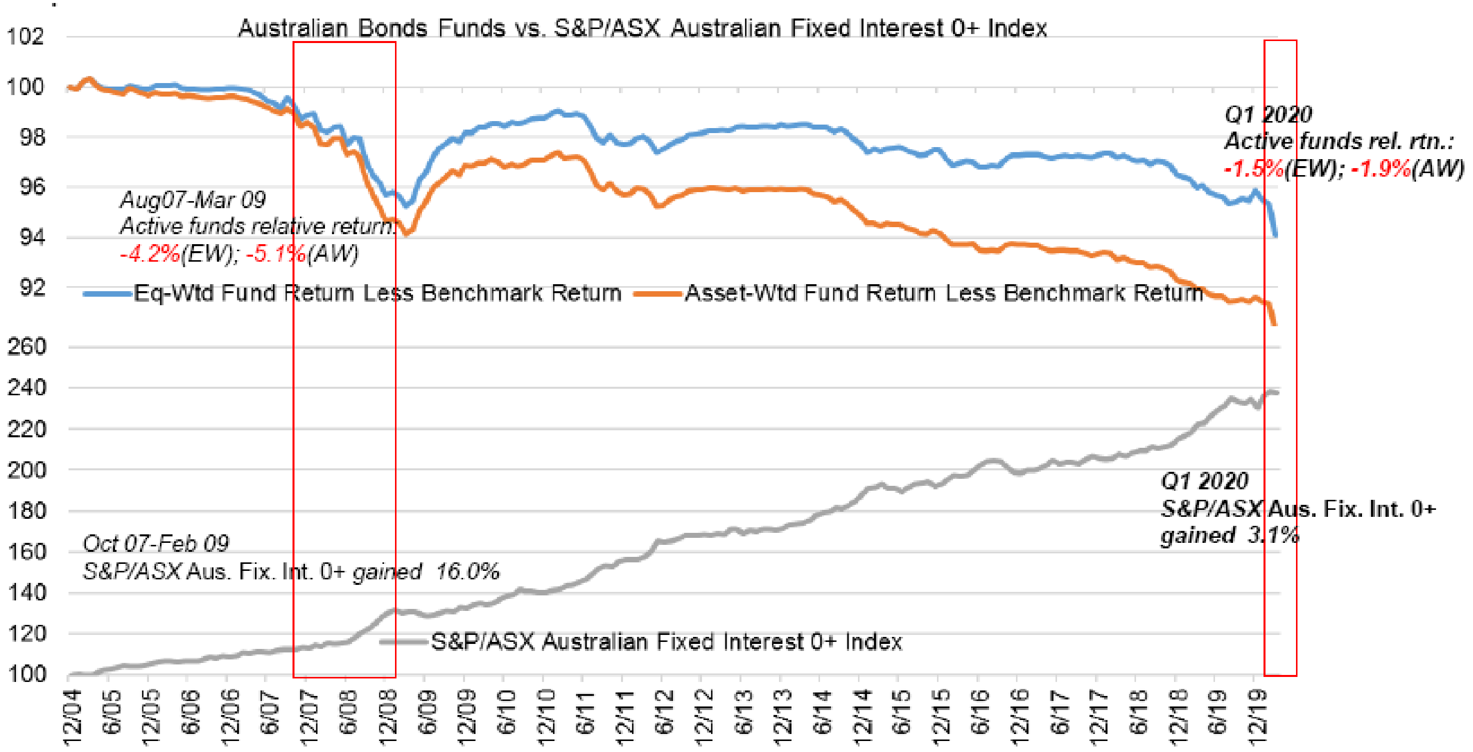
Composition of Bloomberg AusBond Composite by class



Sources: Bloomberg, Betashares. Data to January 2021.

SPIVA Australia Report

Active funds vs benchmark returns: Australian bonds

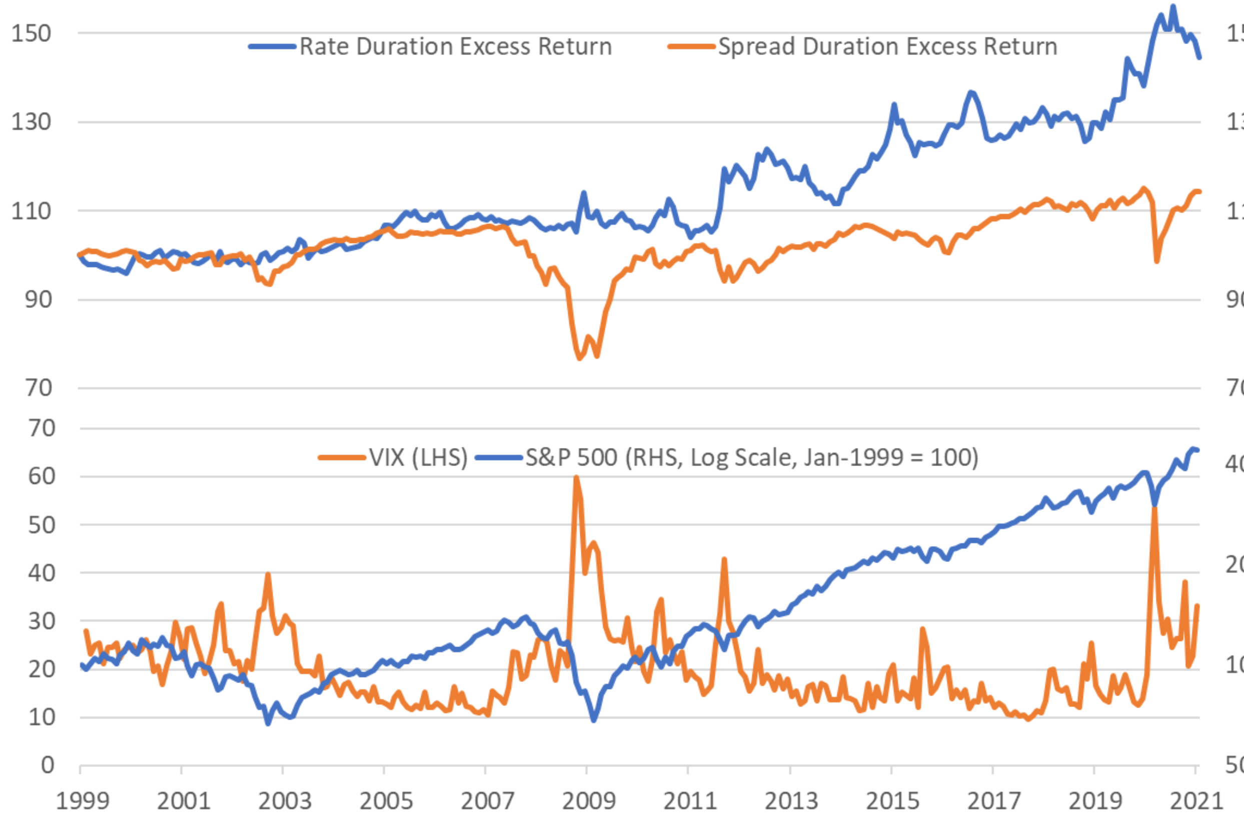


- 88% of fixed income funds underperformed the index in Q1 2020
- 72% of fixed income funds underperformed the index in 2019
- Fixed income active management fared the worst (relative to the broad composite index) among all Australian active managers across all asset classes
- Historically, active fixed income in aggregate has underperformed the index, with underperformance greatest during crisis periods

Sources: S&P Dow Jones Indices LLC, Morningstar. Data as at 15 April 2020. All returns in AUD. **Past performance, whether actual or back-tested, is not indicative of future performance.** Table is provided for illustrative purposes and reflects hypothetical historical performance. The S&P/ASX Australian Fixed Interest 0+ Index was launched 5 September 2014. All information prior to an index's launch date is back-tested (not actual), using the methodology in effect on the index launch date. Please note there are inherent limitations with back-tested performance.

Rate duration, credit duration and equity diversification

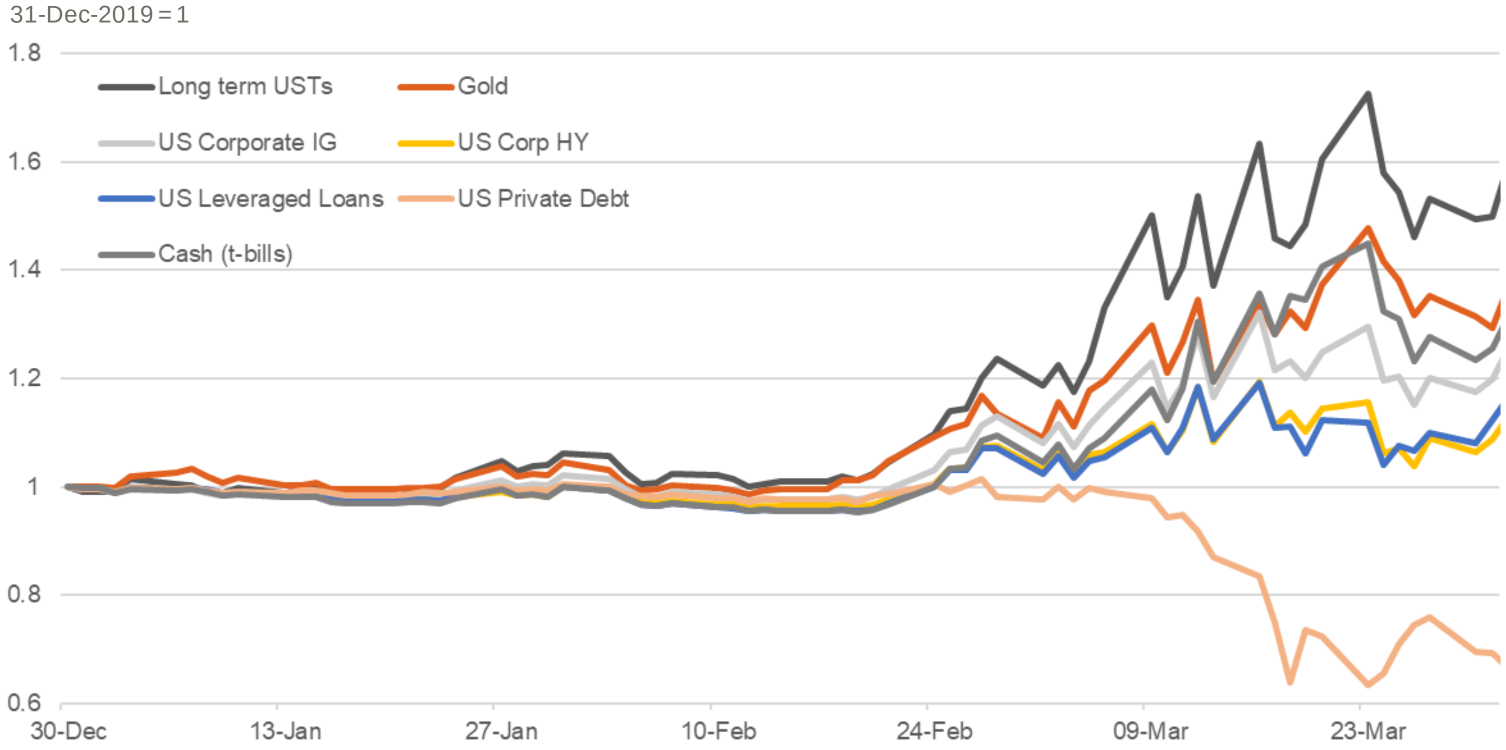
- Historically equity portfolios have benefited more from interest rate duration than credit spread duration
- Credit returns are highly correlated with equity returns, with the correlation increasing during periods of high volatility
- Credit exposures have a negative return skew, with asymmetric downside risk, particularly at starting levels of tight credit spreads



Sources: Bloomberg, BetaShares, data to January 2021. Rate duration represented by excess return of the Bloomberg Barclays US Treasury 10-20y Index over the Bloomberg Barclays US Treasury 7-10y Index; spread duration returns represented by the excess return of the Bloomberg Barclays US Corporate 7-10y Index over the Bloomberg Barclays US Treasury 7-10y Index. Past performance not indicative of future performance.

