Fidelity Compass

Make every dollar count in a fixed income portfolio

Jeff Moore, Portfolio Manager

Pamela Ritchie, Host

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Pamela Ritchie: Hello and welcome to Fidelity Compass. I'm Pamela Ritchie. Today's high inflationary 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 and controlling volatility. So in a low yield world, how can institutional investors realize these benefits while maximizing yield in 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 that we see today, very happy to have been joined by fixed income portfolio manager Jeff Moore. Jeff, of course, has co-managed the Fidelity Tactical Bond Strategy for 15 years. He joined us earlier today to explain why this strategy has seen such an increase in demand amongst institutional investors over the last year or so. Take a listen.

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Hi, Jeff. Great to see you. Thanks for joining us.

[00:02:09]

Jeff Moore: Hi, Pamela. Nice to be here.

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Pamela Ritchie: Great to have you join us here. Actually, let's just go straight to that idea of the appeal of this tactical approach really in terms of plan, the uptake that you've seen over the last year or so. What is the appeal in this particular moment?

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Jeff Moore: It's interesting. Most of our tactical strategies actually came out of work we did with large pension managers and CIOs and so forth on their needs and then we built something, Tactical Bond, a great example. We launched that in 2006 with the help of a large pension fund in the United States. Tactical Credit was launched with the needs of a large Canadian pension manager in mind. A lot of these are actually pretty good solutions right away for institutional investors.

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Pamela Ritchie: It's so interesting. I said in an introduction to you that there's controlling the volatility and there's the leaning into opportunities that volatility brings in a tactical way. Is that kind of the same thing? How do you separate controlling the volatility versus leaning into it?

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Jeff Moore: Well, this is really, really important. For institutional investors it's critical because for a lot of institutional investors, they've given us a beta and said you can have this much beta, we want you to just correlate it to stocks and things like that. When we think about the products we're providing to our institutional clients, we spend a lot of time making sure that they understand our five-step process, how we control risk by product and what the drawdowns can look like in all sorts of scenarios. At the same time, for a lot of clients they say, hey, I need more of my bond product, my core bond product I need more from. Or in Tactical Credit they say, listen, I need a place to go from selling stocks and I don't want to go to high yield, let's say, or EM, I don't want to go there, I want to go somewhere that's core-ish but I don't need that much risk aversion. And so we try to be very precise when we're talking to our clients about the betas they're getting from the different products they have.

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Pamela Ritchie: Well, that's interesting. Right now, again, based on what everyone knows and they're reading and watching with bated breath literally in the markets right now, how do you understand how much need there is for the core, perhaps a more conservative approach, versus the risk seeking? You kind of mentioned both but what's your sense that plans need right now that institutional investors need right now?

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Jeff Moore: That's a great question. For, let's say, Tactical Bond which we can go anywhere but it's actually pretty aggregate bond lite. We actually work with our clients, we're going to have a volatility between 3 and 6%. That's our vol range. And think about stocks, stocks have a vol between 10 and 20%. High yields vol, let's say, 7 to 15. If you buy unhedged Canada, U.S. dollar, that's 10 vol. So we're not going to be in that 3 to 6 vol, we're pretty buttoned down but we'll move that ball around for clients who are in Tactical Bond. Tactical Credit, for instance, again, this came out of work with a really sophisticated Canadian pension manager who said, I'm literally using you when I sell stocks, like fully funded, I'm going to you and I don't need you to be 3 to 6. I'm happy if you're 4 to 8 vol. So little more vol, trying to take a little bit more risk because if and when there's a 2008 drawdown you won't lose anywhere near as much money and stocks and I'll have an obvious allocation.

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Pamela Ritchie: Okay, that's fascinating. Let's go through the five step process to understand how ... this is your approach for all different types of funds but let's go through that because it is the philosophy behind it.

