Fidelity Compass

Making Every Dollar Count: Maximizing yield in a fixed income portfolio

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Pamela Ritchie: Hello and welcome to Fidelity Compass. I'm Pamela Ritchie. In today's ever-changing market environment, it is crucial for institutional investors to proactively mitigate risk to protect their investments. One of the best ways to do this and generate positive returns is through portfolio diversification. But in a low-yield environment, how can institutional investors maximize yield through a fixed-income portfolio? What strategies might they want to consider to achieve this? To discuss a dynamic solution that seeks to meet these challenges, we're very happy to be joined by fixed income portfolio managers Jeff Moore and Michael Plage. Jeff and Michael co-manage Fidelity Tactical Bond Strategy. Welcome to each of you. Nice to see you.

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Jeff Moore: Nice to see you, Pamela.

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Pamela Ritchie: I can't see you, Michael, but you are joining us in audio version, so we're very glad that we can have this discussion between us all, even if we don't see you in person at this moment. I'm wondering, in fact, how much volatility each of you do see in the runway of time ahead. We will come back to that but first of all, I want to give you a little bit of a challenge. I'd like to say that if we go back in time, I gave you $100, 2007 ... and I know you have a chart that you can pull up for us here ... how would I have done in this strategy? Let's ask Jeff to begin this and Michael, I'll ask you to add in a sec, but Jeff to you.

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Jeff Moore: If you had $100 in December 31st, 2007 and you invested with us ... in December 2008, you would have lost eight points, so you would be down to $91. Here it is right here. That's the white box, says Tactical Bond, and this is actually what happened. There's nothing special here. This is literally what happened to our clients. If you waited one more year, '09, you were over $114 and if you fast forward to today, you're over $242. Now let's say December 31st, 2007, you're completely of the view there's going to be a crisis, you want to own just Treasuries, at the end of 2008 you would have $113, see the U.S. Treasury Index and if you wait one more year you're down to $109. Fast forward all the way across, now you're $157. So not bad through the period. Let's look at the stock market though, just as an FYI because we're going to tell a story about maybe the number one thing for clients today will be how do you get return and sidestep some of the vol that you might fear is coming in the marketplace?

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Look at the stock market. We had the Russell here, simple. If December 31st, 2007 you put $100 in, by the end of '08, the Russel's into the 60s. But fast forward through one of the great bull markets in history and now finally the Russel's ahead of tactical bond, as it should be, over a long, long period of time. That gives you sort of a sense of things.

I'll give you one more piece here just before we get going. Look at the gov credit. You decide instead of buying bonds, I want to buy short duration bonds. That, in your mind, is the best place. At the end of '08, a gov credit product, and this is in the U.S., would have $104.97. Unfortunately, by the time you get all the way to today, you only have $131. So it was a good place to hide out for a short period but not the long term. This is the sort of opportunity set, we've done all the sector compounding for you. You can see this, and Mike and I, our goal over any period of time in tactical, as time goes on, we want to compound and get you to the top of this page.

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Pamela Ritchie: This is really interesting. Mike, I'll ask you to … this is for those that are looking at what to do with liquidity, with cash, the idea of putting every dollar that you've got to work. Sketch that out for us, that idea that everything that is there needs to be put to work and this is one of those strategies where you can do just that while you're waiting. Is that the idea?

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Michael Plage: Absolutely. It is important, particularly with cash at zero. You're not going to earn anything on your cash. It's similar to that 1 to 3 gov credit box. Think about that as kind of a cash substitute, if you will. There's actually the next page of the periodic table, which is an important consideration in terms of returns is also how much risk are you taking in each of these strategies? Now, remember, you buy bonds really for three reasons. You buy them for income, you buy them for liquidity, and you buy them for diversification.

Some of these boxes have more or less than each one of those drivers of flows, 1 to 3 gov credit. There's really no diversification benefit and there's no real income there. There's plenty of liquidity. So if that's what you're looking for, gov credit is, as Jeff said, a great place to hide and it's fine.

