Rising Rates, Bond Solutions

June 2014

Bond investments are known to offer one significant advantage over equity investments, namely a more defensive risk return profile, since though their returns may not be as exciting, they benefit from significant downside protection. This sense of relative security may be significantly challenged going forward as interest rates, currently very low, will at some point "normalize". Though the current interest rates may be negative in real terms, they are at least stable, but for how long?

	15/10/93-7/11/94	18/1/96-12/6/96	5/10/98-20/1/00	7/11/01-1/4/02	13/6/03-14/6/04	1/6/05-28/6/06	30/12/08-10/6/09	7/10/10-8/2/11	26/7/12-27/12/13
Yield increase bps	287	154	263	125	176	136	189	115	159
Barclays U.S. Govt/Credit (%)	-5.15	-4.08	-3.38	-3.09	-3.64	-1.49	-2.08	-3.94	-2.14
BoFa ML All US Convertibles (%)	-2.28	11.97	68.85	2.29	11.49	9.46	24.68	11.63	35.49

Sources : Morningstar and Bloomberg.

Looking at the table below, one can see that in the past decades, investors have already experienced multiple periods where fixed income instruments delivered negative returns following rates adjustments.

No investor will dispute that rates will rise at some point in the future, yet many investors feel that this raise will not happen anytime soon and, therefore, have not repositioned their portfolios. What options do they have and what do they risk in case of a rate increase? Whether or not History repeats itself, let us examine past events to assess if they can provide us with a pattern: Viewing the table above, the trend is disturbingly clear and investors are quite justified in their worries. Fundamentally, investors have four options to choose from:

1. stay away from bonds, at least until rates increase (but not all investors can reduce their allocation to zero and many are unwilling to go without bond protection and returns for what might be an extended period)
2. accept that they probably will register negative performance if they get their timing wrong (though this will be less surprising, it will not be less painful)
3. try to actively time the markets themselves (good luck!)
4. decide to delegate the management of their bond allocation to recognised active managers.

Perhaps unsurprisingly, the fourth option is the solution that Mirabaud Asset Management advocates: We find that allocating to talented managers and letting them deal with the complexities of this environment is far more efficient in terms of risk management, but also returns.

So, with a 100% certainty that rates will increase sooner or later, Mirabaud Asset Management offers three possible solutions to protect investors' fixed income investments from results akin to those in the table above:

1. Convertible Bond Investments

2. Strategic Bond Investments

3. High Yield Bond Investments

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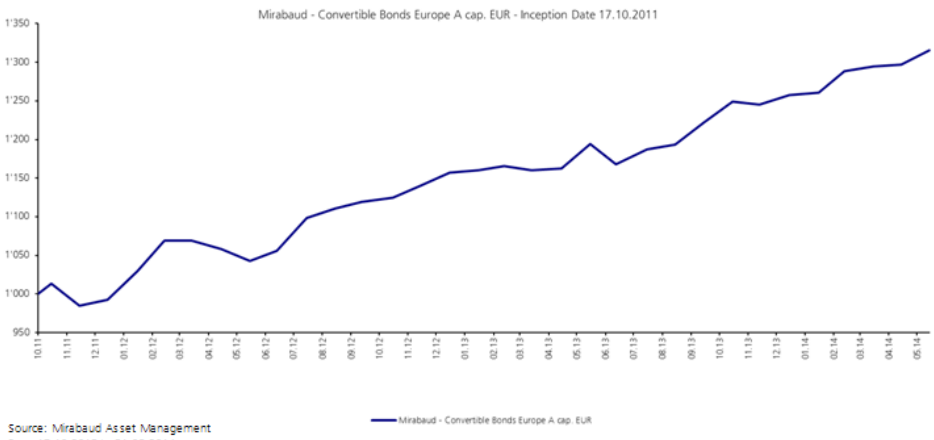
1. Convertible Bond Investments

Convertible bonds are fixed-income securities that include an embedded option to be converted in equity. As such, convertible bonds can be considered as the sum of their parts, combining equity performance with a bond floor. Over time, they have therefore proven less vulnerable to rate increases than non-convertible debt, in part thanks to the influence of the price of the underlying stock. The table on the previous page illustrates this behaviour: of the nine periods examined, only one was negative, losing half of regular bond losses; of the eight other periods, six produced double digit returns and three produced returns in excess of 20%. If this can still be called "down-side" protection, interest rate increases no longer seem too bad.

