

FTfm

Investing in fixed income

Low yields raise fears of Japan-style liquidity trap

Overview

Richard Milne finds a raging bull market may have implications for long-term growth

At the start of 2011, there were a number of ultra-consensus trades for investors including bets on emerging markets and against the euro. But few have proven to be as wrong-headed as the widespread belief that government bond yields had to rise.

Over the past 30 years, US Treasuries have been in an extraordinary bull market with yields on a near-constant downwards path. But as US yields – and those of Germany and the UK – approached 3 per cent, market commentators were unanimous that 2011 would see equities outperform bonds. Yields had to go up.

How foolish such predictions look now. In late September 10-year US yields hit their lowest level since 1946 while German bunds reached their all-time nadir. UK gilts, meanwhile, hit a level that last was plumbed in the reign of Queen Victoria in 1896.

"I don't actually think the bull market is over. To call the end of the bull market you have to call the end of the current crisis," says Michael Krautzberger, head of European fixed income at BlackRock, one of the world's largest bond investors.

One big reason to believe the bull market could have some way to run is the behaviour of central banks. "Low bond yields have become a major tool of policy," says Neil Williams, chief economist of Hermes, the UK fund manager. The US Federal Reserve has gone furthest down this route. After two bouts of quantitative easing – buying Treasuries in a bid to stimulate the economy – the Fed embarked in September on the so-called "Operation Twist".

Twisting meant selling short-dated US government debt and instead buying longer-dated paper. The effect was immediate – US 10-year yields fell to 1.67 per cent two days after the announcement, their 65-year low.

German yields also bottomed that day at 1.65 per cent. That

both yields were below the psychologically important 2 per cent level – and both US and German benchmark rates have dropped below it again since then on renewed eurozone fears – was highly significant to some investors.

They fear a repeat of Japan's situation in the 1990s when its yields fell below 2 per cent and have – aside from a few weeks – never risen above that level again as the economy has stagnated and equities drooped.

"In a Japan-like scenario bonds are fair value," says David Jacob, chief investment officer of Henderson Global Investors. "I think we are in a liquidity trap to some extent and it's very difficult to climb out of it."

A liquidity trap refers to the inability of monetary policy to

'If I were a corporate or maybe a consumer why would I borrow now because I know it will be as cheap in two years?'

stimulate the economy and many investors are worried that central banks may be able to keep government bond yields low but that will have little direct impact on growth.

Japan has long been in such a trap. Its 10-year bond yields hit a trough for this year in October of 0.97 per cent and persistently low rates give little incentive for businesses or people to borrow now.

Mr Williams says of QE in the UK or US: "It could be a growth destroyer not enhancer...If I were a corporate or maybe a consumer why would I borrow now because I know it will be as cheap in two years? That gets us close to Japan."

The Fed has suggested it will keep official rates at zero until mid-2013 while the Bank of England has also hinted at something similar. Mr Krautzberger also expects the European Central Bank to be far more reluctant to raise rates quickly after two false starts in 2008 and earlier this year.

Government bond yields are also supported at a low level by their ongoing status as safe havens in an investing world



David Humphries

where truly safe assets are few and far between.

"It's about fear. When you see that fear kick in, investors head for the safe havens," says Colleen Denzler of Janus Capital, the US fund manager.

Despite having a focus on corporate credit, something Ms Denzler still believes is attractive, she says government debt has an important role to play in Janus' portfolios: "We view US Treasuries as our insurance policy."

In a world where investors are concerned about capital preservation, government bonds are always likely to play a big role. But Mr Krautzberger also believes

they can help with "alpha generation", the part of the return that is due to active investment rather than simply following the market.

He points to the daily changes in direction where German bonds can outperform Spanish ones for a week before a reversal. Spanish bonds, meanwhile, could beat covered bonds. "If yields are very low, 40-50 basis points of outperformance is a big deal," he says.

Not everyone is convinced that yields should stay so low. "We believe the bull market is over," says Rod Davidson, head of fixed income at Alliance Trust Asset Management. "But you are going to have spikes around the bottom.