If you think about the leveraged loan or the high-yield market, you can see them further down on this page in the green and the blue, there's a lot of income there but there's really not a lot of diversification. They're much more highly correlated with equities and liquidity can be challenging from time to time. But there's certainly income but with income, you get a lot of volatility.

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Just to take a look at this chart, lowest volatility strategies are on the top and the highest volatility strategies are on the bottom. Again, in tactical bond, the white boxes, we're trying to be somewhere in the middle. The aggregate bond market is a reasonably good proxy. You get positive returns. There's only been three negative draws in the last 30+ years with a relatively low amount of volatility. We think that's a great benchmark. In tactical bond, we try to take a little bit more risk than that particular benchmark and by taking that risk, we're generally outperforming that benchmark over the course of time and that's what you saw on the first page of *[audio cuts out]*.

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So it's important, you can pick these sectors; you can you can stay in them but just know that what you're getting. It's usually one or two, not all three of the drivers of the reasons to buy bonds. But in tactical bond ... and we can go through our five-step process and talk about how we arrive at our asset allocation decisions but we try to get you a little bit of your income; we try to get you diversification more so than high yield, and we certainly provide liquidity over time. We stay fully invested, and again, that's part of what we mean by make sure you make every dollar count in the strategy.

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Pamela Ritchie: That's great and thank you. Now we're going to sort of zoom out, if you will, from talking about these pieces to actually the landscape, Jeff, of what the developed countries of the world are sitting amidst in terms of demographics. I mean, the reason we're talking about this is there are savers and more savers and will be more savers all over the world. That's only going to increase. Just tell us what we're in the middle of and what we're looking out to.

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Jeff Moore: Demographics, I think, are probably the biggest driver of the low-rate environment that looks set to persist for a long period of time, like decades, not just a few years here. When you think of this, when I think about the ageing of our society, the G10 is a great place to start. We know in the G10, the bulk of the G10 is now in population decline. They're not just getting older, there's fewer of us, sadly ... not sadly but a lot of those people are also older and we know that someone who's 60 has more wealth and income saved than a 20-year-old. Not a surprise, 20-year-olds are starting. We have a lot more 60-year-olds and we're about to double the number of 60-year-olds in Canada and the U.S. in the next 10 years. We're going to double them. That group of people are in the saving mode and as every institutional investor will know, that group is starting to think a little less about total return maximization, they're also starting to think about downside protection which is to say, in my mind, that the demand for fixed income is going up, not down. And it's possible that this is the highs for interest rates, that the interest rate...

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Pamela Ritchie: Say that again.

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Jeff Moore: This could be the high point for interest rates. That's because the demand is just so ferocious by the savers and there's just so many more savers and because they've done so well in stocks, you know, you saw those volatility pieces and Mike did a nice job explaining to you, for people who want to take some profit, whether they want diversification or they want downside protection, they sell the most risky thing, stock market, high-yield loans, and they buy something else. For a lot of our clients and institutions, part of the growth in the U.S. for us has been a lot of clients doing just that trade saying, we're going to go hang out for a while in tactical where as a team we kind of feel we can do 2, 3, 45 pretty comfortably with a lot of downside protection and do it in a very simple way so clients don't have to worry about derivatives and leverage and crazy stuff, esoteric stuff that's going to get you in trouble with your bosses or in the newspaper, worse. So that's kind of where our heads are at right now, that demand for fixed income is going up, not down.

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Pamela Ritchie: Mike, anything … I'll just add while everyone's listening that we are taking questions. Jeff and Mike can take questions, so feel free to use that Q&A function on your screen and send some of those questions in. Mike, anything to add to what Jeff just said on demographics, which is more than just a topic, isn't it? It's literally a lifestyle on some level that needs navigating.

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Michael Plage: I would add that what Jeff was talking about in terms of demographics impacting yields was on the demand side. So older populations require more income therefore the demand for fixed-income products increases driving rates lower. I would also add that productivity is also impacted by demographics. If you think about productivity as the product of … or GDP as the product of productivity and the growth in the working-age population, we're seeing the working-age population rollover, an older working-age population that also tends to be less productive. So the impact on GDP actually is downward pressure. We also know that Treasury rates in the U.S. and Canada are correlated to growth of the economy. So lower growth will lead to lower on average rates in an economy. So you've got both the supply side and the demand side impact from demographics and an ageing society on rates.

