FIXED INCOME

UK BOND BUYERS BEWARE

HOW TO AVOID HIDDEN HOME MARKET CONCENTRATION RISK

AL CATTERMOLE

Portfolio Manager &
Global Credit Analyst

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Having international exposure in your equity allocation has become the norm. The consensus view is that opportunities in global equity markets can be as attractive as those at home and should not be overlooked. But when it comes to fixed income, the home bias remains strong.

While there's comfort in familiarity, considering only GBP debt can result in:

1. A constrained opportunity set
2. Unintended concentration risk

Let's dig into the composition of the UK fixed income universe to see how expanding your geographic remit could prove less risky, with greater return potential, than staying close to home.

GILTS & BEYOND

After 12 years of ultra-low yields, income has returned, with segments of the bond market offering returns akin to equities, making it an opportune time to review allocations for optimised return potential.

Investment grade (IG) is going to feature in most bond portfolios, but holding only UK names can unwittingly leave you exposed to an alarming level of concentration risk. Of the 347 issuers that make up the UK market, 39% of these are banking and real estate names[1]. In today's environment of elevated mortgage rates, this creates significant sector risk, pushing yields out.

To get the best of IG with the lowest level of risk, we believe broadening your geographic remit and taking an international view provides the optimal

[1] Mirabaud Asset Management, ICE BAML, 28 February 2023

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INCOME HAS RETURNED

GBP high quality yields %

Source/ Mirabaud Asset Management, ICE BAML, Bloomberg, 31 August 2023. **Past performance is not indicative or a guarantee of future returns. Indices are not available for direct investment.**

solution. The US IG market has only a slightly lower yield of 5.9% (hedged to GBP) compared to 6.0% for the UK[2], but much less sector concentration risk. In the US, banks comprise 19% of the market and real estate just 3%[3]. There are also opportunities in US IG names in the growth sectors like technology and energy that are not available in the UK market.

IG SECTOR CONCENTRATION RISK

	GBP IG	US IG	EUR IG
Banking	26%	19%	27%
Real Estate	13%	3%	6%
Total	**39%**	**22%**	**33%**

LARGEST IG SECTOR CONCENTRATIONS

GBP IG	US IG	EUR IG
Banking 26%	Banking 19%	Banking 27%
Utilities 16%	Financial Services 9%	Utilities 10%
Real Estate 13%	Healthcare 9%	Financial Services 7%

Source/ Mirabaud Asset Management, ICE BAML, 28 February 2023. US High Yield = ICE BofA Merrill Lynch US Investment Grade Index. EUR HY = ICE BofA Euro High Yield Index. GBP HY = ICE BofA Sterling High Yield Index.

[2] Bloomberg, as at 22 September 2023
[3] Mirabaud Asset Management, ICE BAML, 28 February 2023

The story is similar in high yield (HY). The UK market is small, with 99 bonds offered by 66 issues. 26% of these bonds sit in the retail sector, with supermarket names dominating[4]. With CPI sitting at 6.7% and unemployment ticking up, the UK consumer is set to decline and this degree of retail concentration could negatively impact returns.

While HY can be an interesting allocation for higher potential returns, we believe exposure needs to come from a spread of sectors for an optimised risk/return profile. The US and European markets are much larger and are without the elevated concentration risk that the UK has, yet yields are attractive at 8.7% (hedged to GBP) and 8.6% (hedged to GBP) respectively, versus 10.4% for the UK[5].

HY SECTOR CONCENTRATION RISK

	GBP HY	US HY	EUR HY
Retail	26%	6%	4%

LARGEST HY SECTOR CONCENTRATIONS

GBP HY	US HY	EUR HY
Retail 26%	Energy 12%	Banking 13%
Telecommunications 12%	Media 9%	Telecommunications 12%
Utility 10%	Leisure 8%	Automotive 10%

Source/ Mirabaud Asset Management, ICE BAML, 28 February 2023. US High Yield = ICE BofA Merrill Lynch US High Yield Index. EUR HY = ICE BofA Euro High Yield Index. GBP HY = ICE BofA Sterling High Yield Index. EM HY = ICE BofA US High Yield Emerging Markets Corporate Plus Index. Global HY = ICE BAML Global High Yield Index.