In the current market where you have a lot of fear a lot of people feel there is nowhere else to put it. It doesn't make it a good place."

One big worry about such low yields is that government bonds offer little compensation set against inflation rates, especially in the UK where consumer prices have risen by more than 5 per cent against a low for 10-year gilts this year of 2.18 per cent. Even in Germany, nominal bond yields fell below the inflation rate for the first time in decades.

Mr Jacob expresses the fears of many investors that the temptation will rise, particularly for countries such as the US and UK, to use inflation to reduce their debt burdens: "It is always easier to inflate your way out and that would make bonds dangerous things to own."

Whether or not the bull market continues, the bottom line is that few are convinced that government bonds will be as good investments as they have been in recent history. Says Mr Krautzberger: "Total returns will be lower in the next five years than in the past five."

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FTfm – Investing in fixed income

Eurozone crisis piles on the pressure

Credit default swaps

Recent events have caused uproar among buyers, says Tracy Alloway

Credit default swaps – the insurance-like derivatives instruments once labelled “financial weapons of mass destruction” – are now themselves under attack.

Vilified by regulators after the financial crisis, the \$26,000bn market is already slowly being moved towards central clearing, which will see the CDS more tightly controlled. At the same time, however, the swaps have come under renewed pressure in Europe, where politicians say they have contributed to the region’s dramatic debt crisis.

These new developments have left many users of CDS scratching their heads. “We need clarity from European leaders and regulators on the CDS market before it freezes,” says Simon Thorp, chief investment officer of fixed income at Avoca Capital. “At the moment huge questions remain.”

CDS are used by banks, hedge funds and asset managers as a way of hedging their vast exposures of loans and bonds, or managing counterparty risk. Importantly, such CDS differ from insurance con-

tracts in that users do not have to own the underlying bonds that are being “referenced” by the derivatives – meaning the swaps can also be used to make outright bets on a company or country’s creditworthiness.

CDS are meant to pay out once underlying bonds sour enough for the International Swaps and Derivatives Association (Isda), the industry body, to declare a “credit event”. But the association has yet to announce such an event in the case of the \$3.7bn worth of net notional CDS written on Greek bonds, even as banks are being asked by European authorities to take up to 50 per cent losses on their holdings.

This turn of events has caused uproar among buy-

ers of CDS, especially banks which may have used the instruments to hedge their portfolios of Greek government bonds or even corporate or banking exposures to the Hellenic Republic. Those that bought CDS simply to express an investment view have other reasons to be riled, however.

“Insurance products of this importance just don’t disappear because they don’t meet the European Union’s dress code”



CDS have been implicated in the eurozone debt crisis, which has led to riots in Athens. Getty

Last month European authorities moved permanently to ban the use of “naked” sovereign CDS, meaning investors will no longer be able to buy CDS protection without holding the underlying bonds. The idea is to prevent “speculative attacks”, which some European leaders say can push up countries’ borrowing costs.

These twin events have helped push CDS into one of their biggest ever crises, with many users questioning their effectiveness as a hedging and investment product.

“There is still a lot of

detail to thrash out [in the ban],” says Dinesh Pawar, head of credit flow trading at Aviva Investors. “If you ultimately can’t hedge a position, you would have to consider whether you would hold that position.”

Indeed the significance of CDS as a hedging tool for the world’s banks and funds means the swaps are unlikely to retreat entirely. They may, however alter their form.

“Insurance products of this importance just don’t disappear because they don’t meet the dress code of the European Union,” says one hedge fund manager.

“They may shift to friendlier jurisdictions, or they may morph into an altogether different product.”

It would not be the first time the CDS market has changed in response to new challenges. Contracts on the swaps have been tweaked many times to deal with new challenges posed by various corporate and sovereign “credit events”.

The majority of the contracts are now governed by Isda’s standardised credit definitions, which lay out the requirements needed to trigger pay-outs. However, some market participants say that if CDS buyers are

not satisfied with the way Isda is interpreting the rules, there could be a shift away from standardised contracts, with banks and funds agreeing their own terms to avoid a Greece-like situation.