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Not to mention, just one other aspect of why rates will stay low for probably forever, the developed market economies around the world all have much lower rates than we do here in the U.S. and Canada. That gravity is really hard for us to generate enough escape velocity to move higher. We've seen it time and time again. Going back to pre-COVID, the 10-year Treasury tested. We're seeing lower highs and we've tested 3%, we've tested 2%, most recently tried to make a run at 2%, the 10-year Treasury got to 175 and failed. So we're seeing lower and lower highs and I think a big driver of that is low global rates.

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Pamela Ritchie: Jeff, I have to ask, many will probably overuse the phrase "awash in liquidity," but that is the case and we know the reasons why and so on, and so the discussion does head towards a lot of inflationary discussions, sort of demystify this overall picture for us then.

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Jeff Moore: On one hand, we're all worried about the velocity of money spiking and obviously inflation taking off. The hard part, though, is the velocity of money has done nothing for 30 years but decline. Which is to say we've added all this liquidity to the system and it's gone into deposits that are sitting there unlent and they have nowhere to go and they would love to go somewhere, but they really can't. This market that we're in is at the end of a 10-year period where the banks around the world, because of Basel, were forced to build capital, and so they stopped lending as much and they still have a lot of rules on lending. We have a very constricted sort of lending set, and so you have a world right now where even though we're awash in liquidity … I use the … it's like we flooded the engine to the car, it just won't work. It's not the car's going too fast; it's not going anywhere. That's kind of where we see things in the marketplace right now. At this stage, that MV = PQ kind of story, that the velocity money looks like it's stuck because we can't get a lot of PQ which is GDP growth.

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Pamela Ritchie: Right. Interesting. So with that, Mike, heading back to you just on the sense what you're going to be drawing on to be putting into this strategy is ... I think it's your term actually, more pure vanilla but it's going to get to where you're going. Is that a fair description? I think I've heard you say that before.

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Michael Plage: It is and I think when we talk about plain vanilla, it goes back to the kind of simplicity argument that Jeff made earlier. This is a strategy that we don't use a lot of derivatives, we don't use leverage, we don't think we need to. There's an old Fidelity adage, "know what you own" and we believe that. We also think that our investors should know what we own and we should be able to explain our strategy in simple terms that's easy to understand but yet still effective.

That's part of the reason that we publish a two-pager every month telling our investors exactly what we're thinking about the markets, talk about the big story. We talk about each sector that we're evaluating and what we think and we talk a little bit about portfolio positioning and why we're positioned the way that we are. That level of transparency, I think, is refreshing for most as opposed to kind of a model-driven black box solution even with strong performance over time, not knowing where that performance comes from, not being able to look at or understand attribution, I think is a challenge for most and with tactical bond strategy, not only do we tell you in advance what we're thinking, we'll tell you ex-post exactly how we got there.

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If I could just add a little bit on liquidity, like Jeff said, there's a lot of money in the front end with nowhere to go, with front end rates at zero, sitting right at zero. I mentioned the gravity of global term structures pulling rates down, but there's also gravity in the front end. We saw the U.S. yield curve starts to steepen but the front end wasn't going anywhere. The longer term Treasuries kind of returned to pre-COVID levels for a nanosecond and then in June, when the Fed decided that they were going to try to pull rate hikes forward, the market basically said, I don't think so, and flattened back out. We've seen lots of evidence, more evidence today with a really strong long-term auction driving rates, again, lower, positioning seems to be a little bit off-side. So just further reinforcement of our lower-for-longer argument on rates.

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Pamela Ritchie: Very interesting to see that just after the lunch hour today. Jeff, let's go to you to get at overall positioning, ultimately the five-step process, which you told us about before but take us through step-by-step where you get to how you're actually going to be stocking this overall strategy.