Liquidity and taking advantage of opportunities in risk assets

Performance vs S&P 500 Q1 2020

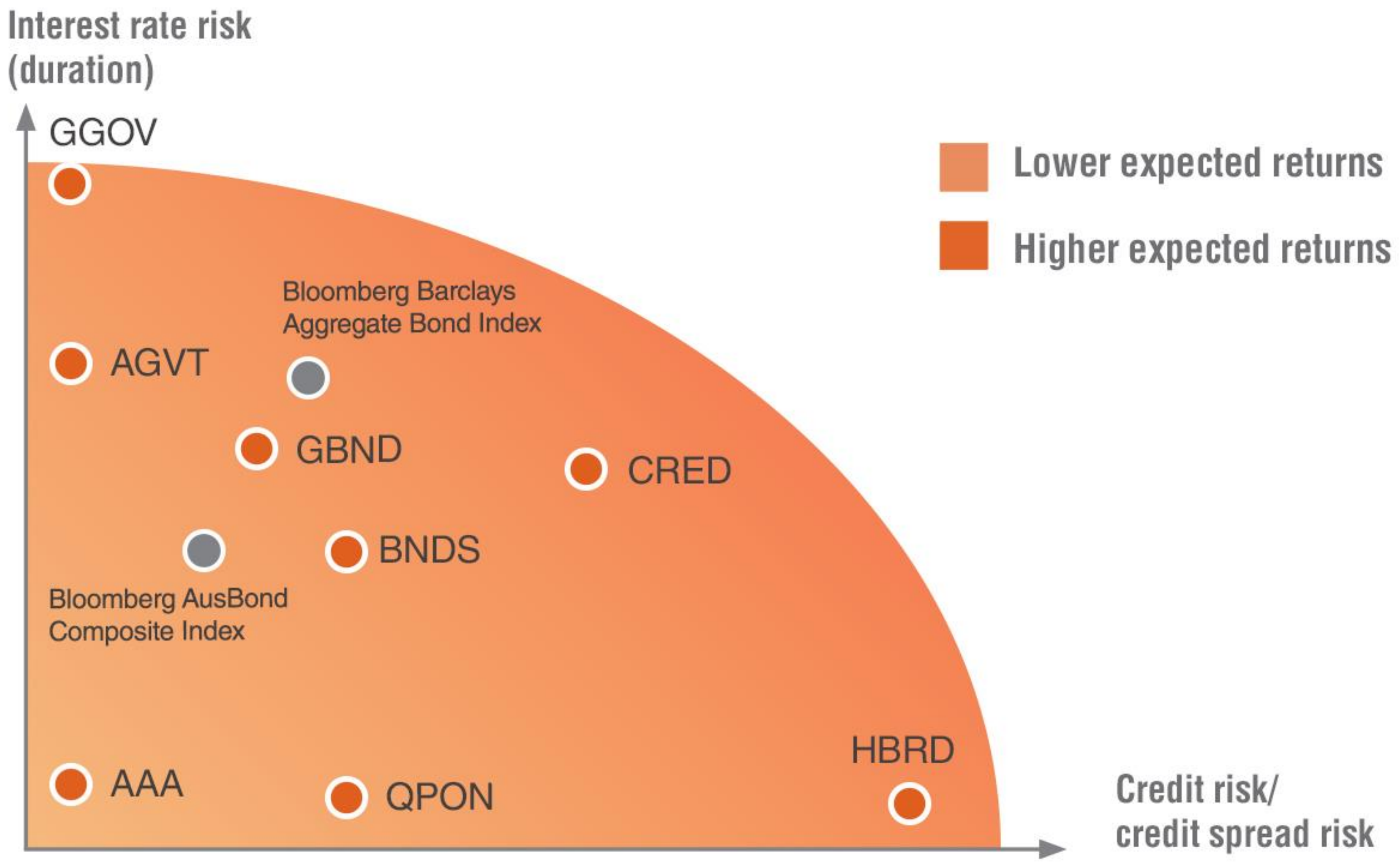


Sources: Bloomberg, Betashares. Past performance not indicative of future performance.

- Rebalancing and equity dip-buying is not frictionless during periods of market stress, with liquidity disappearing from many segments of fixed income in March 2020
- Long term U.S. Treasuries performed the best, followed by gold, with credit exposures struggling
- Highly touted 'defensive alternatives' like leveraged loans and private debt lacked both the capital gains and liquidity to take advantage of the equity decline

3. Product solutions - how to invest in fixed income (pros & cons)?

Finding the right “building block” with ETFs



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Sample framework for diversification

- **Longer time horizon → more duration**
- **More liquidity needs → more government and cash; less credit**
- **Larger equity allocation in portfolio → more government; less credit**
  - More cyclicals/value/financials → more government; more duration; less credit
  - More quality growth (e.g. U.S. tech megacap) → more credit; less duration
  - More bond proxies (REITS, utilities, infrastructure) → less credit

Adding value in asset allocation

- **Fixed income can generate equity-like returns in the right economic environment**

- **Still has strong portfolio diversification benefits even with yields at historical lows**

- **However, we should be mindful of:**
  - Embedded duration in our equity portfolios - diversification benefits of fixed income vary greatly, depending on the type of equity exposures
  - Equity-like risk in our fixed income portfolios - be cautious about taking on excessive credit risk well into an economic expansion.

4. What are the key questions to ask your fixed income manager?

Questions to ask your fixed income manager

1. Investment strategy and asset allocation outcomes

- What are the fund's investment objectives?
- In terms of the three objectives of fixed income in asset allocation, which does the strategy focus on?
- Do these objectives match my client's needs and complement their overall portfolio?

2. Fund outcomes

- Has the fund outperformed its benchmark after fees?
- How and why has the fund under/over performed?
- How correlated was the fund's performance to equities?
  - Is my client paying fees for "equity beta" in their defensive building block?
- What were the fund's spreads during February / March 2020?

3. Future expectations

- What are the fund's current characteristics?
  - YTM
  - Sector allocation
  - Duration
  - Credit quality
  - Correlation with risk assets
- What net-of-fee returns can my client expect in a lower rate environment?
- Is the client's overall portfolio protected against inflation or deflation?

Questions?

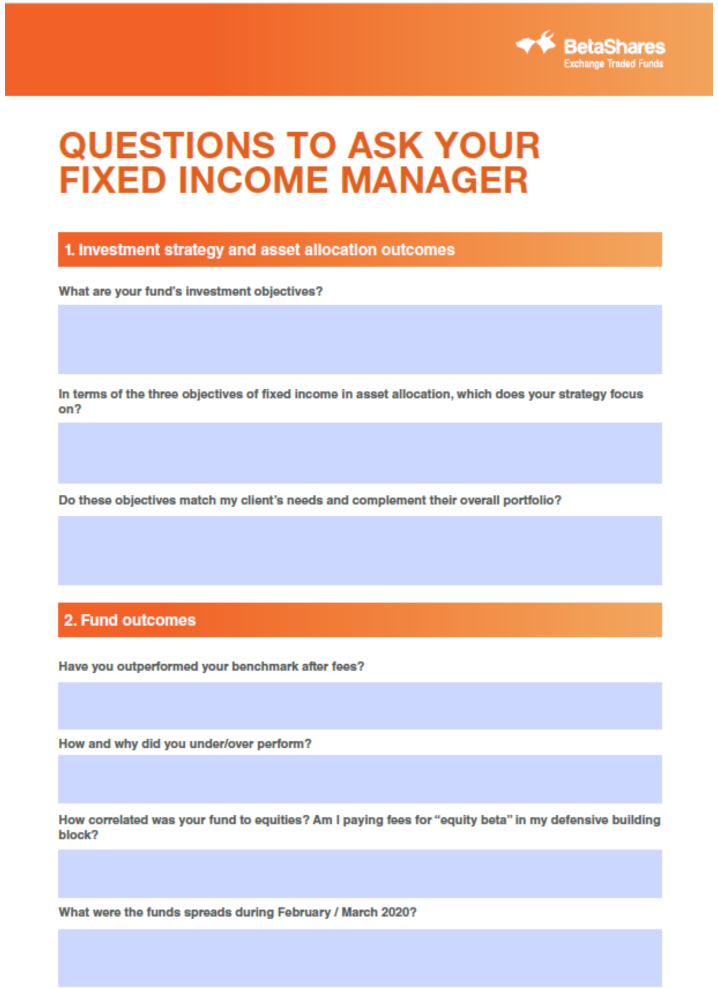
Next steps

1. **Checklist – questions to ask your fixed income manager as a template**

2. **Request for your current fixed income allocations**

   - Portfolio Analytics – performance, risk measures, fees
   - Portfolio Optimisation utilising the "building block" approach

Email to info@betashares.com.au



BetaShares
Exchange Traded Funds

QUESTIONS TO ASK YOUR FIXED INCOME MANAGER

1. Investment strategy and asset allocation outcomes

What are your fund's investment objectives?

In terms of the three objectives of fixed income in asset allocation, which does your strategy focus on?

Do these objectives match my client's needs and complement their overall portfolio?

2. Fund outcomes

Have you outperformed your benchmark after fees?

How and why did you under/over perform?

How correlated was your fund to equities? Am I paying fees for "equity beta" in my defensive building block?

What were the funds spreads during February / March 2020?

Things to consider

- **Investment risk: The value of an investor's portfolio can go down as well as up. Risks include:**
  - Market risk with equities
  - Currency risk with international investments
  - Instrument complexity and bank sector concentration risk with hybrids
  - Interest rate and credit risk with bonds and cash.
- **No guarantees:** Future outcomes are uncertain – desired return outcome may not be achieved.
- **General information only:** Today's discussion does not take into account any person's individual circumstances and is not personal financial advice.
- **Professional advice:** Investors should seek professional financial advice before investing.
- **Research:** See relevant PDS for more information about risks and other features of each fund.

The challenges of building Managed Account Programs for larger Advice Businesses

Justin McLaughlin, ClearView

Martin Crabb, Shaw & Partners

Paul Saliba, AMP

Moderated by Angela Ashton,

Evergreen Consultants

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How Central Bank Policy and Geopolitical Stresses will Affect Investment Markets

