

Schroders TalkingPoint



Why Asian bonds for absolute returns?

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With markets plummeting again in recent months, in response to the worsening eurozone debt crisis and heightened fears of a recession, many investors have become unwilling to accept the volatility that they have come to associate with traditional mutual funds. These investors have grown weary of having their fingers burned repeatedly in recent years by falling markets and have been seeking alternatives, with absolute return funds garnering serious assets as a result of an increased focus on capital preservation.

A cushion against volatility

Absolute return funds aim to offer investors steady and modest returns over a given time period regardless of the market conditions, and are seen as 'all weather' funds that can shelter an investor from sharp market falls such as those seen recently and those that followed the collapse of Lehman Brothers in 2008. At Schroders, absolute return funds are managed with an objective of generating a positive return over rolling 12 month periods.

The number of absolute return funds available has been on the rise in recent years, with investors now able to access a growing number of unusual sectors which offer attractive diversification benefits to your portfolio. One such sector which is now starting to receive increasing levels of attention is Asian bonds. So what is the attraction?

Why Asia for bonds?

For a start, if you look at the fiscal position of countries in Asia, it is far stronger than those of developed markets, with far lower debt to GDP ratios. At the same time, the GDP growth forecasts for the Asia Pacific region far outstrip those of the eurozone, US, Japan and even Latin America.

You might think that bonds in Asia are risky - after all, the Asian stockmarkets are notoriously volatile. However, the Asian bond universe is mainly composed of highly rated countries. Singapore and Hong Kong, for example are AAA rated by rating agency Standard & Poor's, the same rating as Germany and higher than the US. At the same time, foreign currency reserves held by countries in the Asia ex Japan region are around the \$5 trillion mark, providing a considerable cushion to foreign investors.



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Attractive potential

Currently, institutional investors around the world have extremely low allocations to Asian bonds in relation to the sector's increased size and influence in global markets. Asian bonds only account for 2.4% of the main global bond index, despite having 8% of the world's total outstanding domestic debt securities. In the coming years, this systemic underweight allocation to the region will correct itself and add support to valuations and liquidity there. Clearly, as investment documents frequently tell us, past performance is not indicative of future returns, but the returns from Asian bonds in the past ten years are encouraging. Data shows that Asian local currency bonds have shown a



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better risk return ratio over ten years than eight other major asset classes (US treasuries, Asian US dollar bonds, emerging market debt, global sovereign bonds, emerging market equities, Asia ex Japan equities, global equities and European equities). In this period local currency Asian bonds have generated annualised returns of 8.1% and Asian US dollar bonds 7.6%, both of which have come with significantly lower volatility than equities and emerging market debt, as shown in the table below.

Asset class	10 Yr Return annualised	10 Yr Volatility annualised	Return/ Risk ratio
Asian Local Bonds	8.1%	6.5%	1.23
Asian USD Bonds	7.6%	7.5%	1.01
US Treasuries	5.5%	4.8%	1.14
Emerging Market Debt	10.5%	9.5%	1.10
Global Government Bonds	7.4%	7.6%	0.98
Emerging Market Equities	13.4%	24.1%	0.55
Asia ex Japan Equities	11.2%	23.3%	0.48
Global Equities	2.5%	17.2%	0.14
European Equities	2.1%	20.7%	0.10

This information above is for illustrative purposes only. Past performance is not indicative of future returns. Source: Bloomberg, Schroders, as at 30 September 2011.

Generating absolute returns

When investing in Asian local currency bonds, fund managers can not only benefit from their generous yields (currently averaging around 4% on the Asian index) and price appreciation, there is also the added kicker of currency appreciation. For absolute return managers, this means a wealth of opportunities for currency trades; playing one currency against another and hedging various exposures while having the stability of bond returns underneath.

Looking at the corporate sector, it is also worth remembering that Asia went through its own financial crisis a decade before the West. This has given companies in the region the chance to shore up their balance sheets to levels that would cause envy among many business leaders in Europe. Asian companies tend to not be saddled with too much debt and have decent levels of cash; both of which are factors that make firms there in a strong position to pay bond holders and unlikely to default on their obligations.

Furthermore, while interest rates in the UK and US are expected to remain at record low levels for some time yet, the yields on Asian corporate bonds look enticing. Over the past ten years the average yield of Asian corporate bonds has been 9.5% per annum.

Sources of performance

When investing in absolute returns it is important to understand the ways in which managers look to generate returns (or 'alpha') and protect against performance falls. In the Asian bond sector, the sources of alpha tend to fall into six categories, which managers dynamically allocate their capital to. The main two sources of alpha are allocation to countries and allocation to currencies.

The other, smaller contributors to returns include yield curve positioning (i.e buying bonds with short term or longer term maturities). Security selection is also a contributor – this involves picking only bonds from the best companies which offer the best risk and return. Other sources of returns include sector allocation, and instrument selection, as there are a wide range of investment instruments at an Asian bond managers' disposal; not just corporate and sovereign bonds, but also convertibles, interest rate swaps and various derivatives.

Promising outlook

The current outlook for Asian bonds looks promising. With slower growth ahead and peaking inflation, expectations for interest rate hikes (which would be negative for bonds) in Asia have been reduced, while currencies look undervalued. Furthermore, the recent market turbulence has seen credit markets suffering and has brought about some interesting opportunities as value has emerged in certain areas of the market, such as government-backed investment grade credit and the top rated end of high yield, sub-investment grade debt.

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