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Jeff Moore: The five-step process, it always starts at your macro call and here we're looking at how much money can you make for your clients and include, what do we think that's going to happen to the price level? If you're worried about inflation, you're worried about the price level, we want to build a portfolio that can outrun the price level. Period. That's one of our overarching goals. We've done that over and over. You don't need TIPS per se to do that, inflation protected bonds. You can outrun the price level in a lot of ways, compound faster. So macro, step one is always how much risk to take. We look around and say, how much more can we get? Right now, our return expectations are really low in the marketplace but we think we can do a quality 2, 3, 4, 5% once in a while return starting from here for clients, given how we see the world unfolding. We're putting a portfolio together that has that characteristics and the people who help us, that's Kana, Didi, Heather and Tom who know everything about every central bank around the world that matters.

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In our step two, sector, that's where we say, okay, now we've decided how much risk to take, now what do we buy? Do we buy some high yield, do we buy loans and right now we're looking at buying European investment-grade credit. Why? You're off of the dead yield curve, so if you're worried about inflation in U.S. and Canada, you're probably not worried about it in Germany. And if you are, you're probably not worried about it as much.

So let's go buy a lot of mom-and-pop company bonds using our London team off of that European yield curve, hedge it back to dollars, so we take a currency risk and because our rates are higher, we get an extra 1% and we can put together a portfolio of what I call high-quality names, mostly investment grade, that yield 2.5 to 3% and we'll have a high expected value of getting that. That's kind of the sector work, but we also like loans here, floating-rate leveraged loans, just the bank market is really, really awash in liquidity and with the CLO machine just wound right up right now there's a constant bid for loans. So even if you don't like loans today, you should buy them today because the CLO machines are here, maybe in two years you sell them but you can do that later. So those are the kind of things we're doing in sectors and we're working with our teams across Fidelity who live and die in those sectors. We're asking, do you love your sector? Is it good beta, bad beta, is it knowable? What's the downside risk?

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The third step is asset allocation. This is where Stacey takes over. She's our quant; she's embedded on our team and really Stacey's job is to stress-test our portfolio. What if we're wrong about inflation? Mike and I told you rates are low. Stacey's job is to stress test. Well, what if rates go up 100 basis points tomorrow? What if they go up 200, how will you do? We try to build a portfolio that not only has our Bayesian view, which you've heard from Mike and I, that sort of expectation of 2 to 3%+/- also says, assume something goes wrong, what's the envelope of returns for clients? And basically for us, we build a portfolio that gives you positive return if rates go up 100 basis points, down 100 basis points, the stock market falls 20%, you get a positive return on a 12-month period. That's how we try to size the portfolio, 'cause we want this to be like Mike said, very diversified, lower vol than the stock market, as few tails as possible and then we'll generate what income we can but mindful of all the stuff that could go wrong.

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Step four is every bond in the portfolio has a fundamental analysts review it and help us put it in there. So it's not Mike and I putting bonds in; it's actually our team of analysts who work with our equity group to get a 360-degree view of every company. This is a very robust process that we've used for decades, now it's decades, and it's really generated great returns with amazing downside protection. Just one more thing, if something like a March 2020 happens, which we didn't expect, when clients called us it wasn't if we were going to get their money back, it was just how long. And that's a nice conversation to have.

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Pamela Ritchie: That is a nice conversation to have. Very interesting. Mike, can I ask you to add anything? Again, we're sketching out the simplicity of process and actually how you go through your process. Anything to add?

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Michael Plage: In those first three steps, that top-down macro sector and asset allocation, that's all described in our two-pager that we send out. That fourth step, security selection, we call that the engine that runs 24/7 here at Fidelity. That should be generating alpha regardless of the market environment. Like Jeff said, I don't think we can understate how important that is. We've got hundreds of analysts on the fixed income side, both in investment grade and in high yield, plus our equity analysts all around the world and you hear it from our equity portfolio managers all the time, turning over stones, looking for ideas. We've got an army of analysts and traders helping us do that and bringing to us recommendations. From those recommendations, that's where Jeff and I put together the portfolio that we think can skew the beta of the portfolio to high beta in rally and low beta in the sell-off. I think it's a really important step. We don't talk about it as much because we are top-down, macro-focused but again, that is a consistent source of alpha in various market environments and it has been for, like Jeff said, decades.