Jonathan Baird, Western Asset Management

Jesse Imer, Mason Stevens

Moderated by Nigel Douglas,
Douglas Funds Consulting

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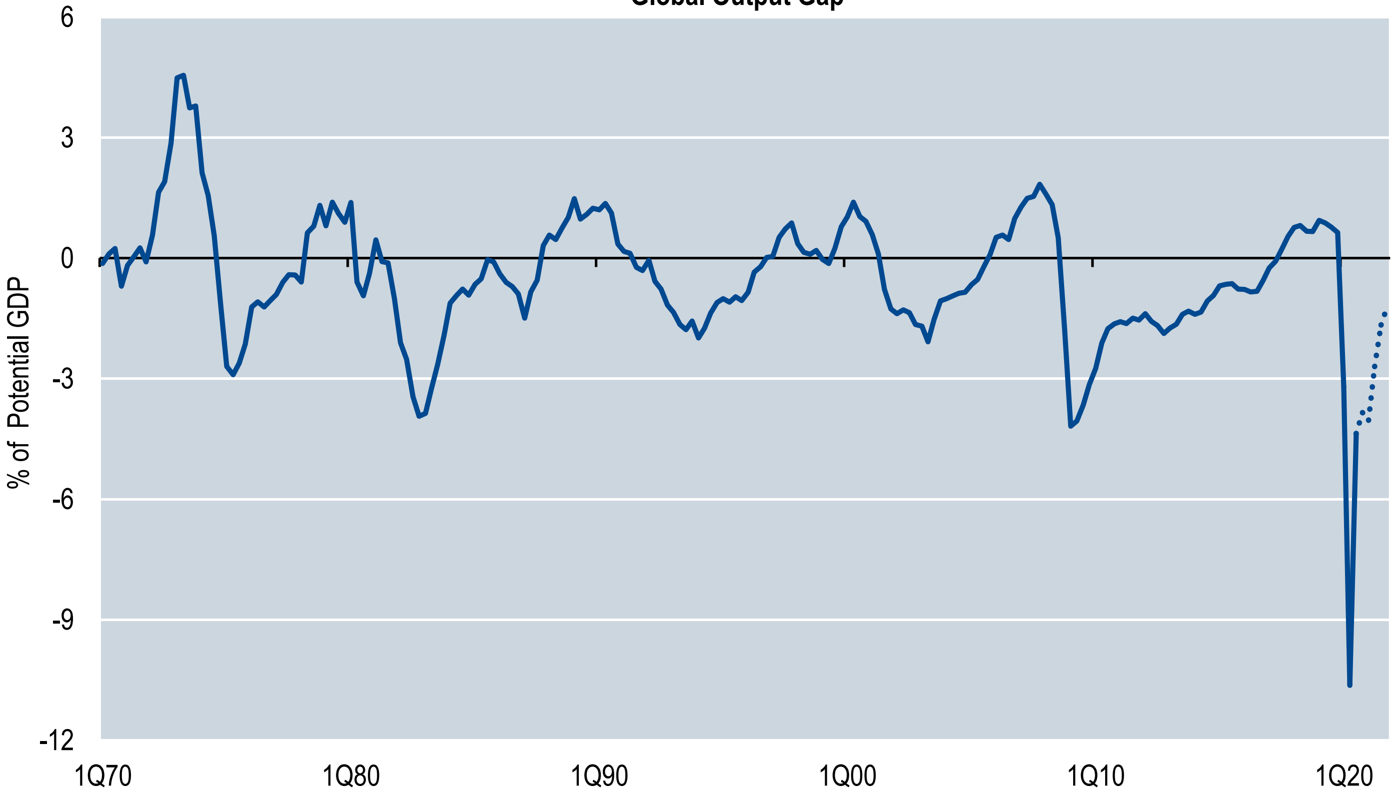
PANEL DISCUSSION:
HOW CENTRAL BANK POLICY AND GEOPOLITICAL STRESSES WILL AFFECT INVESTMENT MARKETS

Jonathan Baird
Head of Client Service and Marketing
– Australia & New Zealand
Western Asset

23 February 2021

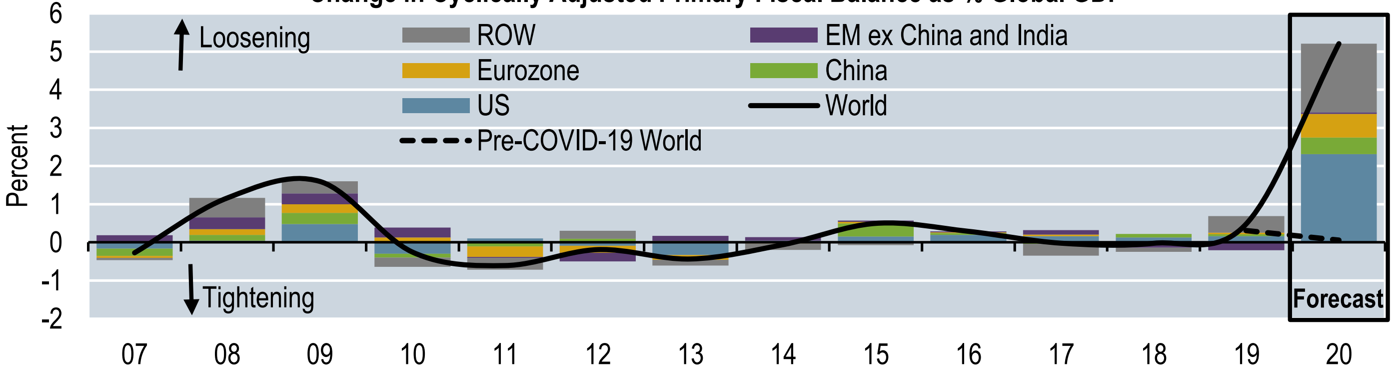
The Global Economy Is Gaining Traction But Faces a Protracted Period of Output Slack

Global Output Gap

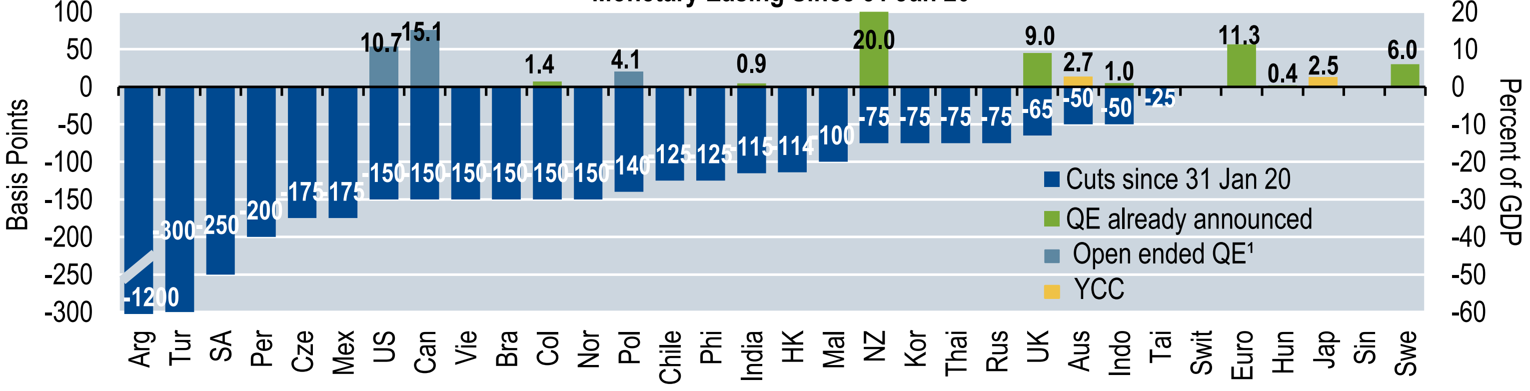


Source: J.P. Morgan. As of 30 Sep 20

Global Governments Have Provided Enormous Amounts of Stimulus

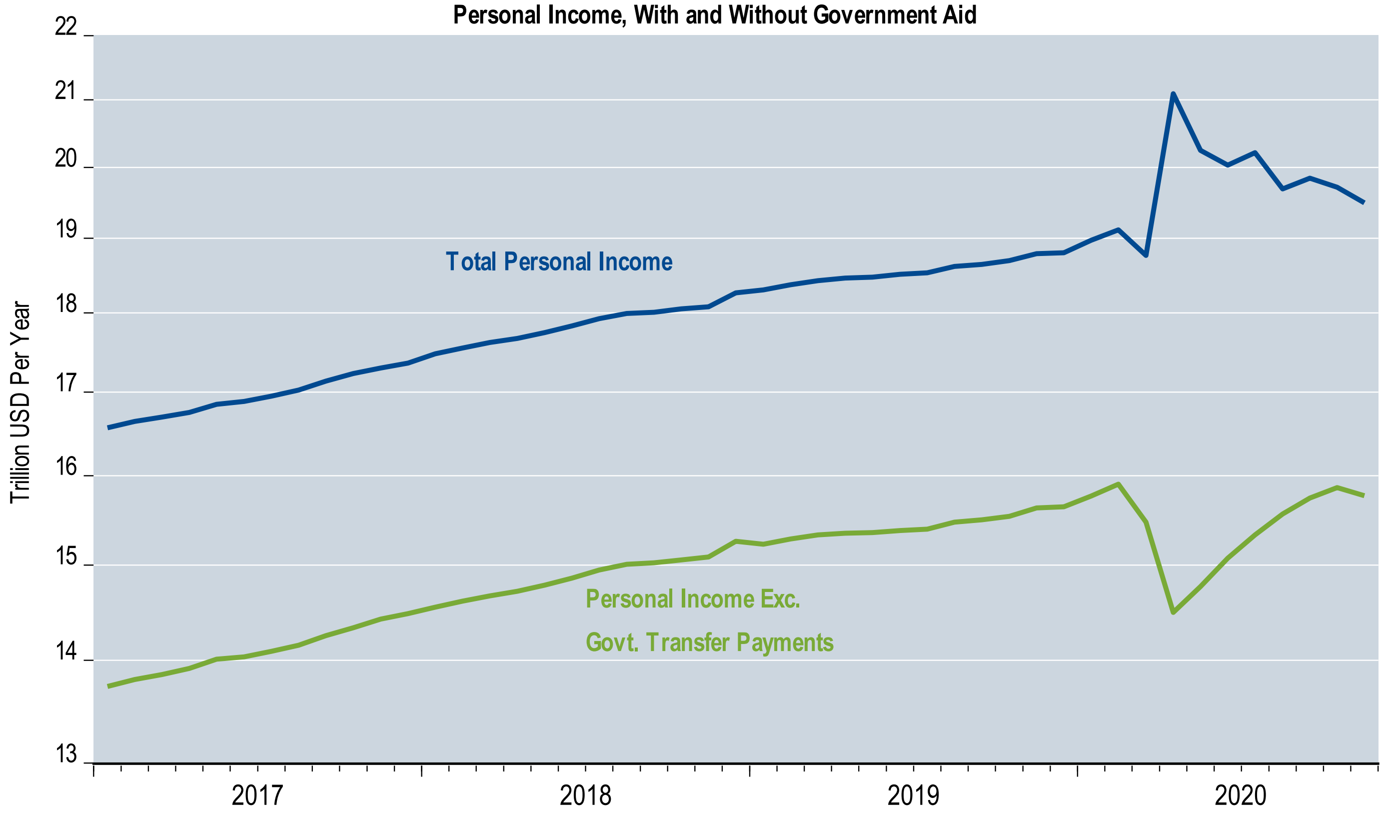


Source: UBS, Haver, European Commission, CBO. AS of 29 Jul 20



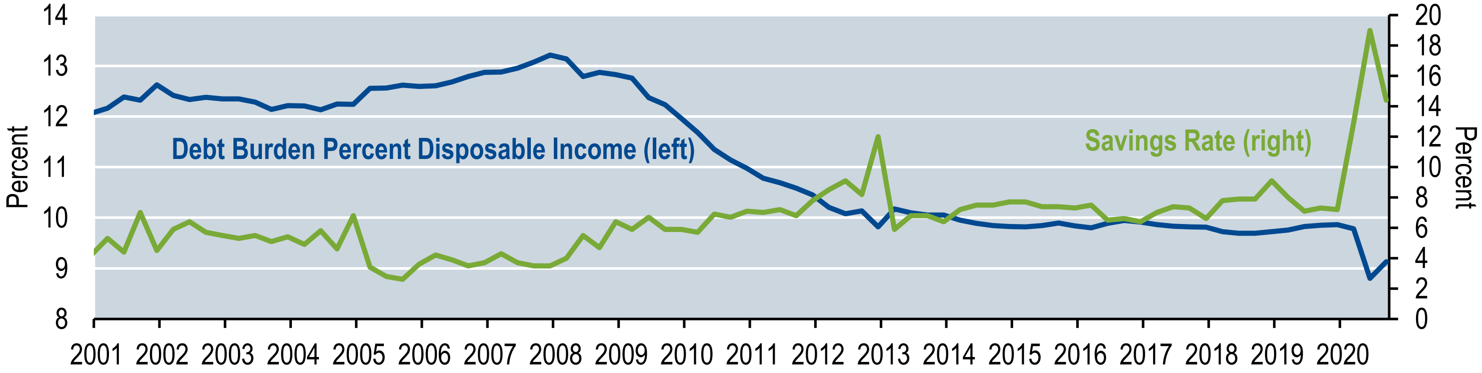
Source: UBS, Haver. As of 15 Jun 20
¹Size of bar denotes CB bal sheet increase since January 2020