“That could happen,” says Brett Tejpaul, head of European credit sales at Barclays Capital. “But I doubt that would really come back because the whole market is moving towards transparency, clearing and standardised contracts.”

Still others argue that the CDS market may shift in more fundamental ways, particularly when it comes to the more politically-sensitive sovereign swaps. Even as authorities clamp down on private CDS, they are proposing public versions of insurance.

European leaders are now reimagining the eurozone’s €440bn bailout fund as a leveraged provider of partial guarantees on the region’s government bonds. Under that proposal, the European Financial Stability Facility (EFSF) will promise to make good on investors’ losses on government debt, in a similar way to CDS pay-outs.

“The EFSF is a specific means to encourage investment in sovereign debt,” says a credit specialist at a major European bank. “It’s a good example of how bespoke CDS can actually be very beneficial to the markets in general.”

ETFs flourish as alpha stays elusive

Indices

Active managers are under fire, says David Ricketts

It is no secret that active managers have received considerable flak for often failing to outperform benchmark indices and generate returns in line with their handsome fees.

Investors remain convinced that those with superior investment clout should be best placed to navigate market turbulence in search of the highest possible returns.

Figures suggest performance among active managers has been lacklustre, to say the least. A report by Standard & Poor’s earlier this year revealed that in 2010, with the exception of emerging market debt, more than half of US active

managers failed to beat various benchmarks.

The most underperforming mutual fund categories over the past five years, according to S&P, were mid-cap stock and small cap growth funds, where 78.2 per cent and 72.7 per cent, respectively, of all actively managed funds underperformed their peer index.

In comparison, exchange traded funds (ETFs) linked to the S&P MidCap 400 Index and the S&P Small-Cap 600 Growth Index beat corresponding professional stock pickers.

It should come as little surprise, then, that growing demand for ETFs, coupled with investor appetite for stable returns in a low interest rate environment, has created the ideal landscape for fixed income ETFs.

Appetite for the products has grown steadily, and fixed income ETFs have

become the second largest category of ETFs in Europe with a total market share of around 20 per cent and assets under management of around €43.5bn (\$60bn).

Nizam Hamid, head of ETF strategy at Lyxor, says the trend towards using ETFs to gain exposure to fixed income “is not just a shunning of active management” by investors, but a move to transparency of asset class exposure, returns and pricing.

“It is true that active managers have failed to deliver consistent alpha in the fixed income space, but

Established index providers such as S&P and Barclays Capital could face new competition

the main attraction of ETFs has been choice of exposure and ability to use ETFs to manage portfolio risk,” he says.

Historically, during periods of high market volatility, fixed income ETFs have benefited from positive inflows. But with risk being mainly focused on sovereign credit, this has not been the case this year, adds Mr Hamid.

“However, investors continue to use fixed income ETFs to address issues such as a search for income in a low interest rate environment, together with tactical positioning with respect to inflation.”

S&P and MSCI remain the dominant index providers for the ETF industry, while Barclays Capital is considered the market leader in fixed income indices.

However, established index providers could see competition. In August,

BlackRock filed with the US Securities and Exchange Commission to establish its own indices, rather than rely on those developed by third parties.

Alex Claringbull, managing director and fixed income portfolio manager at iShares, says the next five years in Europe “will very much be a fixed income story as the ETF market matures to match what investors are investing in.”

“ETFs did start with an equity flavour, and it has been predominantly an equity story so far,” he says.

Others are sceptical about what is truly driving demand.

José Garcia-Zarate, European ETF analyst at Morningstar, says the rise in fixed income appetite is nothing more than an effect of the financial crisis and “classic safe-haven flows”.



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FTfm – Investing in fixed income

Demand tilts from sovereign bonds to company debt

Corporate bonds

Non-financial paper is attracting more interest, writes **Brian Bollen**

Good quality corporate bonds remain very much in demand, according to the broad consensus prevailing in the investment management industry. As the appetite for at least some sovereign bonds is tested, interest is growing in corporate debt rated BBB and above.