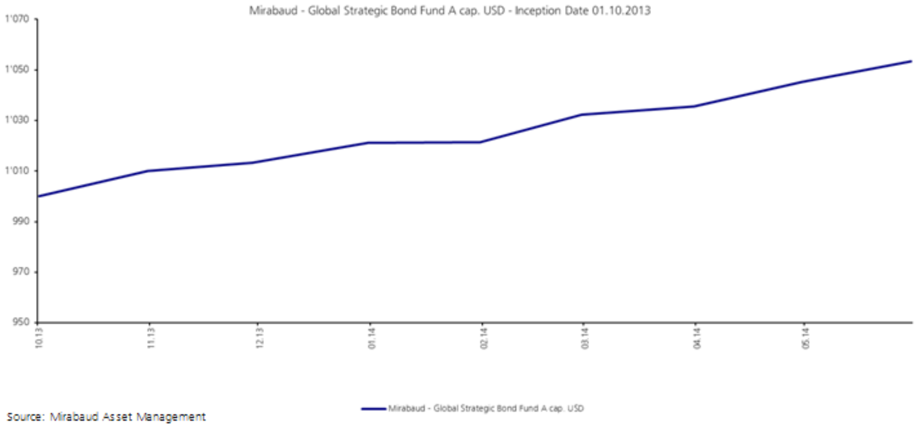


Source: Mirabaud Asset Management
From 17.10.2013 to 31.05.2014

Convertible bonds are an attractive source of funding for companies as the potential upside they would share with investors allows them to benefit from a cheaper cost of funding compared to traditional bonds. New issues are therefore increasing allowing active stock pickers to widen their research universe.

2. Strategic Bond Investments

Just as equities do not all react the same way at the same time, various bond investments will react differently in various market environments. A "strategic bond investment" approach has the flexibility to invest in government bonds and corporate bonds, ranging from high yield to floating rate instruments on a global basis searching for the best opportunities in terms of risk return profiles. This active approach to the bond universe mixes instruments, sectors and markets, identifying at any point in time real value and aims to deliver positive performance through various market cycles and limit the downside compared to what a traditional bond fund would experience, specifically in a rising interest rate environment.



Source: Mirabaud Asset Management
From 01.10.2013 to 31.05.2014

As flexibility is key to a successful implementation of the strategy given the current navigation in unchartered economic territory, the fund accesses the most liquid investments in the universe, such as derivatives, including futures and options, thereby complementing the cash bond portfolio and maintaining crucial manoeuvrability.

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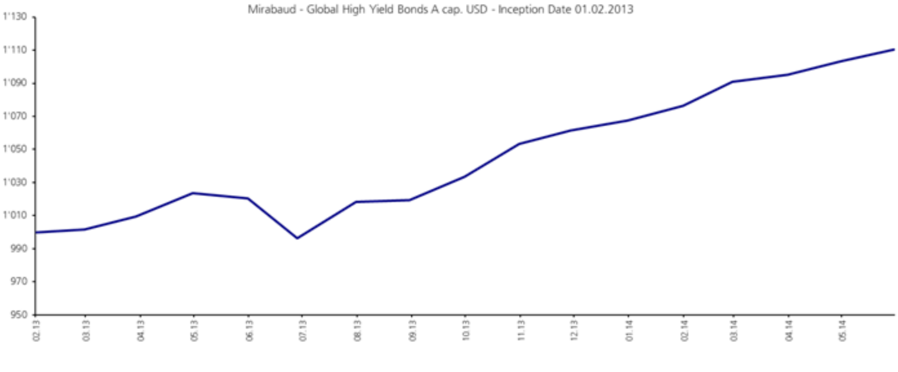
3. High Yield Bonds

With high yields, High Yield bonds are naturally less vulnerable to a shift in interest rates than low interest government bonds. Furthermore, as long as interest rates remain low, high yield bonds' comparative attractiveness remains high and shall continue to do so until government bonds return to 1980s rate levels - an occurrence which very few economists foresee anytime soon.

Furthermore, many high yield companies have reduced their refinancing risk going forward, for others, their coverage and leverage ratios remain robust and many enjoy much more robust balance sheets. Overall, the companies we have selected are well prepared to weather a low growth environment.



Source: Mirabaud Asset Management
From 01.02.2013 to 31.05.2014

Investor inflows since 2011 reflect this, thereby confirming our conviction in this asset class in the foreseeable future. The current valuations of high yield spreads can be considered as expensive on an historical and absolute level but remain still attractive when compared to other asset classes. High yield remains the ultimate source of income for investors searching for a regular stream of cash flow from their portfolio.

With these three fixed income solutions, Mirabaud Asset Management provides investors with compelling options to protect their investments against the negative effects entailed by a rise in interest rates. Given our philosophy of investing with active managers, we believe that the approaching threat provides the opportunity to make the allocation that will pay off particularly when rates increase and this is probably the type of decision that, if taken before ones summer vacation, will provide peace of mind to avoid monitoring one's portfolio from the beach and knowing ones' investments are protected against the impending rise in interest rates.

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