Government Support to Households Has Already Been Massive

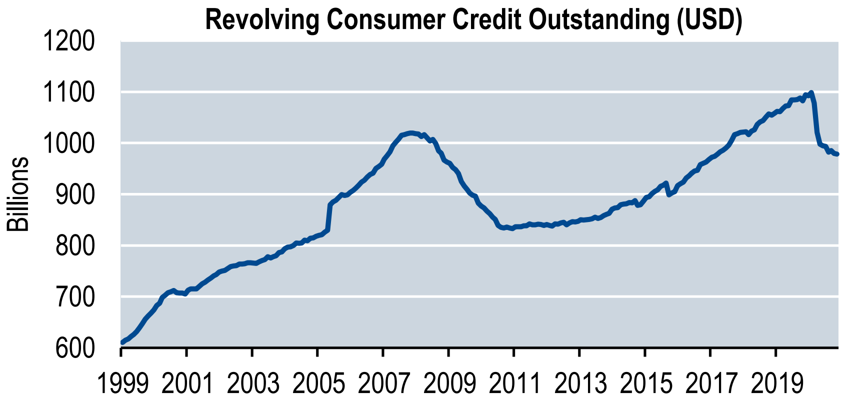


Source: Bureau of Economic Analysis. As of 30 Nov 20

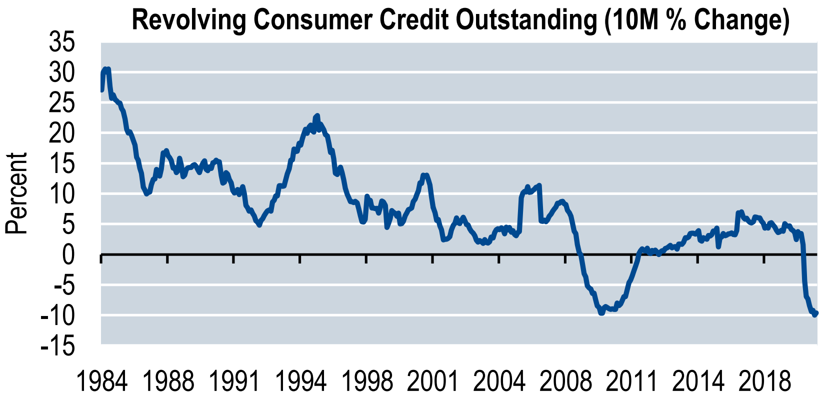
Consumer Fundamentals Have Improved Post-COVID-19



Source: New York Fed Consumer Credit Panel/Equifax. As of 30 Sep 20

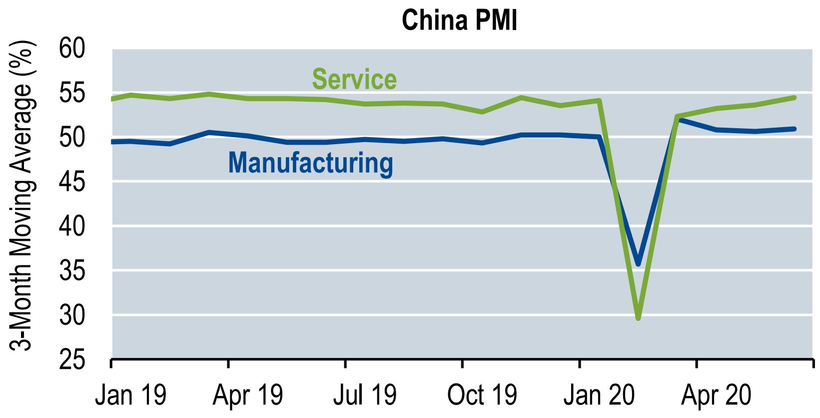


Source: Bloomberg, Rosenberg Reseach. As of 30 Nov 20

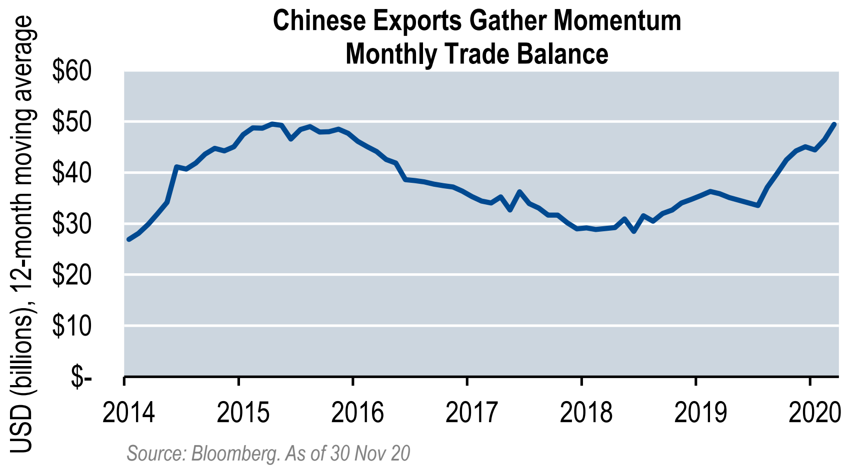


Source: Bloomberg, Rosenberg Reseach. As of 30 Nov 20

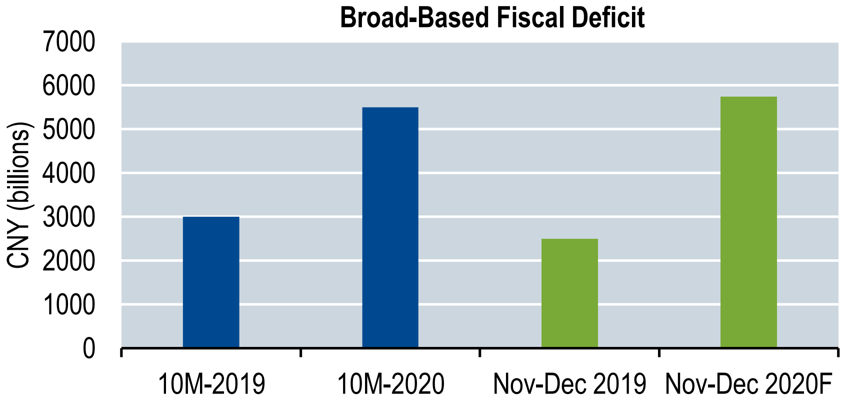
China Outlook: Firm Signs of Economic Normalisation



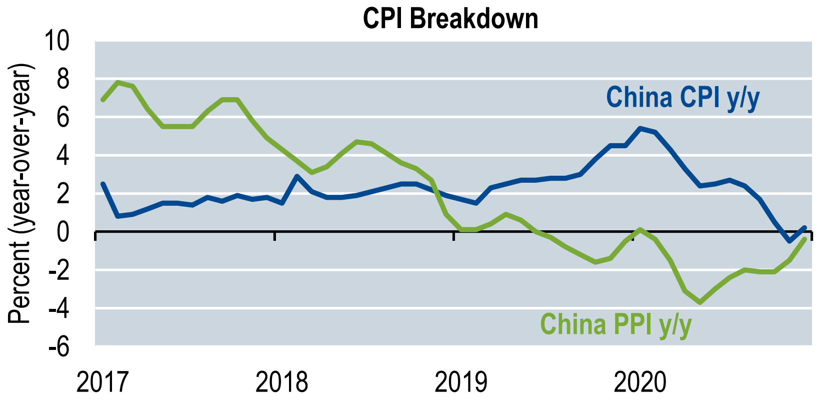
Source: Bloomberg. As of 31 Dec 20



Source: Bloomberg. As of 30 Nov 20

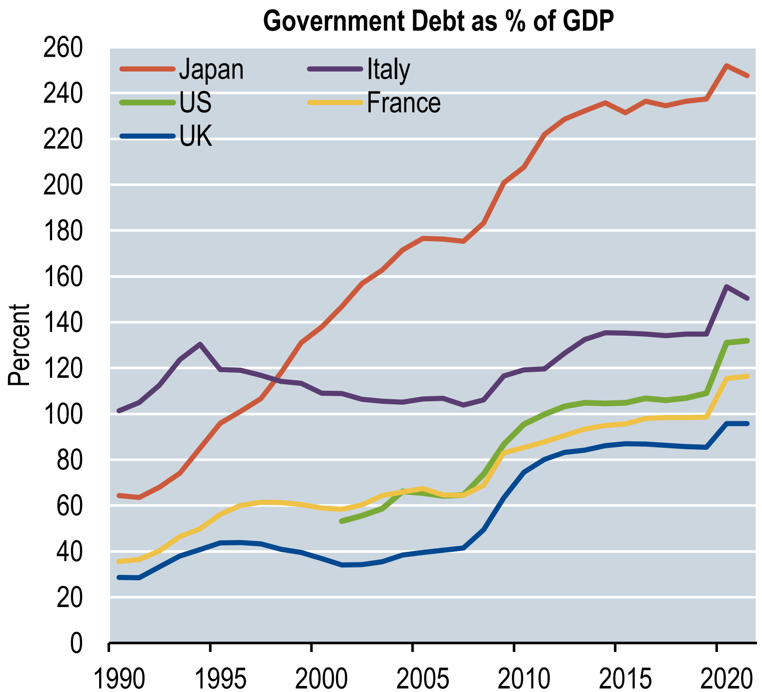


Source: Standard Chartered
Based on calculation following widely accepted fiscal accounting, covering general public and government budget; assumes full implementation of budget

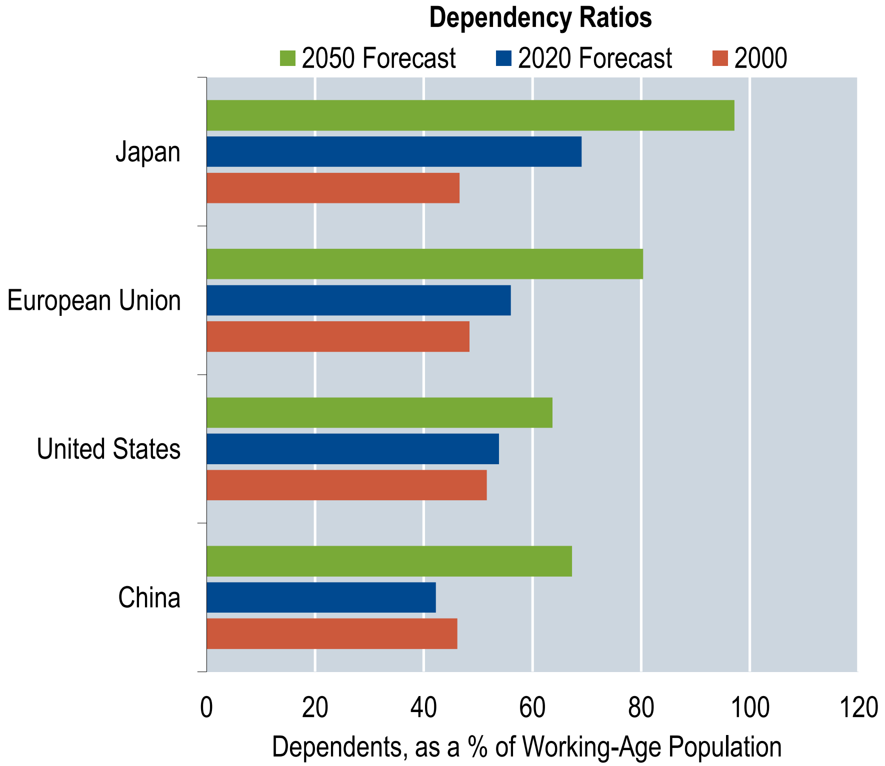


Source: Bloomberg. As of 31 Dec 20

The Challenges to Future Growth



Source: IMF. As of 08 May 20



Source: World Bank. As of 09 Sep 20

Market Confidence in Renewed Inflation May Be Misplaced

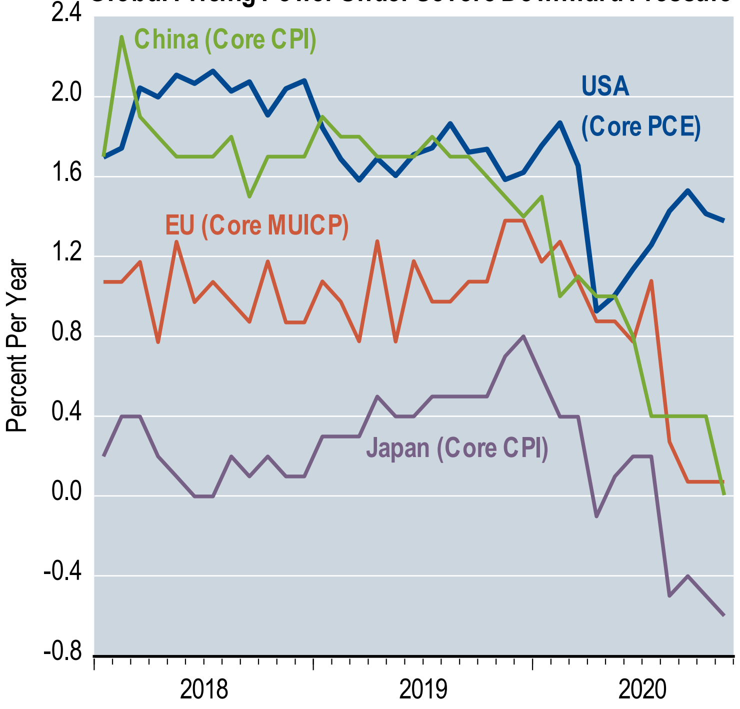
Breakeven Inflation Rates Near Beginning of the Year Levels