Professional investors cite a number of reasons for this. They say many large companies have repaired their balance sheets radically in recent years, deleveraging quickly by deferring large-scale capital spending in favour of paying down debt. For those whose business remains fundamentally sound, large cash piles are becoming commonplace.

Fund managers and their clients like the comfort that this happy combination delivers, together with the yield pick-up and diversification of credit. “We like higher yielding bonds, primarily corporate bonds,” says Kommer van Trigt, head of rates, fixed income, at Robeco in the Netherlands. “We are quite bullish about corporate fundamentals.”

Boosting overall favourable sentiment is the availability of investment firepower. Luke Spajic, head of European credit portfolio management at Pimco in Europe, says more than 20 per cent of total corporate debt has matured and been repaid in 2011, meaning that investors have significant volumes of cash at their disposal.

A clear distinction is drawn, however, between financial and non-financial companies. “Non-financial corporate valuations are attractive, in fact they look cheap,” says Roel Jansen, head of European investment grade credit at ING Investment Management. “But there are elevated risks in financials, especially with subordinated debt.”

These well documented elevated risks could crystallise quickly if the eurozone fails to remedy its financial woes, and a true crisis of confidence in Italy and Spain erupts. In such a scenario, Mr Jansen posits that in the case of weaker issuers callable (redeemable) bonds might not be called, and coupons on Tier 1 securities might not be paid.

Market concerns are of course reflected in yields, some of which look extraordinarily high to the lay observer. James Foster, fund manager and partner at Artemis Funds, reels off a list of callable bonds from Aviva (callable 2014), Lloyds Bank (callable 2015) and Standard Life (callable 2015), and yielding 17 per cent, 20 per cent and 15.5 per cent respectively.

“Corporate bonds are where the real value is, and the further you

go down the food chain [the credit quality spectrum] the greater your return,” he says. “If the economy completely melts down, and the euro collapses, and there is restructuring in Europe, utilities and other corporates will still be around.” As one other fund manager put it: “In a decade’s time they will still be drinking Coca-Cola in Athens; it doesn’t really matter which currency they’ll be paying in.”

Fiat will still be making cars, adds Mr Foster, but the cars will be priced more competitively, and economic fundamentals will come to the fore. He is very much a buyer, believing that the extra yield more than compensates for the extra risk, and 40 per cent of his funds are in high yield. “The risk-reward balance is utterly wrong, all balanced towards the reward,” he says.

Against this backdrop, ING is, says Mr Jansen, overweight in non-financials, but slightly underweight in financials – except in the case of covered bonds issued by banks, and backed by a ring-fenced pool of quality assets.

“We see value in covered bonds,” he says, adding the rider that the risk and therefore

‘In a decade’s time they will still be drinking Coca-Cola in Athens; it doesn’t really matter which currency they’ll be paying in’

spreads are very much country-led. At end-October spreads of around 440 basis points (bps) over the benchmark German bund are expected on average for Spanish covered bonds, given worries about the quality of the underlying Spanish collateral.

By stark contrast, spreads for the French and UK equivalent bonds will be around 200 bps on average.

At Pimco, Mr Spajic says: “We haven’t avoided the financial sector. We think it is a great secular opportunity as banks delever.” New corporate issuance will, however, remain subdued until early 2012, he adds, in line with the traditional annual issuance cycle.

Try as one might to separate the corporate story from the sovereign story, the two remain stubbornly conjoined. Valuations for certain non-financial companies remain clouded by the high spreads and yields on some sovereign debt, cautions Mr Spajic.

Telecom Italia, he comments, might appear superficially attractive at a 7.25 per cent yield on five-year debt, but Italy, recently forced to pay 6.06 per cent on the latest auction of its benchmark 10-year bond, looks a better buy than a BBB credit paying slightly more.