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Jeff Moore: It really is. Think about when you're talking to me you're talking to a core manager, core bond manager. You're not talking to a dedicated high yield or emerging markets manager or clearly stock metrics. We are [indecipherable] purposes. We use the same five-step process for everything, including Tactical Bond and Tactical Credit. The goal of that five-step process, we start with your macro, trying to say how much risk to take. Remember that 3 to 6 vol? Do we want to be at the bottom end of that vol range? Do you want to be at the top end? The more vol you take the more you should be offering your clients in terms of returns and yields. So a great example in this market, if you go back to September, our team, our macro team, it's Khanna, she does the Federal Reserve, she's our expert on the Bank of Japan, the PBOC in China. It's Heather who's Bank of Canada, Bank of Mexico, RBA in Australia, Brazil. It's Tom Nolan in our London office who's our expert on ECB and the BOE. They were saying, hey, we're at an inflection point here. The yield curve is super flat, there's almost no gains from just buying a flattener and so we should be protecting the portfolio.

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So what we've done is we've pulled vol down and say to our clients, we're taking at our bottom end of our range for vol. We're not going below that. We're still going to take risk but we kind of promised 3 to 6, we're kind of edging to the bottom end of that vol, knowing that the Fed's [indecipherable] play here and now, obviously, the ECB is … that's kind of how we've done our trades. So we pulled back our high yield, we went up in quality and high yield. Instead of owning triple-Cs and single-Bs, we now own double-Bs, we sold a lot of high yield and we took the duration of the portfolio's way down but still left them with nice positive beta to the marketplace because that's kind of the offering.

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Pamela Ritchie: By the time you get to your securities selection you're at what step in the process?

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Jeff Moore: That's step four. Macro is one, sector's two. Once we decide how much risk we're going to take vol, let's say, 4%, step two is where are you going to take it? You can buy anything kind of on earth within a 4% vol, what are you going to buy? It's hard to buy unhedged FX because that's a 10 vol and you're 4 vol, it's hard to stuff 10 vol into a 4 vol. We don't do a lot of that. So that's sector, second. Third is where the quants take over and it's all those scenarios because we have our Bayesian view what's going to happen but we know we're going to be wrong a little or a lot … always. So we always want our portfolios to be robust enough for clients that if even if we're wrong by more than one standard deviation, it's still a positive return for clients. That's kind of in our head. Step four is security selection. Every bond that goes in the portfolio has a fundamental [print?] assessment done by one of our own analysts in fixed income working with all their colleagues in equity around and around the company at Fidelity to get a 360 degree view of every credit. Let me give you one example. In March 2020 when COVID happened, our analysts went home, we all went home, and they went over the next 10 days, certified every security in the portfolio good for COVID or not good for COVID.

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Pamela Ritchie: Every single one. That's quite a visual if you think about what those days must have been like. What were those 10 to 15 days like [inaudible]?

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Jeff Moore: This started Zoom calls so let me just say there is a lot of back and forth. We didn't have a good Zoom etiquette per se but I remember being on a call, specifically with our energy team, so we had John Cassidy who's my specialized energy analyst, we had our high yield energy team and we had our equity energy team on the same call. It must have been 10:00 p.m., it was a Thursday night at 10:00 p.m. and we're working out of the house and it was quite a thing because that was the time we all had to do energy and we were going to spend three hours going soup to nuts through every name in the energy complex, what their funding needs looked like, where they could possibly get their funding needs, all that stuff. It was very exciting.

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Pamela Ritchie: It must have been very exciting burning the candle at both ends. It's very interesting. Let's fast forward to a lot of central banks' decisions that were also made in that three-week period or month-long period, to now where central banks are pulling it all out. You just discussed all the people that work on your team and have their eyes very closely trained on central banks around the world and [indecipherable] re-invest, what are you expecting ultimately in March?