10-Year Breakeven Inflation (%)

	31 Dec 19	23 Mar 20	11 Jan 21
Australia	1.41	0.09	1.82
Canada	1.39	0.04	1.50
Germany	0.99	0.23	0.99
Japan	0.16	-0.15	0.06
US	1.79	0.81	2.06

Source: Bloomberg. As of 11 Jan 21

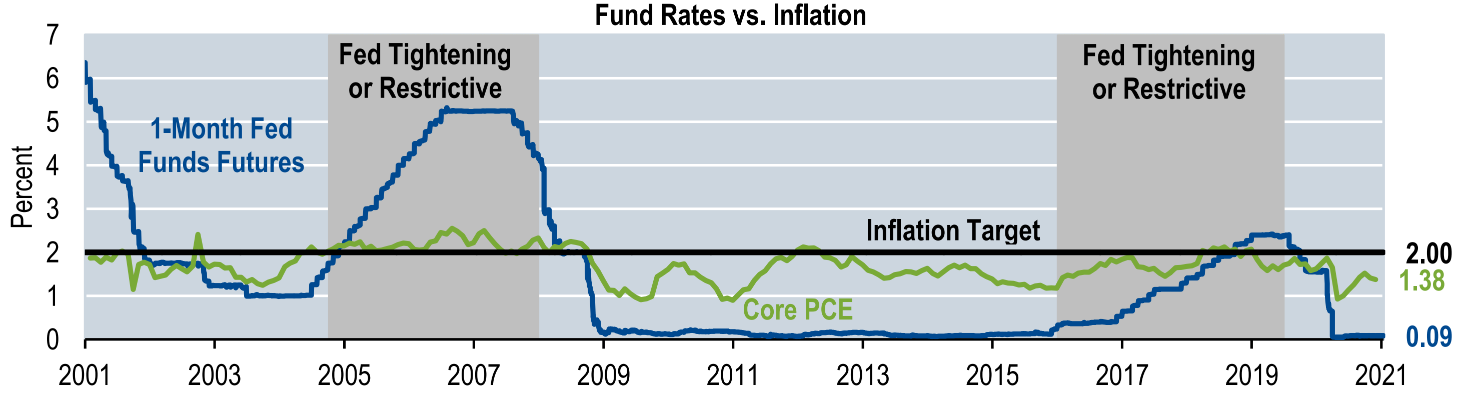
Global Pricing Power Under Severe Downward Pressure



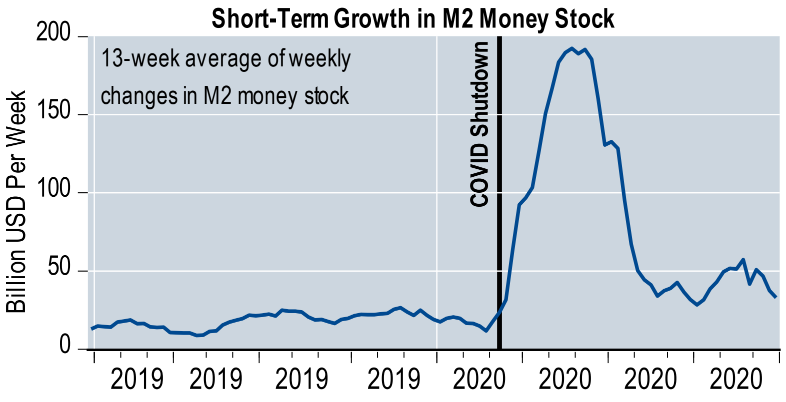
Source: US Bureau of Economic Analysis, Bloomberg. As of 30 Nov 20

Year-on-year (12 Month) change in core consumer prices

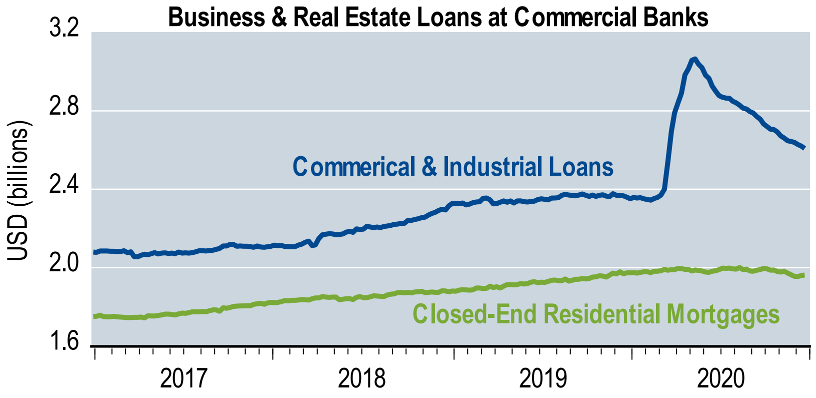
Market and Fed Expectations for Rising Inflation Have Been Seen Before



Source: Bloomberg, HSBC. As of 13 Jan 21



Source: Federal Reserve. As of 28 Dec 20



Sources: Federal Reserve. As of 23 Dec 20

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IMAP: Portfolio Management in the New Normal

Central Bank Policy and Geopolitical stresses

Jesse Imer, Fixed Income Strategist
February 2021

MASON STEVENS

Structural Factors Driving Portfolio Returns

- Geopolitical Imperatives and Strategy
- Global Labour Supply
- Demographic Trends
- Real Wage Growth
- Inflation, Productivity, Borrowing Costs
- Taxation
- Political Stability
- Monetary Velocity

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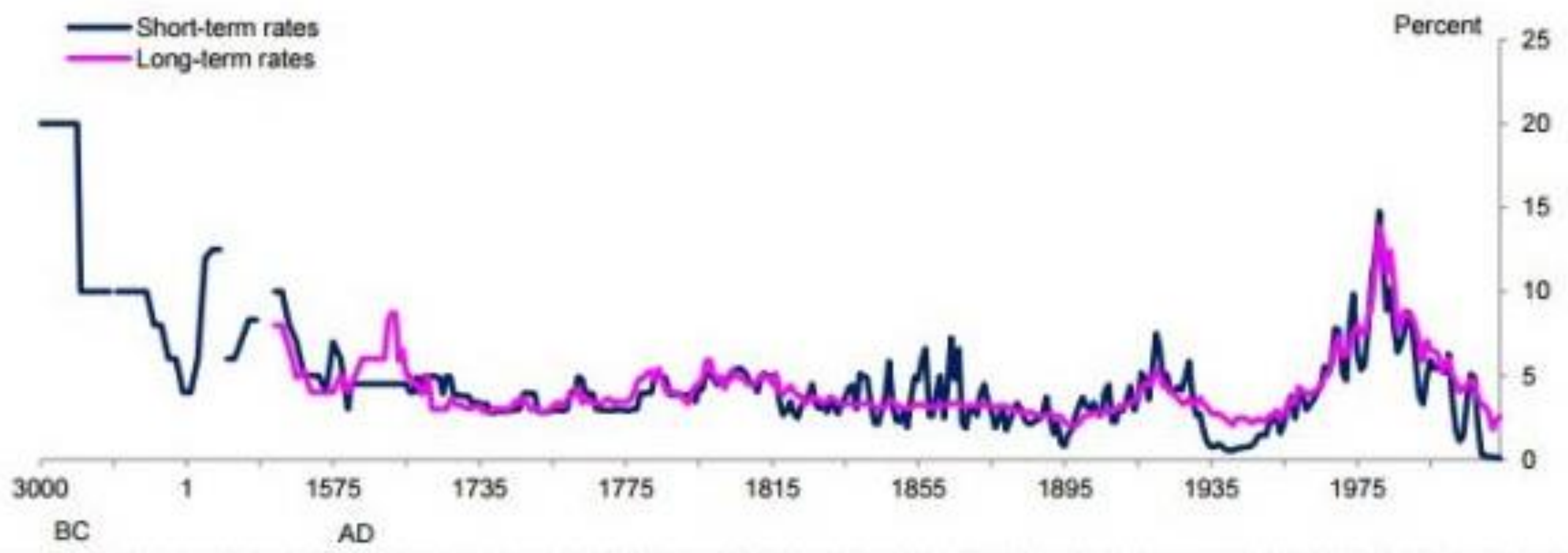
Borrowing Costs: A 5000 Year History of Interest Rates