Seoul city: South Korea faces the prospect of a bump-up to developed market status
Bloomberg

No safe haven but useful as a portfolio diversifier

Emerging markets

The sector did well in 2010 but sentiment has recently turned, says **Josh Noble**

Emerging market debt used to involve a straightforward pitch to investors. As an asset class, it was seen as a risky, but exciting place to be invested. Those intrepid enough to lend to developing economies, or to their companies, were rewarded with high yields, but suffered a realistic possibility of default.

Now things have changed. A shift in the global economy has prompted a role reversal, with yields in emerging markets falling sharply, just as yields in the eurozone have risen.

With many emerging market assets now seen as aggressively priced, the pitch has had to change, too. In a world convulsed by the European sovereign debt crisis, could emerging market debt offer an anchor of stability?

In 2010, emerging market bonds became all the rage. Bond funds investing in developing economies experienced record inflows, drawing in more than \$53bn, according to data from EPFR, the fund flow tracker. This is a huge jump from the \$9.4bn inflow in 2009, and a conclusive reversal of the \$18bn of withdrawals in 2008.

This year things have slowed, but the inflows continue. More than \$18bn has been put into emerging market bond funds since the start of 2011, almost all of that into debt denominated in local currency.

With emerging market debt having performed so well during 2010, some began talking of it as a safe haven from the west’s woes. The economic argument is indeed compelling. Most emerging economies are not suffering from an overhang of debt, many

run significant fiscal surpluses, and growth has so far continued at a brisk pace.

In Asia, two markets, South Korea and Taiwan, face the prospect of a bump-up to developed market status, while Indonesia and the Philippines are moving towards investment grade status.

Investor preference this year for local currency debt highlights another longer term appeal of emerging market bonds – currency speculation. Although most EM currencies have performed poorly this year, the longer term trends, especially in Asia, are clear.

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Worries over growth and the threat of a double dip recession hang over the industrialised world. Yet, index-linked bonds are in

hot demand in the US, UK and Europe. The reason for this paradox is simple, as **David Oakley** (pictured) explains online www.ft.com/FTfm



Since the start of 2010, the Malaysian ringgit has increased 9.5 per cent, the Thai baht is up 8.3 per cent, and the Philippines peso has gained 7.8 per cent.

However, this summer offered proof that emerging markets could not withstand the headwinds from the developed world. Market sentiment changed rapidly during August and September, as worries over the state of the global economy mounted.

In September, as panic set in across global markets, investors sold out of their long emerging markets positions, withdrawing more than \$4bn from EM debt funds. The yield on JPMorgan’s benchmark EM debt index rose to a one-year high of 6.39 per cent at the start of October, from 5.46 per cent in early August. New issuance all but disappeared.

“Those who believed in decoupling and that you could find a safe haven in emerging markets were disabused of that notion during the sell-off,” says Tim Condon, chief economist in Asia, ING Bank. “Everything they thought would be safe was not.”

Some analysts attribute the sell-off, in part, to a need for European banks to deleverage without running down their eurozone debt. Sure enough, central and eastern European markets, those to which eurozone banks were most exposed, were among the worst hit by the sell-off. Yields on Poland’s 10-year notes rose from 5.52 per cent in August to 6.1 per cent in late September.

In October, however, the market began to turn around. Yields began to fall again, and in recent weeks bond funds have once again recorded inflows, albeit small ones. Both governments and corporations have returned to the market.

“When risk appetite returns, which is already happening, the first port of call will be emerging market debt,” says Mr Condon.

Following this summer of tumult, emerging market debt is no longer seen as a safe haven. But its position as a risk asset is also under question.

“Emerging markets used to be high yield, and worked as a way to add a bit of go to a portfolio,” says Paul McNamara, an investment director at GAM who manages emerging market bond strategies. “Now EM acts as a diversifier.”

Since the start of the boom in emerging debt, yields have indeed tumbled. At the start of 2010, 10-year Indonesian government debt yields topped 10 per cent. Since then the yield has fallen to 6.25 per cent. Indonesia’s two-year bonds trade just 20 basis points above those of Italy.

