M&G Investments

M&G Insights

Why active matters in global fixed income

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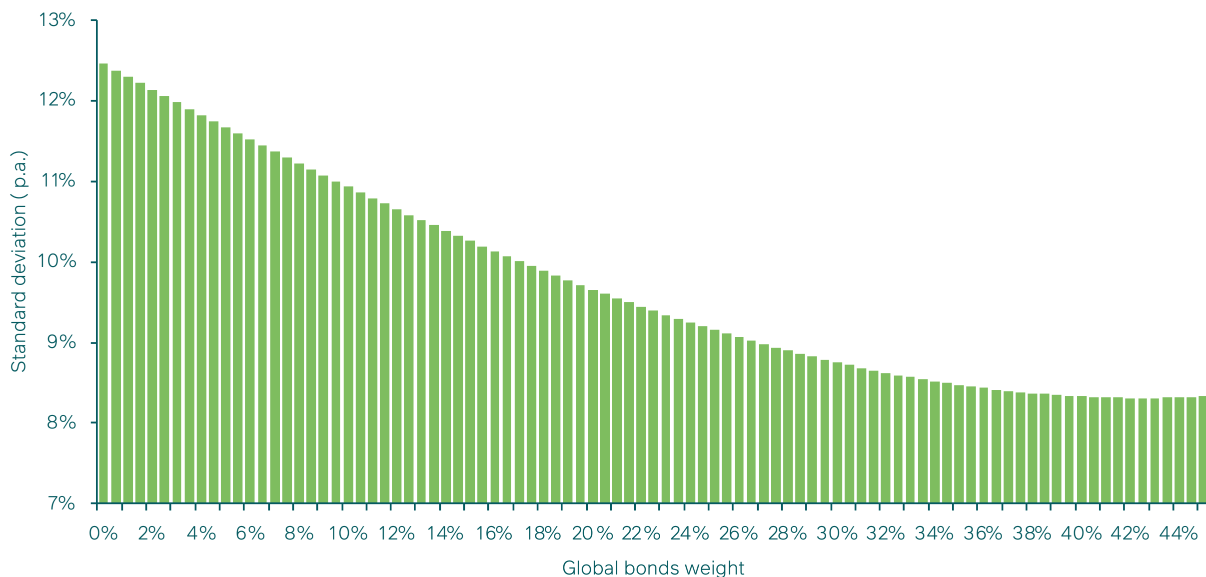
South African investors have necessarily limited their exposure to global fixed-interest bonds over the past several years for two primary reasons: unattractively low yields and the 25% offshore asset restriction for retirement portfolios under Regulation 28. Under the 25% limit, it made sense to allocate the global allowance primarily to global equities and cash, given the upside to potential returns of the former and high risk-reduction and liquidity benefits of the latter. However, the February 2022 increase in the offshore limit to 45% effectively opened up a new world of opportunities to South African investors, and we believe global fixed-interest sovereign bonds, in particular, can offer considerable benefits to a local portfolio generally and currently present an excellent buying opportunity.

Why global fixed income?

South African investors have several good reasons to consider adding global bonds to their portfolios, the most important being their effectiveness in lowering the risk of local balanced portfolios.

Graph 1

Combining a South Africa 60 - 40 portfolio with global bonds



Source: M&G, ICE BofA indices (Ref .ER00, UN00, C0A0). Data as at 30th April 2024

Graph 1 shows how a standard balanced portfolio with 60% SA equity and 40% SA bonds experiences a significant reduction in risk (as measured by its standard deviation) as increasing amounts of global bonds are added: with no global bond exposure, the portfolio's risk is around 12.5% p.a., which falls meaningfully to around 10% once an 18% weighting is reached, for example. This is due to both the diversification of geography, currencies and economies, and the inherent lower volatility of bonds as their weight expands in the total portfolio.

Another key reason to buy global bonds is their currently high yields on an absolute basis compared to history. Today's global bond yields reflect the steep hikes in base lending rates implemented by global central banks between 2021 and mid-2023, and subsequently kept steady. Although yields have fallen from their highs, they are still at attractive levels. For example, the 10-year US Treasury yield has been trading around its 20-year average of 4.5%, after having stayed below this level since 2008. At the same time, expectations are for central banks to keep interest rates higher for longer in the face of persistent (but lower) services inflation in many countries.

In M&G's view, it is not an ideal environment in which to start cutting interest rates, especially given the elevated prices of global risk assets. Not only are stock markets hitting all-time highs, but in the corporate credit market, keen investor demand for both investment-grade and high-yield bonds, driven by higher interest rates, has pushed spreads versus government bonds to unattractively low levels. However, global government bonds, especially those in developed markets, do fulfill many of our investment criteria.

Creating outperformance

It is well-known that it is difficult to achieve market-beating returns from global fixed income assets given the market's huge size and high efficiency. We have built up a global team of nearly 50 credit analysts to cover more issuers and dig deeper to truly understand the companies' strengths and weaknesses and how they impact credit risks. The analysts and portfolio managers can then be prepared for unexpected events that cause pricing anomalies and take advantage of them by already knowing which companies are more at risk, and which are more resilient to that type of event. For example, when Credit Suisse failed in March 2023, the team was ready. Combined with our understanding of regulations and the banking system, M&G was able to value Credit Suisse's various levels of debt in its capital structure, from senior to subordinated (including its AT1 bonds), under different future scenarios of government rescue, buyout and failure, to the benefit of our clients.

Meanwhile, the Credit Suisse collapse triggered indiscriminate selling across most global bank bonds (and all AT1 bonds), creating a significant buying opportunity within a short window of time. Because we knew which banks were the strongest, and risk was lowered by the early European Central Bank and Bank of England statements honouring the rules for investor repayment, we felt comfortable purchasing HSBC AT1 bonds. HSBC had one of the very lowest risks of a deposit run, and we were able to purchase the bonds at a spread 800bps higher than they had offered before the market sell-off.

This is only one example of the numerous ways in which we are adding value to client portfolios, through both avoiding losses and adding above-market returns. South African investors would be wise to consider the inclusion of an actively managed, carefully analysed and diversified mix of global fixed income assets to help improve the performance potential of their local portfolios on both a risk and return basis.

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