Rates of interest are at all time lows, never experienced before in history



Source: Homer and Sylla – A History of Interest Rates

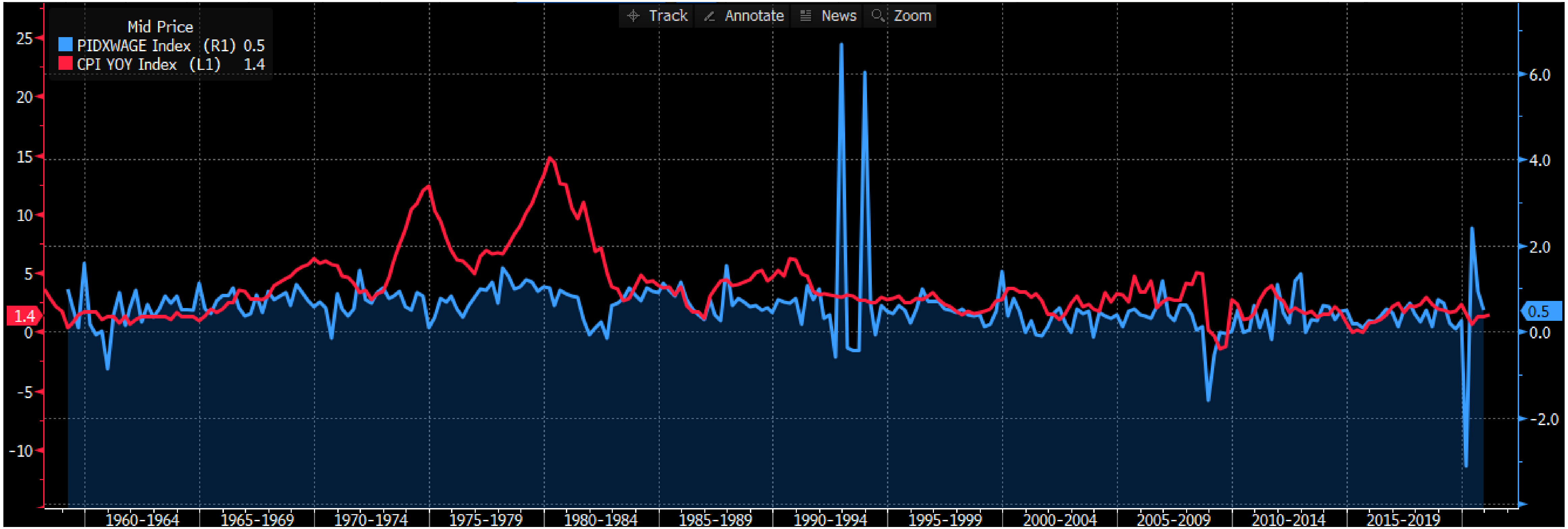
Global Labour Force Growth

A positive supply shock, doubling the available workers

Source: World Bank, Mason Stevens

Real Wage Growth

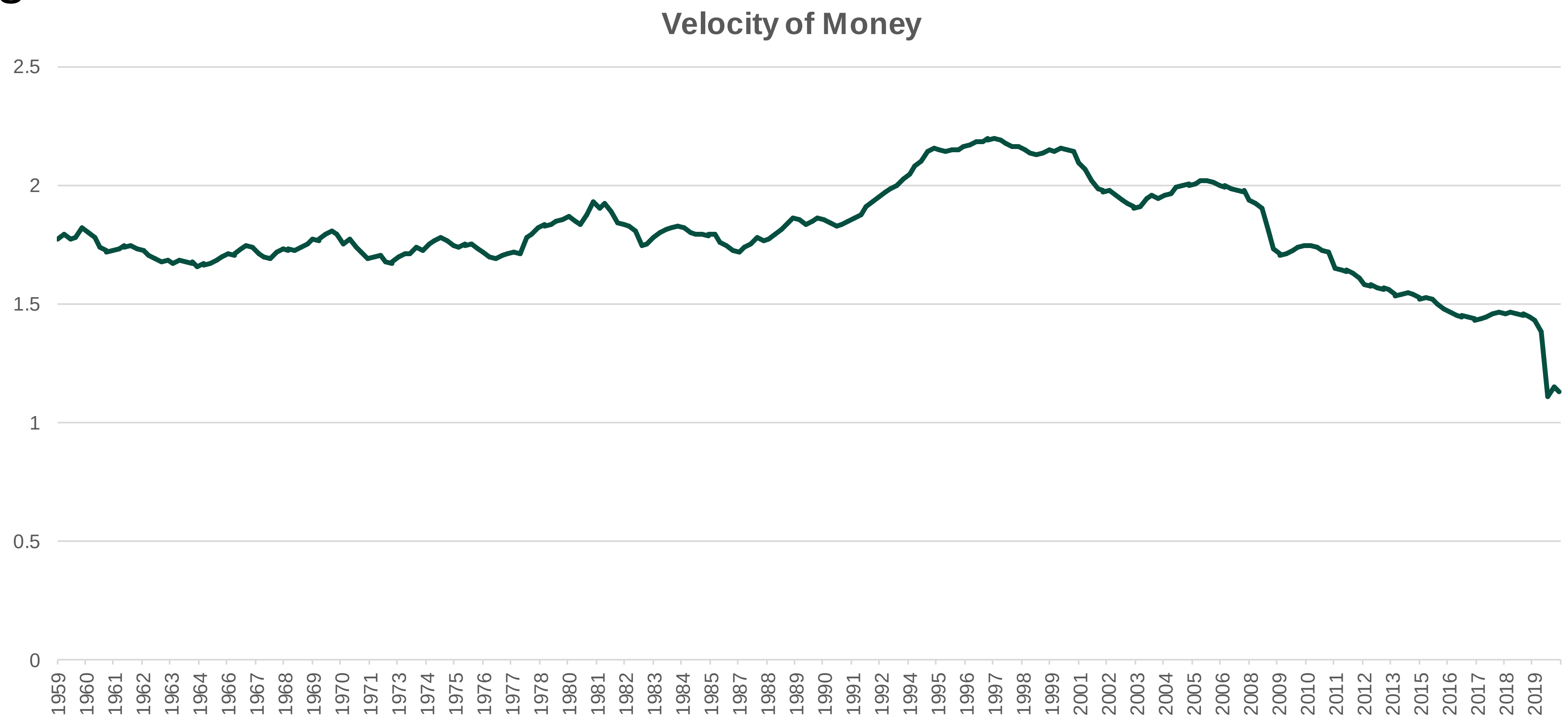
Wages (blue) have grown less than inflation consistently over 30+ years, depressing net disposable income and therefore economic growth for nations reliant on household consumption



Source: Bloomberg

Velocity of Money

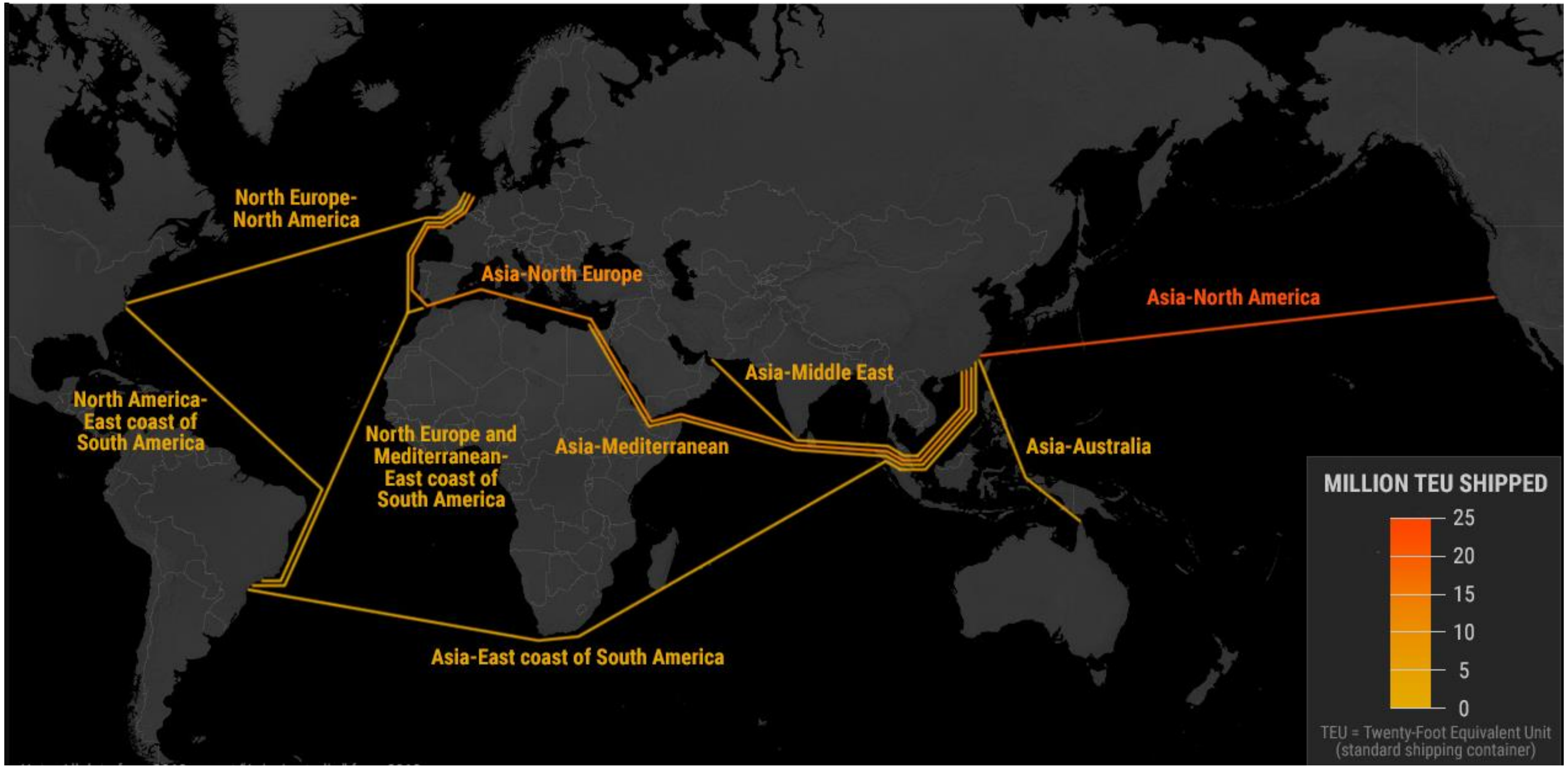
Without real wage growth and economic mobility, velocity of money subsides



Source: Federal Reserve Bank of St Louis, Mason Stevens

Geopolitics: Global Trade Routes

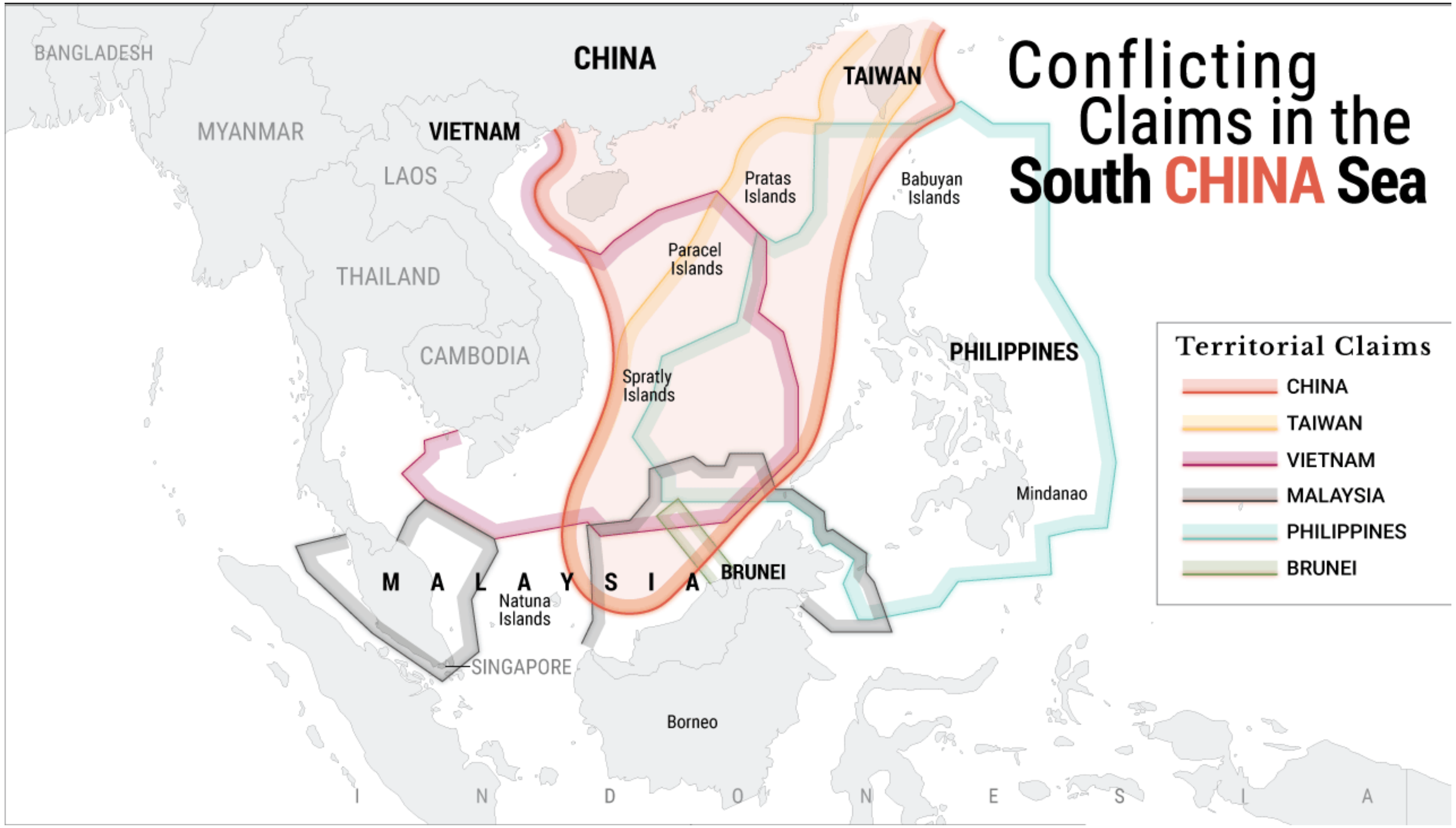
90% of international trade takes place through shipping, mainly through Pacific Oceans