“A portfolio that includes the likes of Indonesia, Brazil and South Africa is going to be better protected in a range of scenarios,” says Mr McNamara.

Signs of recovery in US and Europe

High yield bonds

Investors returning cautiously to junk bonds, says Robin Wigglesworth

The global high yield market was heading towards a tremendous year in the first half of 2011, with record issuance in both Europe and the US, but the market came thoroughly unstuck in the summer.

Signs that the economic recovery was faltering spooked the normally resilient US junk bond market, while the eurozone's worsening sovereign debt crisis froze Europe's smaller and more skittish market.

After three straight quarters with global junk bond sales surpassing the \$100bn market, issuance shrivelled to just \$29bn in the third quarter, according to Thomson Reuters. Yields spiked to levels that typically signify a recession on both sides of the Atlantic, and companies that braved the turmoil were forced to increase the average coupon payments by almost 1 percentage point to 9.15 per cent.

There are now tentative signs that the high yield market is recovering from the third quarter's panic – particularly in the US, the largest and most developed junk bond market.

Average yields on US junk bonds have narrowed markedly from the two year high of 9.32 per cent touched on October 4, according to the Bank of America Merrill Lynch Global High Yield Index. Issuance has recovered more gingerly, but investors remain bullish on the market, and hungry for new deals.

"The market is close to regaining most of the ground lost in August and September," says Russ Covode, a Chicago-based high yield portfolio manager at Neuberger Berman, the asset manager. "Fundamental credit conditions are

very good, and we remain very constructive," he adds. "The earnings outlook is OK, balance sheets are robust, and companies can survive a sustained period of no or low economic growth."

The European market was hit even harder than the US by the recent sell-off, and companies that did come to the market were forced to pay a hefty new issue premium for the privilege.

Yet even in the European junk bond market, there are heartening – if halting – signs of a recovery.

The Crossover index of credit default swaps on European high yield bonds has fallen from a two-year high of almost 900 basis points, to about 700 bps.

While the gauge's price still indicates a swathe of defaults across the continent in coming years, bankers and investors are turning less negative on the

'The euphoria of May is not going to come back any time soon'

Henrik Johnsson
Deutsche Bank

market's outlook. "The euphoria of May is not going to come back any time soon, but the recent improvement is welcome," says Henrik Johnsson, head of European high yield at Deutsche Bank. "I think we could see a lot of new issuers come before the end of the year."

Investors are also returning to the asset class, enticed by the returns on offer. US, European and global high yield bond funds absorbed more than \$3bn in the week ending October 19. That was a record in dollar terms and the highest in terms of percentage of assets under management since the first week of 2009, according to EPFR Global, a data provider that tracks fund flows.

Still, the high yield market, both in the US and Europe, remains vulnerable to bad news. If the two economies do slump back into recession – as seems likely in Europe, and possible in the US, analysts say – then junk bonds will suffer once more.

Despite the recent rally, investors remain particularly cautious on the European market.

"Investors have high cash balances, but there's a lot of uncertainty," says Luke Spajic, head of European credit at Pimco. "Spreads have gone to very wide levels, and that's when

you see problems crop up."

Non-financial, non-investment grade companies in Europe have to repay \$325bn of debts in 2012 to 2015, according to Moody's Investors Service. Thanks to heavy issuance earlier this year, the refinancing needs for 2012 have fallen, but still stand at \$66bn.

Most looming bond and loan repayments are for

safer non-investment grade companies, but analysts warn that the likelihood of extended turmoil in Europe may cause some to founder.

"Refinancing uncertainties remain even for such companies given ongoing negative market sentiment surrounding the global economy and sovereign creditworthiness, as manifested by the sharp reduc-

tion in high-yield bond issuance since the summer," Moody's said in a recent note.

Investors stress they are still looking at the European market, but will be far more selective than was the case in 2010 and early 2011. "We haven't stopped buying European high yield names, but we've set the bar for what we will buy a lot

higher," says Ashish Shah, head of global credit at AllianceBernstein. "There are definitely tail risks in this market."