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Jeff Moore: The one thing we've been telling clients back in September is the Fed should not be at zero. Just like the Bank of Canada got off zero, there's really no reason we have anything emergency now. There's no emergency. COVID's a pain in the rear. Goodness knows it can't end with the truck convoy and truck blockages. We know it's a pain ... but it's not an emergency. The zero rates is an emergency level so we knew we had to get off of that. Whether it's here in Canada, the Bank of England, most of the world, heck, even the Bank of Japan stocks, smidge off of zero. The same thing with fiscal policy. We know we don't have an emergency so we don't need massive fiscal stimulus like we had in the last 24 months that was 10 and 15% of GDP a year.

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Our take right now is how do we go from emergency to okay, this is where we're heading, pre-2019, think about that. This is going to be the bumpiness of the ride here. It's not that we're getting off zero, we should. So we're going to get at least a couple Fed hikes this year. Do we get 7 that's in the market? That seems like a lot for me and I think it's a lot, especially for the Fed when you have quantitative easing going into quantitative tightening and you have Chair Powell always talking about financial conditions. So I think the market's probably overshot the mark on 7 for this year by a lot. You may get 7 over 2 years or 2 1/2 and that would take us back to 2017, 2018, we ultimately got 7 although we had to cut 3 out in '19 so keep that in mind. The way I'm looking at it is we're going to get a Fed hike in March. Could we get 50? I guess we could, the markets are open to it.

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Pamela Ritchie: We've seen pieces of news around some lining up with a higher hike than others. It's been a conversation for a few weeks now, how important is the pace from your perspective?

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Jeff Moore: There's two parts to this. One, the reason this is so uncertain for the market is there's only so many Fed committee members and you can imagine a few of them will want 50 off the bat and a few, like the San Francisco Fed, she said, no, we'll start with 25. So how will this fall? It could be a really close vote, 5/4 vote and you're going to be watching it so you can't focus on the first one. I think the pace though they'll be mindful of inflation, they're going to be super mindful of financial conditions. So if financial conditions get tighter and tighter like they did at the end of 2018, things like the stock market really wobble.

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If you think about that 20% drawdown we had in the fourth quarter of '18, a lot of that was financial conditions were getting tight and it gets hard to get a loan. So senior bank loan officers [indecipherable] and things like that. I think the Fed is unbounded here. Chair Powell has given the Fed all of the unboundness but I don't think you should assume that unbounded means rates are going to the moon. I think unbounded means he and the committee will get to choose the timing pace of this. If you told me, okay, in two years, we're going to end up at 1 1/2 to 1 3/4 overnight rate, I'd say, that makes sense to me. That would make sense to me. If you say we have to get there this year, I'm like, yeah, I don't know.

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Pamela Ritchie: That begs the question, pace, what can the market handle but then there really is inflation. It's hard to know exactly where that all goes and if it drops off suddenly. We've seen the Canadian inflation print doing similar things. How worried do they need to be about that? Can they just move that amount, 1.5 to 1.75 when they have inflation and these numbers [inaudible]?

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Jeff Moore: I think the Fed and the Bank of Canada have immense credibility still with the markets. I'm looking at things like the TIPS breakevens for inflation-protected bonds. Long breakevens around 3.2%. They're fairly elevated versus where they were five years ago. Kind of what I think the market's saying is, listen, we have this two-year period COVID fog of war. There was so much action, fiscal, monetary and technology change under the covers. We just don't know know what 2024, 2025 looks like. So we actually have pretty benign inflation expectations in the marketplace. Even if you look at the 5-year, 5-year forward which is inside baseball, it's at 2% in U.S. That's right down the middle for inflation. So I guess where I am, be cautious annualizing every one of these inflation prints because the market's kind of looking forward, saying, yeah ... not.

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Pamela Ritchie: Another piece of the unwind is what the Fed will stop buying in the market. One of the things that gets spoken about a fair amount is mortgage-backed securities but there are other areas where the Fed has been buying. How does that go? Are there people lined up to make sure they take over? How do you view that? Is it a concern?