Source: World Shipping Council

Geopolitics: Conflicting Objectives

All nations have different territorial claims over the South China Sea



Source: Geopolitical Futures

Cyclical Factors Driving Portfolio Returns

COVID Infection Rates

Risk On / Risk Off

Interest Rate differentials

Fiscal policy, Debt Burdens & Economic Growth

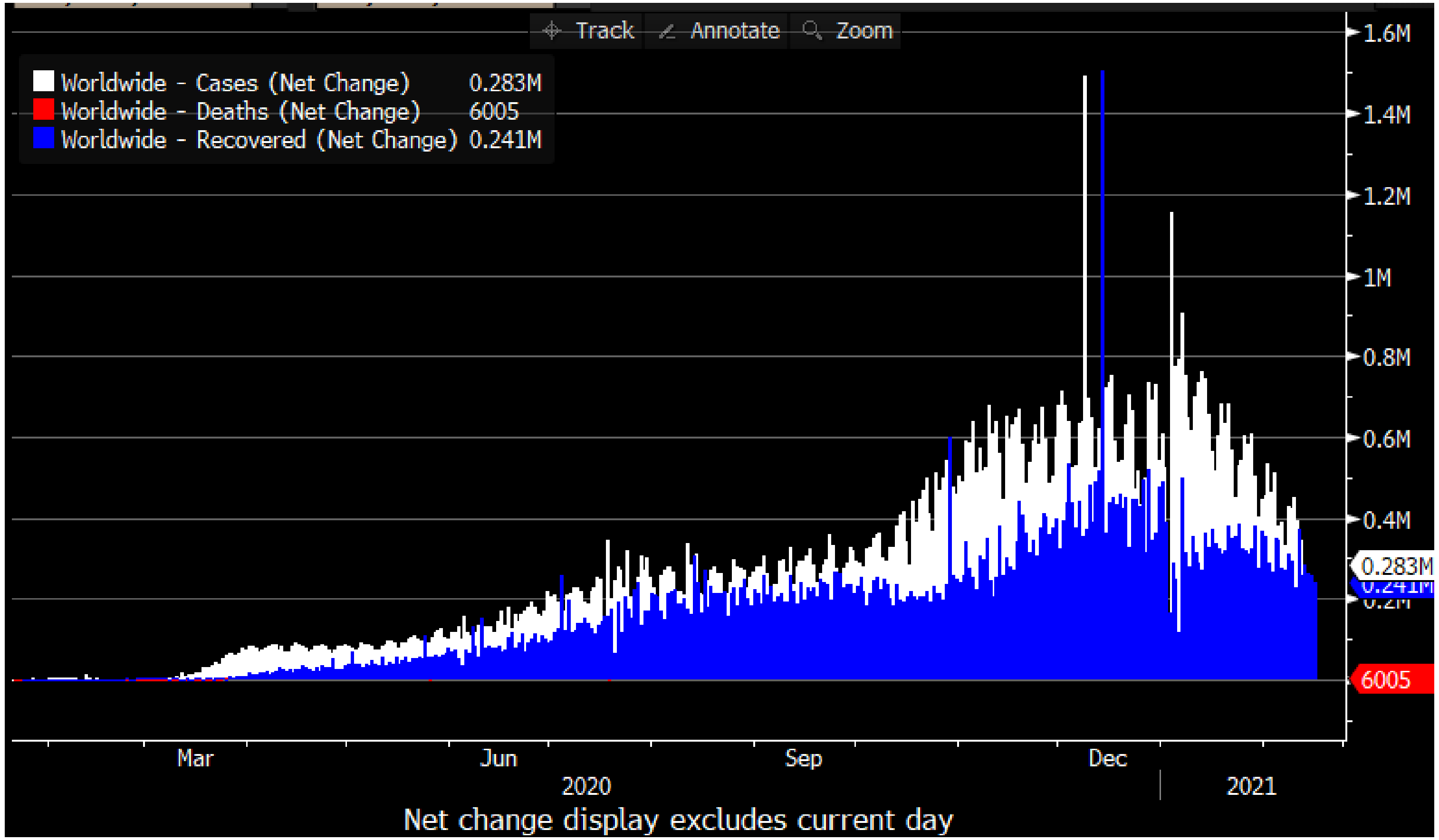
First Mover Advantage – economic mobility

Supply Chains and Logistics

MASON STEVENS

COVID Infection Rates

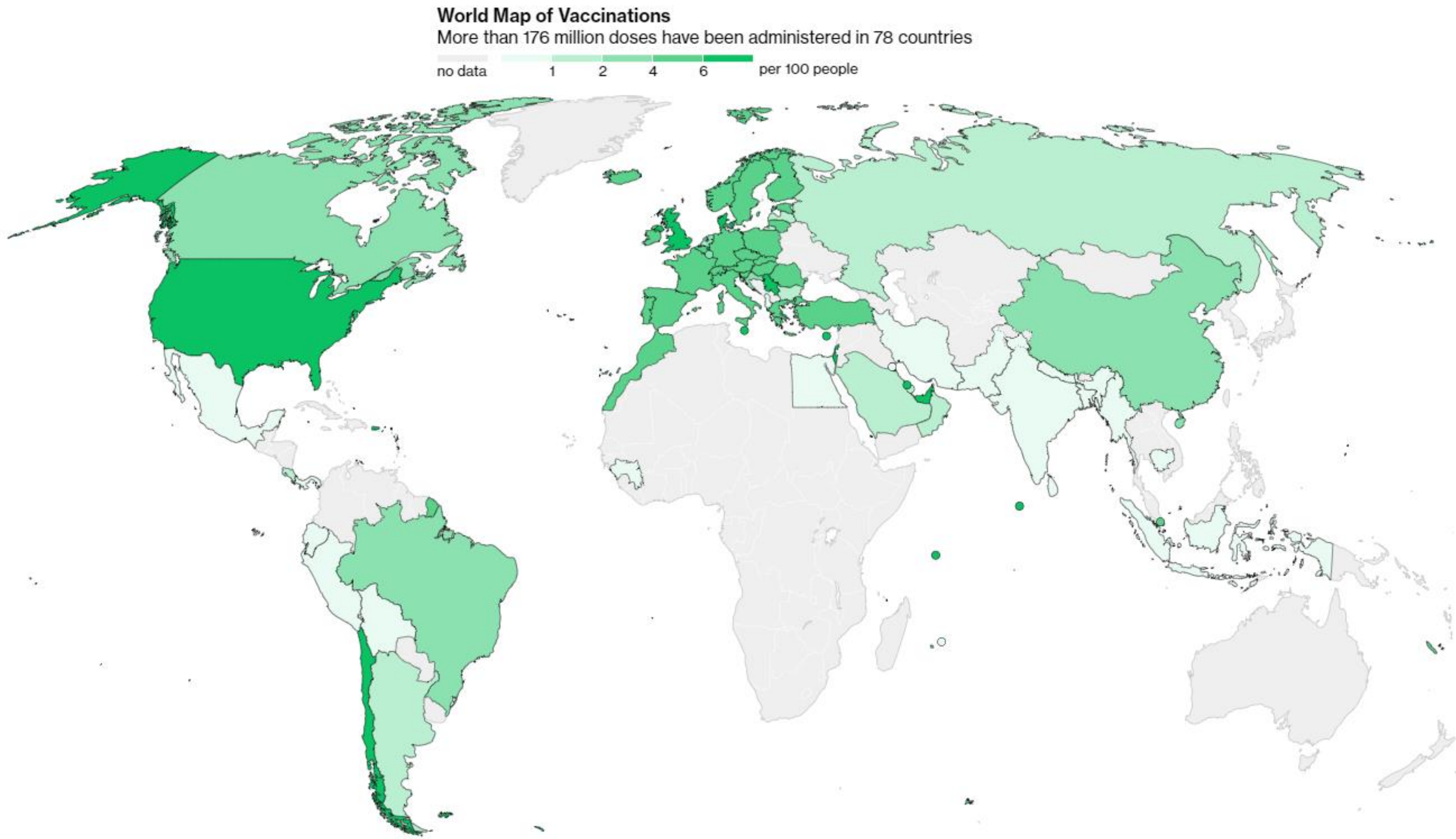
Subsiding, less than 300k per day



Source: Bloomberg

COVID Vaccination Rates

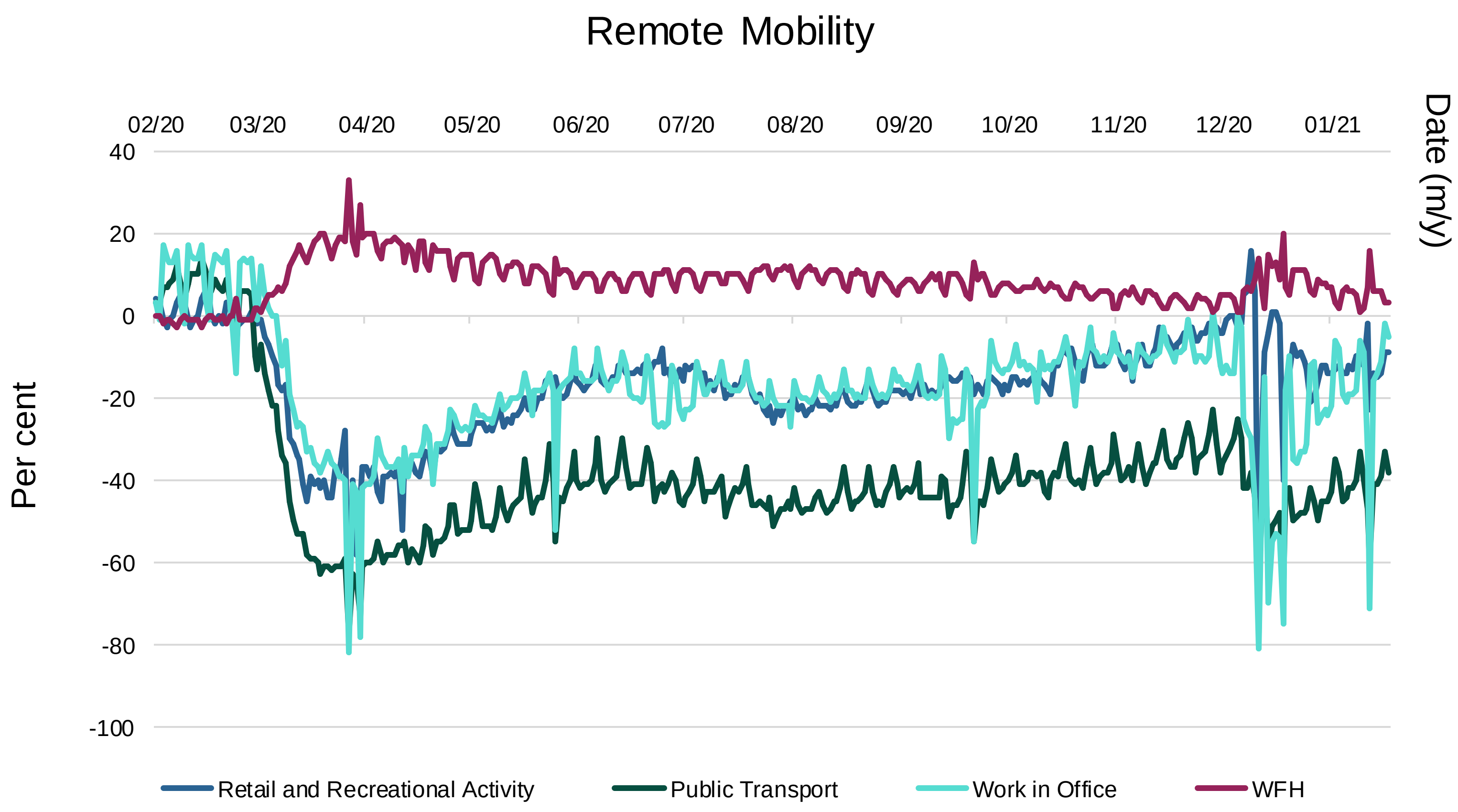
More than 176 million doses administered worldwide, across 78 countries