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Pamela Ritchie: Jeff, just a couple of thoughts on the idea of if it's difficult to find yield, if it's a difficult environment for this, anecdotally, do you see people perhaps reaching too far into a risky realm to make sure that they are, in fact, exposed to make sure they find yield? Just some comments on that.

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Jeff Moore: This is one of the downsides of having so much liquidity in the system—is it can lead to people seeking return and seeking it in a way that ends up putting them in a corner down the road. So far the marketplace, and this is one of the nice things about this market, there hasn't been a lot of speculative binges in terms of credit markets. You look at the banking system in the U.S., year-over-year on C&I loans are actually negative. The banks aren't doing anything. The banking system in the U.S. and Canada, particularly in the U.S. though, has never been stronger in my lifetime. Never. It's got so much capital and they haven't overlent. Partly that's because they were building capital, so they couldn't lend. You have a strong banking system here in the States. When you think about our high-yield team, our high-yield team in Fidelity, we're sort of the big gorilla in the market, and so if you're going to do an LBO, your company management team, you're going to take yourself private and lever up six or seven times, generally, you're going to want to call us because we're going to help you fund it, those calls aren't happening.

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If you even look at private credit, maybe that's an area where for a few clients that they're getting fairly highly leverage, so if you're looking at triple-C private credit for 6 or 7% yield, you're probably levered six to seven times through the structure, which is pretty aggressively levered. Having said that, you probably feel like you have a great relationship with your private equity manager as well, so you feel like there's a piece of this whole piece. But you look at this right now, there's not a lot of terrible lending going on right now, on the corners maybe.

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We can talk about China for a second. China's not the China we grew up with 25 years ago. This is a slow-growing, population-declining country that will be looking more inward as President Xi has demonstrated. Even though it's not going to fall into the ocean or anything like that, it's going to have trouble growing faster than Canada and the U.S. over the next 20 years. It may not, for a whole lot of reasons. What we're doing, we're coming back. If we're trying to get you 3, 4% yields, we're not going to go esoterically. We're not going to go into really aggressive emerging markets. I think that the market itself hasn't gone too badly and we, as a group, won't go there either. We'll go get you your 3 or 4% and we'll try to do it in the highest expected value way.

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Pamela Ritchie: Final question coming in here, just a couple of thoughts on the repo market in the *[audio cuts out]* agreement market. With all of this liquidity, it's really had its own piece of a story here. Mike or Jeff, whoever wants to take that, just a quick final answer.

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Jeff Moore: I'll start since I'm on video here. The big story this month was reverse repo, so for clients, basically you get five basis points a year if you go through the overnight reverse repo facility from the Federal Reserve. It's over $1.1 trillion in usage right now. There is basically no yield in the front end of the cash markets unless the Fed's in there pulling liquidity out of the market and giving you five basis points. This is a huge, huge issue. One of the things that *[indecipherable]* yields, forget your view of inflation. That's not going to work right now until the front end opens up and that's not going to open up until the Fed raises rates, which could be years away. So reverse repo is being used heavily for *[audio cuts out]* $80 billion cap for institutions will be widened to 100, 120, so big bank, for instance, and all its clients, that might give a little bit more room for more people to get the reverse repo but keep that in mind, there's just nothing good there and that's keeping rates pinned.

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Pamela Ritchie: It's great to have both of you join us here today. I just want to thank Jeff Moore, Michael Plage, for joining in this conversation, for all of you joining us here today. Thank you very much for being part of this. We look forward to hearing back from you certainly. If there's anything that you'd like to see or you'd like to give us a sense of shows you'd like to see in the future, we're always happy to hear from you. In the meantime, certainly stay tuned for more Fidelity Compass webcasts in the weeks and months ahead. Thanks for joining us. I'm Pamela Ritchie.