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Jeff Moore: I think you've hit on something that people should be more concerned about, especially professional investors here. Who's the national buyer for inflation-protected bonds? If the Fed's selling, and they will be a hard seller QE to QT, who's going to pick that up? There's no natural buyer, especially Wall Street, because it's hard to hedge them. What nominal curve do you use? What's the duration? All that piece which means they're going to trade with more vol, not less, as the next 60 90 days come on. So TIPS are going to be more fog of war. More of just the same thing. 25% of mortgages are owned by the Fed and they were pretty much an indiscriminate buyer. Any yield was fine, we'll survive across the coupon stack, blah, blah, blah, blah, blah. I don't think that's the case. The problem that TIPS and mortgages have is they don't have enough yield to entice the professional investors back. High yield, if high yield goes down 10% there's a ton of people probably on this call who are interested in buying because the yield's there. But mortgages and TIPS, not so much.

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Pamela Ritchie: There was an announcement just out earlier this week that the Canadian government is committed in terms of immigration policy over the next three years to admit 1.3 million new people through immigration to this country. You talk a fair amount about demographics globally, the impact of the ageing demographic. This is what Canada is doing. They're doing this for some time. It's a new update. What do we need to be concerned about, again, connected to inflation ultimately, on the demographics front?

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Jeff Moore: Canada has been averaging 400,000 immigrants for a little bit at a time. One of the neat data points is that over 50% of Canadians were not born in Canada. I think that's just an amazing wow factor. We talked in the past that immigrants, someone chooses to move and uproot their family and take a big risk is probably someone who's actually going to contribute a lot to GDP over time. Most of us will look at that as a big positive for Canada in terms of GDP growth. Doesn't mean there won't be social change, that's part and parcel, but countries are always moving and shaping and time moves on. So it's going to be positive for GDP. Look at the G10 though. The bulk of the G10 does not do well with immigration at all, especially Europe, Japan, China. These are not friendly to immigration at all. It's not something that society has embraced widely. In most of the G10 we have population decline.

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If you go back to first year university, GDP is the number of people working times output per person. That's your GDP. The number of people working is going down, you've got a headwind to GDP and so G10 demographics look awful. Canada will be a relative winner and probably an absolute winner as well. And the U.S. will too because the U.S. still takes more immigrants than pretty much the rest of the world combined other than Canada. So keep that in mind too, that two of the countries that take the most immigration are probably the two faster growers. And so we have a lot under the covers happening demographic-wise. If you think GDP just gets slower into the future and if you think the 10 -yield looks kind of like long term GDP and it's going down, you're probably getting to the point where you like 10-year Treasuries now. You may not like them at 1% or .5, who did? As they get north of 2 where they are now, everyone should know that we like them much better now than we liked them in September. Way better.

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Pamela Ritchie: So that brings up duration ultimately and what you turn to. I don't know if we're still in the fog of war ... we'll talk about geopolitics in a second ... really, how do you start to look at duration? How does that start to look about now?

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Jeff Moore: When you think about that 3 to 6 vol, we've been at the bottom end, we're going to start wanting to buy some of that vol because as interest rates go up, now interest rates have two-sided risk. They can rally again if we need them too if the Fed cuts again or has to cut, or things that are priced off in the Treasury like high yields, which is down almost 5% year-to-date, that's almost 100 wider. Maybe you don't like high yield quite like ... maybe your target is 300, that's fine, 200, whatever the number is but you're getting to the point where yield will start mattering again. If we think about Tactical Bond product for clients, we're yielding a comfortable 3 1/2%++, probably touching 4. In our Tactical Credit we're in the mid [4s?]. Those are with lots of diversification, lots of protection and we're not even close to maximum allocations. We're starting to add a lot of yield here and so the question will be, our team will be trying to figure out a way to buy back to [indecipherable] because we're so short.

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Pamela Ritchie: Really interesting. I want to just go to ... we've spoken for a lot of the reasons for why there is this, as you put it, fog of war, all the changes that are coming ultimately to the monetary policy over the next little while but how long do you think certain things will last till they settled, till you can see some clarity. I guess the liquidity is pulled out, we actually might see the economy a bit more clearly.