Source: Bloomberg

Mobility Data

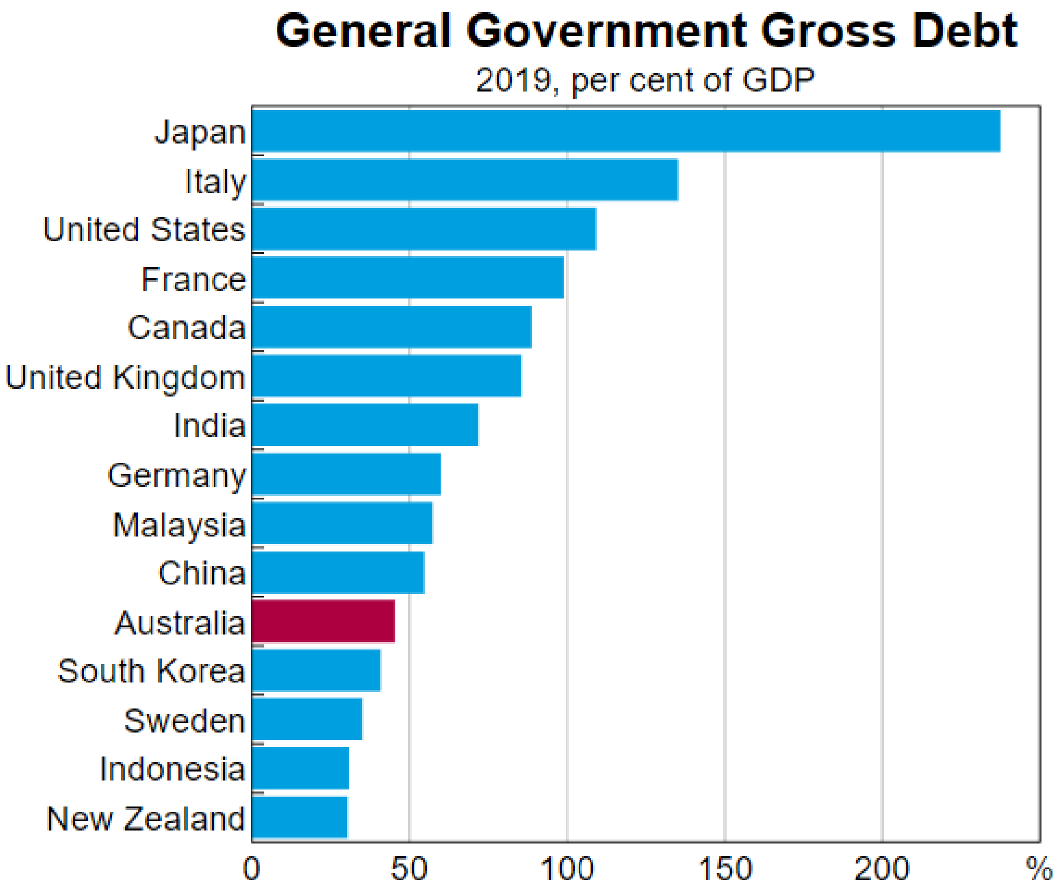
Retail and Transport industrial sectors still adversely affected by government and self-imposed restrictions



Source: Google, Mason Stevens

Fiscal Policy and Current Debt Levels

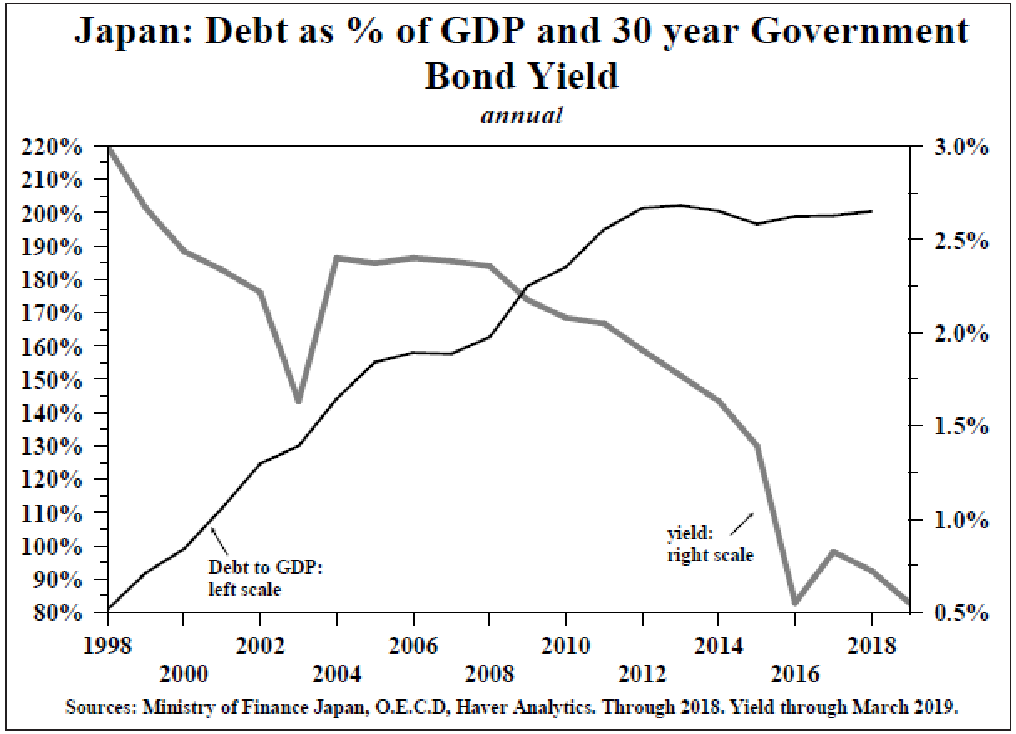
Australia has a low starting point of public indebtedness

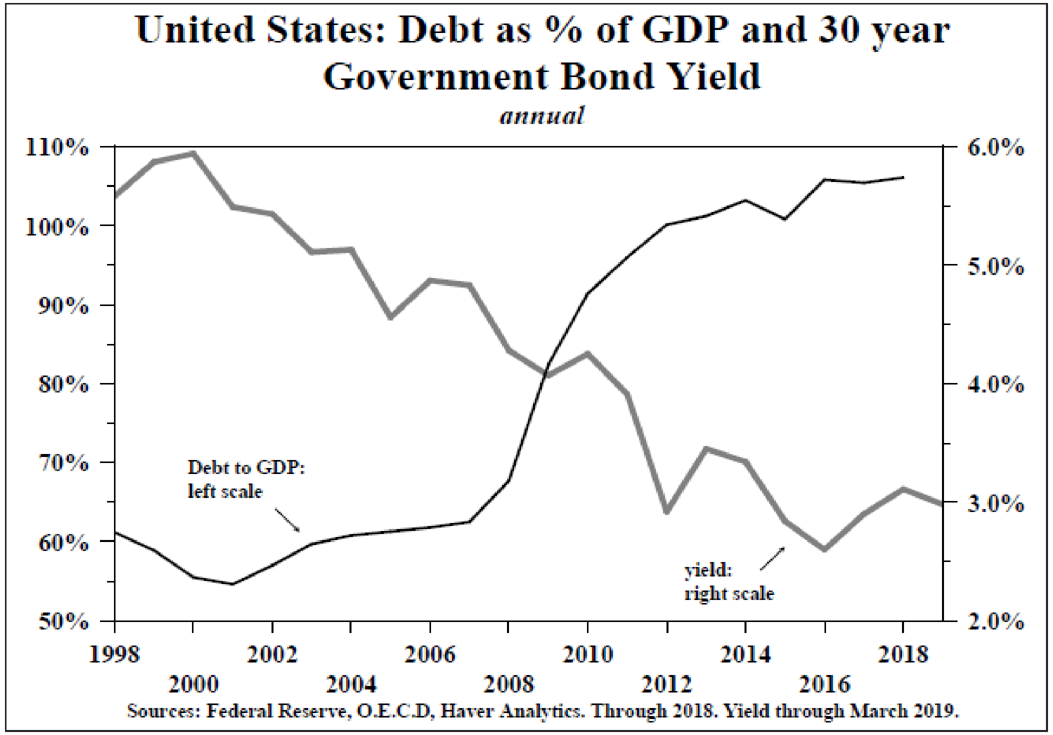


Source: IMF

Government Debt

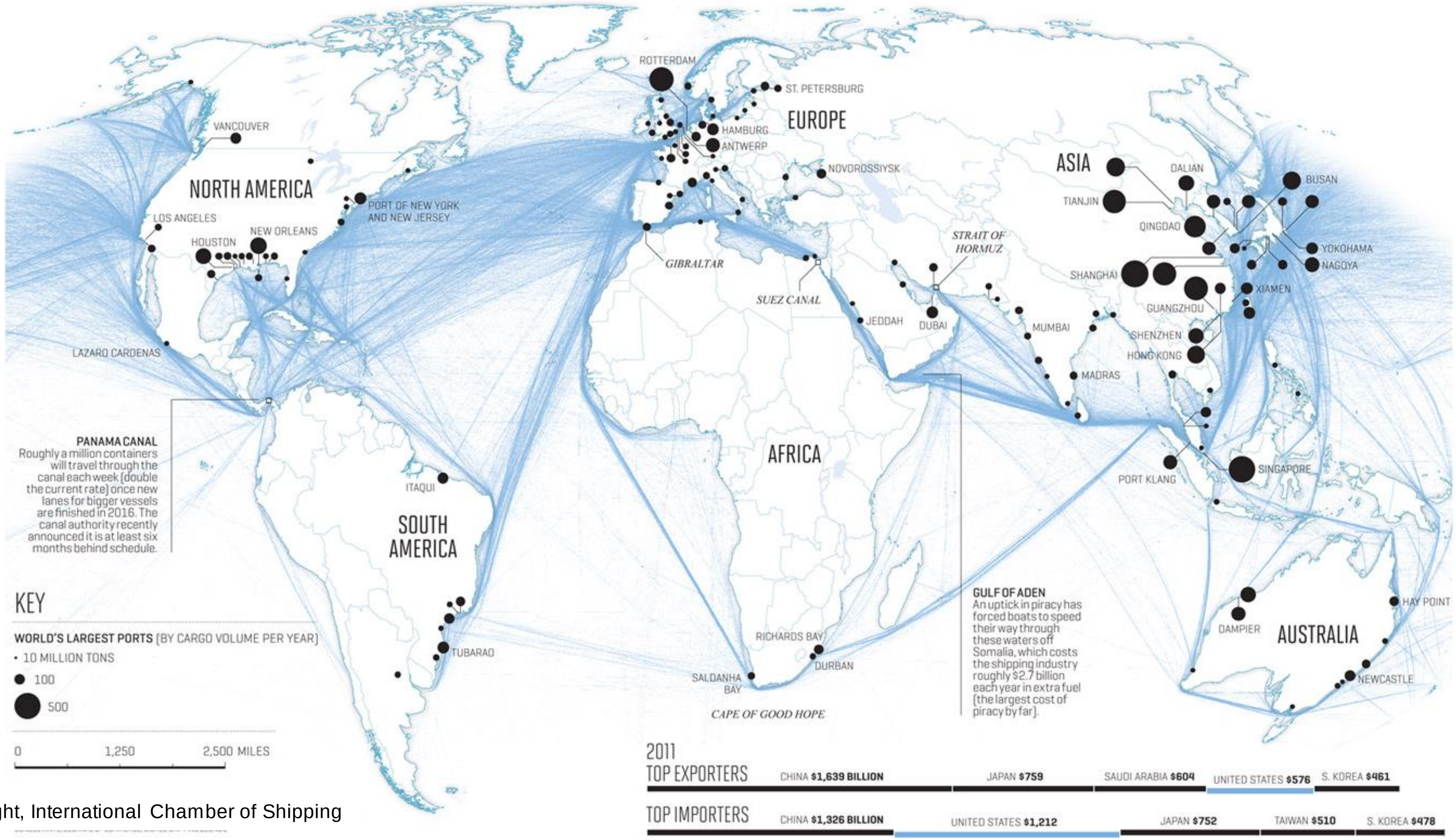
High government indebtedness anchors yields at low levels





Source: Federal Reserve Bank, Japanese Ministry of Finance, OECD, Haver Analytics

Supply Chains Centre on East Asia



Source: IHS Global Insight, International Chamber of Shipping

QUESTIONS

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Where we are looking for growth

Chris Lioutas, Insight Investment Consultants

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