The more muted expectations for the European market stand in sharp contrast to the bullishness of investors on the US market, where many expect yields to continue to tighten into next year.

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Luke Spajic: 'uncertainty'

FTfm – Investing in fixed income

Rethink the notion of risk-free assets

Government bonds

Investors now need to diversify and globalise, finds **Brian Bollen**

Risk is, as many readers may have learnt, like fat. You cannot eliminate it from the financial system, you can only move it around. The truth of this statement is arguably starker today than at any point in living memory.

When even the world's most risk-free financial assets, US Treasury bonds, have been downgraded, and the very notion of risk-free assets debunked, according to some, what are investors to do?

Prepare for war is one startling piece of advice. Even if it is a war fought with numbers rather than with flying bullets or nuclear weapons, the very mention of the word pulls one up in one's tracks.

A second piece of advice, from Karl Dasher, head of fixed income globally at Schroder Investments, is to

forget about benchmarking investment expectations on the real return experience of the past 30 years. He advocates taking a 150-year view stretching back to the American Civil War, and describes the past 30 years as something of a golden age in terms of returns from government bonds: “

Everyone forgets the previous 120 years during which there were elongated periods of negative real returns in bond markets,” he says. Markets will eventually force yields back to the “right” level, he argues.

Investment professionals identify at least two other clear risks presented by the prevailing conditions of recent years. The first is the risk of inflation created by quantitative easing.

“If you are debasing your currency via quantitative easing, one day it will come home to roost,” says James Foster, fund manager and partner at Artemis Funds. Quantitative easing will lead to inflation, he says, and that will undermine government bonds in the long term.

By contrast, Paul Brain, head of fixed income at



For a long term view, go back to the American Civil War Getty

Newton Investment Management, does not see inflation arising from such central bank action.

If inflation provides an effective route to gradual default, the second clear risk is of outright default. Mr Foster says the chances of this in countries such as the US, UK and Germany are very low. The first two can always resort to the printing press, Zimbabwe-style if need be. Germany's well documented extreme

fear of monetary disaster keeps it on the financial straight and narrow. With Greece, though, the chances of getting any money back seem to become slimmer by the day.

What exposure, then, should investors have to sovereign bonds? Arif Husain, who runs the European fixed income business at asset management house AllianceBernstein, tackles the question in two parts. “You should first ask

what you are using government bonds for,” he says. “It has become increasingly evident that government bonds do not all fit into the non-risky definition in the asset allocation process and investors are holding risky portion of their portfolios,” adds Mr Husain. “That transfer of risk is causing problems.”

His advice is to diversify and globalise, with the aim of mitigating risk while maximising yield, at a time when near-zero yields from the countries perceived to be safest severely limit the potential investment upside of government bonds.

Mr Husain identifies Mexico as one emerging market that returns a relatively high yield while having a low debt-to-GDP ratio, and Australia and New Zealand as two mid-developed countries offering the same combination.

Benno Weber, head of fixed income at Swisscanto, is advising his Swiss pension fund clients to cut their holdings of government debt “massively”, and to look instead for true diversification of interest

rate, credit duration and currency rather than a debt-weighted collection of assets.

For Bill Street, global head, fixed income alpha, at State Street Global Advisors, there are four principal pillars of investment to consider when making a sovereign investment decision. Is there liquidity? Are dealing costs low? Does the issuer have integrity? Is there easy access to the market?

“But even when the answer is no, that doesn't necessarily mean you don't invest,” he says.

“You just invest in a different parameter set, perhaps sacrificing a degree of yield or liquidity, and accepting a bit of credit migration from one sovereign to another.”

Chris Lynas, head of fixed interest at Smith & Williamson Investment Management, says his firm likes US, UK and German government bonds, especially if index-linked. But these are likely to be in short supply. “No sane central bank or Treasury would issue index-linked in the current climate,” he concludes.

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