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Jeff Moore: I think so. I think everyone will, including the Fed, but including government. I think government really doesn't know either. I think everyone's been surprised that we have really low unemployment. We do wonder where did the workers go. That 25 to 50-year-old cohort has left the workforce in a decent size?

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Pamela Ritchie: Do you have any sense?

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Jeff Moore: If you think about it, our analyst, Colin, who is really focused on inflation and cohorts like that and working with Khanna, the two of them are trying to figure it out. Part of the issue is data. We have some really crazy slices of data by government and so you're kind of caught using data that's not fine tooth and it's a little tricky. And survey data, a lot of those data streams started in the 1930s so it's not like today where you're using digital, all this stuff and crypto like that. We are using a survey we've used for 100 years. It's tricky. We do know that the over 55-year-old cohort has dropped out a lot. We do know that the bulk that drop out is males. So can you guess that maybe they've hit their targets? Maybe they've worked 30 years and this has been an amazing 30-year period and so they're fully funded. Maybe they're with a lot of these clients on this call and your pension looks locked and loaded and they've got everything they need and maybe their spouses still work. The over 55-year-old could be permanent or more or less permanent. The 25 to 54-year-old, that dropout rate, we need that group to come back one way or another and we need to figure out why they left. And it's not obvious. There's a chance it's elder care, there's a chance it's child care. Those are things we have to think about.

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Pamela Ritchie: Interesting. All part of the overall demographics discussion. Do you see in the next month and a half ... let's say we get to mid-spring, some of the let's get this rolling if you believe that March is live as a Fed meeting, which I think you do, at least we'll be on the road at that point, we're still a little bit in this pre part, do things settle down once we're on the road a little or...?

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Jeff Moore: I think so. I think if they don't settle down we'll at least have more clarity that they're not going to settle down. I think clients should be looking ... the next 60 to 90 days we're going to reveal a lot. So if you're going to buy your duration back you're going to probably have to do it before we reveal it. So for a client it probably means you have to make your choice the next 60 days because once it gets revealed, it'll be obvious to everyone. I think that some of the pieces here ... remember, it's been a while since we've had massive fiscal stimulus at a global level, not just Canada and U.S. And there's not much coming in fiscal stimulus. Even think about what President Biden passed in terms of infrastructure, a lot of his infrastructure projects will take years, years to affect anything. It's great that it's there but it's not like a surgeon, GP coming. So as deficits fall his monetary policy rises and as we go from QE to QT there's a lot of friction in the system that we're going to watch. So I think 60 days to 90 days makes sense to me and then we'll decide, okay, if this is more permanent or less permanent,

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Pamela Ritchie: Anything to do know on the geopolitics front? No one can escape the discussion that's going on. It is affecting certain markets for sure. On the Ukraine, Russia front, how do you keep it in the universe of what you're keeping an eye on?

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Jeff Moore: When I work with clients I tell them it's awfully hard to make money calling geopolitic things. Think about the worst case here, invasion of Ukraine by Russia. It's one person making the call, there's no committee, one person. How the heck will we ever know? And so we then have to say, okay, what we do is we stress test the portfolio. We saw what happened [indecipherable], we stress tested and looked at that period. In general ... and this is the hard part for markets, I don't want people get mad here ... but the markets will be less inclined to care care, if there's no direct linkages. As long as it's not a shooting war with NATO, energy prices could be the contagion but in general, something that happens in whether it's Ukraine or Belarus or one of the other 'stans, which has happened, those things generally don't lead to big, global, long lasting events. So I almost think you have to look through it, again, on an investing side maybe not on a personal side but on an investing side.

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Pamela Ritchie: I want to take a look at your ... I think it's step two in your process, sectors, and just kind of get a sense of what you think of sectors right now, where you see opportunities. Again, health care, energy you've mentioned there, staples, we've got some more information about the retail picture generally from numbers that have come out today. We've had PPI recently, we've had CPI, we've got all these data points swirling around, what sectors are coming through your process that you're leaning into?