[4] Mirabaud Asset Management, ICE BAML, 28 February 2023
[5] Bloomberg, as at 22 September 2023

COSTING-UP FX HEDGING

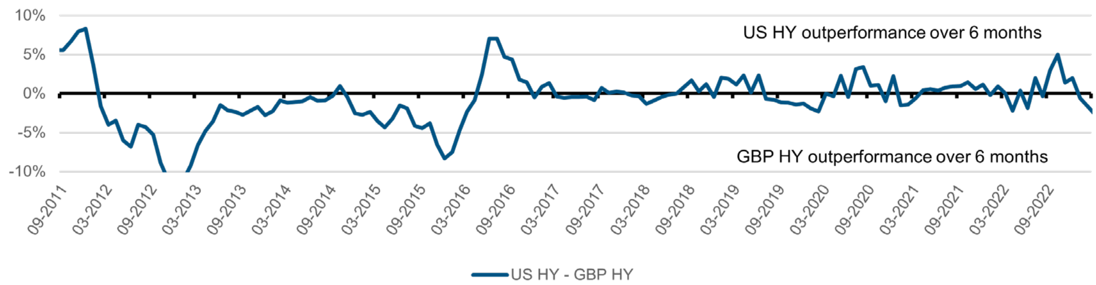
We believe allocating across geographies lets you capture the best of the opportunity set while minimising concentration risk. But maybe you're wondering 'at what cost?' The perception that it's prohibitively expensive to hedge FX risk back to sterling isn't accurate. In fact, the potential pay-off means it's something we think investors should actively consider.

The cost to hedge foreign currency bond funds back to GBP is essentially the government interest rate differential – so at the end of August 2023, it cost around 8bps to hedge back from USD to GBP. However, fixed income assets in USD have a higher yield to begin with, as risk assets are priced off a higher risk-free rate. Therefore, the hedging cost nets out and you should invest in the region where you see the highest potential returns going forwards.

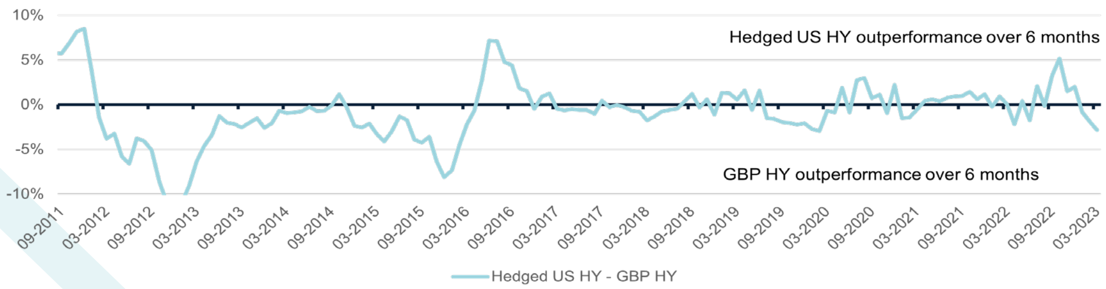
To illustrate this, we can look at six-month periods where US HY outperforms GBP HY by +2%, even after hedging costs are applied. Holding the higher-yielding US assets with a stronger outlook cancelled out the hedging costs and generated a better overall return. The same illustrations played out in the IG market. But putting return potential to one side, we believe the real benefit is

PERIODS OF OUTPERFORMANCE FOR US HIGH YIELD

Relative rolling 6-month HY returns



Relative rolling 6-month HY returns hedged to GBP



Source/ Mirabaud Asset Management, ICE BAML, Bloomberg, 31 March 2023. Past performance is not indicative or a guarantee of future returns. Indices are not available for direct investment.

Putting return potential to one side, we believe the real benefit is the additional diversification that currency exposure brings – even if overall performance is neutral, your portfolio risk will be lowered.

the additional diversification that currency exposure brings – even if overall performance is neutral, your portfolio risk will be lowered. Including geographic flexibility in your investment arsenal can give you a useful fifth lever to pull on (alongside asset allocation, duration, credit quality and sector) as market direction shifts.

While yield has returned to UK fixed income, having a strong home bias could leave your portfolio unduly exposed to sector concentration risk. Evaluating your fixed income allocations through a global lens is, in our view, the best way to optimise risk-adjusted returns.

OUR APPROACH

At Mirabaud Asset Management, we believe our nimble and flexible approach, implemented by a small, hands-on team, presents the best way to capture upside potential while managing downside through active hedging.

The Mirabaud Sustainable Global Strategic Bond strategy is a dynamic, 'go-anywhere' fixed income solution that aims to achieve an attractive total return through a high level of income combined with long-term capital appreciation.

The strategy is positioned to avoid a home bias and single-market concentration risk through a fully hedged, global portfolio diversified by geography and sector.

It is currently tilted towards the US, where historically high all-in yields are supported by robust economic fundamentals, while the lack of a strong rebound in China is weighing on the outlook for Europe and emerging markets.

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