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Jeff Moore: Think about what is our biggest positions right now, in Tactical Bond, 30% is floating rate plus a little cash. In Tactical Credit, we're almost 60% floating rate and floating rate notes have eked out a small gain. They look like a bad cash instrument but they're still positive while other asset classes have all fallen. One of the things we're considering is we look at bank loans. Bank loans, where we really like them, it's one of the biggest positions we have, has massively outperformed high yield by multiple per cent year-to-date. If that continues, an even obvious trade because at the end of the day both loans and high yield deal still have default risk, still have to offer you similar yields through a cycle, blah, blah, blah.

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So you can easily imagine that at some point here, when we decide to add duration, one of the ways we do that would be to sell loans and buy some high yield. So if we can get high yield double-Bs to 5%, well, that gets high yield double-Bs back to where they've been in the 1990s. All of a sudden you're going, okay, now we have 30 years here, maybe 5% is too early it should be 6 but you're not thinking it's more than that so I think that there could be a trade out of floating rate into fixed rate, which seems obvious. So far, investment grade credit is one of our biggest underweights right now. It worked in 2020, we loved it. Today it's just so tight in spreads. They've actually behaved very well and they've just been falling by their duration. There's nothing to do there there. There's no reason to go buy 30-year corporates at this stage.

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We like international still hedged back to dollar although to be honest with you, President Lagarde, she rolled a hand grenade into the room about a month ago and said she might raise rates and now that's our call, you're going to get a rate hike in fourth quarter '22. It seems to be where the ECB wants people to be which is a pull forward. Anyway, that still works because ultimately we think that Bunds curve will have less rate hikes than Canada, U.S. curves. So if we can price something off and spread it to the Bunds curve then we'll still only be in a better spot on a price basis over the next six months. We still like that trade but it hasn't really worked that well in the last couple months.

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Pamela Ritchie: What did you think when you watched that press conference? It was almost uncomfortable to watch Madame Lagarde go through [inaudible].

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Jeff Moore: She was the most vociferous leader of the we're not going to raise rates into a supply shock. She was very clear about that. By the way, that's where my head would be too. I wouldn't want to raise rates into a supply shock because raising rates into a supply shock, that does nothing for the supply chain. The supply chain will have to get fixed by companies and with maybe a little bit of government support here and there. I think she must have felt pushed by it. You can imagine there's a contingent ECB, let's call them Germans, that were pushing that, yeah, maybe we need harder money, not less, and so it's this give and take. This is the problem with committees, right? They often will take an average of everybody's feelings. So if there's outliers they start to have more of an impact because they're still part of that average.

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Pamela Ritchie: Very interesting. Just a final thought on the tactical strategy and why now just to wrap up our conversation, sort of the way we started it, actually.

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Jeff Moore: We launched this in '06 for the same reasons as today … yields are kind of low, sometimes they go really low, then they [indecipherable] some. The last 10 years, the 10-year Treasury is high, almost 3 1/2%. It's very difficult for me to imagine a world where the 10-year Treasury gets to 3 1/2%. Maybe there's a tail that it says it gets there again and so the why now, it's the same problem we had in '06, '07, '08, '09, 2010, 2011, the bond market just doesn't have a lot of yield left in it. Remember the early 1990s, we had a lot more yield. The 10-year yield in 1996 was 4 1/2% so it's just less yield, you need to be more flexible and you need your bond product to work a little harder but within beta constraints.

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Pamela Ritchie: Jeff Moore, it is always a pleasure to speak with you. Thank you for sharing your time and your thoughts really with everyone here in this call today. All the best.

[00:32:03]

That was Jeff Moore joining us a little earlier today. Thank you for tuning in and joining us here. If you have any suggestions for future Fidelity Compass topics or guests that you'd like to see on the show do share your ideas with us. In the meantime, stay tuned for more Fidelity Compass webcasts in the weeks and months ahead. I'm Pamela Ritchie.

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