

## **Commando rolling with Baa baas, Bardens and Bonds**

By Gareth Abley, Senior Asset Consultant and  
Jave Abley, Barden Consultant

“Baa baa black sheep” or indeed any other type of sheep has yet to really excite my two year old son. Lion’s on the other hand – which he calls “Bardens” for reasons I’ve yet to establish – drive him into a frenzy of excitement.

If equities are the “Bardens” of the investment world, then the ‘sheep’ is without doubt the humble bond. And the more equities deliver 20% p.a. plus returns, the more humble bonds appear.

However, unloved asset classes often provide interesting opportunities, precisely because they are neglected. But if you think hard about the opportunities in this docile asset class, you could add a decent amount of value to your portfolio as a result.

What many don’t realise is that there are actually three distinct ways to add value in bonds:

- a) Setting the right risk level
- b) Investing in the right breed of bond
  - Asset allocation
  - Mandate tailoring
- c) Using good shepherds

### **a) Setting the right risk level**

A key innovation made in 2003 was to tailor the debt strategy within each client diversified option. This recognised that conservative and aggressive investors have very different needs from the debt portion of their respective portfolios.

A conservative investor wants to preserve capital, which suggests investing mainly in short maturity nominal debt; this secures a steady yield and reduces the risk of interest rate rises eating away at the capital value. Longer term investors on the other hand, are more likely to want their debt exposure to give them low risk real returns and inflation protection, which suggests inflation linked and total return strategies and portfolio diversification (for example, through high yield and emerging markets bonds).

### **b) Investing in the right breed of bond**

While sheep are ultimately all sheep, a good sheep farmer needs to know the relative merits of the Barbados Blackbelly breed compared to the Rabo Largo, as well as the the benefits and risks of combining a Pelibuey with a Quanglin Large-Tail; this knowledge allows the farmer to design a portfolio of flocks accordingly.

Good breeding can capture desirable characteristics -- breed out weak traits and introduce a sheep more capable of flourishing in all weathers. Designing a portfolio of bonds is no different. It is the type and mixture of bonds – nominal versus inflation linked, global versus domestic etcetera -- that is the most influential driver of performance. Particularly, if you want a portfolio that is diversified enough to cope with many different economic environments.

The table below showcases two important points. Firstly, the variance in returns over one year illustrates the benefits of diversification. Secondly, it shows how getting in early to inflation-linked

bonds, high yield and emerging market debt can prove to be very beneficial in the environment investors have experienced in recent years:

	1 year	3 year	5 year	Std dev 3yr	Sharpe ratio*
Australian nominal bonds	3.1	5.3	5.5	2.0	2.7
Australian inflation-linked bonds	1.8	7.8	7.4	4.0	1.8
Global investment grade (hedged)	4.4	6.6	7.6	2.5	3.0
Global inflation linked bonds (hedged)	1.9	7.5	9.5	4.2	2.3
US and European high yield	12.0	10.8	12.1	3.7	3.3
Emerging market bonds	11.1	13.5	18.0	7.2	2.5

\* The Sharpe ratio is the 3 year return divided by the standard deviation over 3 years. It measures the total return achieved per unit of risk. The higher the ratio, the better the risk adjusted return.

At a big picture level, you can think of this strategy or benchmark design as the ‘asset allocation’ between bond sectors. It is primarily designed to spread exposure across a wide range of countries, companies and interest rate regimes. But it is also structured to enable access to assets that are driven by factors other than interest rate risk. For example, high yield and emerging markets debt - which are exposed to company, industry and political factors – help to diversify risk at a portfolio level and make it more likely to flourish in different economic conditions.

This leads to the second way in which the benchmark design can add value – what I call ‘mandate tailoring’. This refers to not just giving bond managers the conventional market benchmark – the Lehman Global Aggregate Index or the UBS Composite -- but tailoring mandates to provide exposure to desirable parts of the market (and tempering the parts of the market that are not so desirable). It is then important to give managers the freedom to invest within their area of skill and where the best value lies.

The ‘asset allocation’ and the ‘mandate tailoring’ together define the strategic benchmark, against which you can measure the performance of active managers. It is especially interesting that implemented consultants have found that outperformance often comes despite managers collectively being flat against the high hurdle that is the strategic benchmark over the period. This highlights that it is the design of the strategic benchmark, more than the choice of manager, which is the key driver of performance.

### c) Finding good shepherds

In reality, the choice of asset allocation, mandate and managers are all intrinsically linked. While different shepherds are generally better off with different types of sheep, there are some managers with (arguably) the skill to determine their own asset allocation across a range of global debt assets. They can be tasked with the objective of achieving returns significantly in excess of CPI with bond-lik risk.

In our vie, few managers have the ability to do this, but if the stars align and there is a meeting of minds, skills and objectives, it can be very effective.

### Conclusion

A while ago farmers in England couldn’t work out how sheep in the Yorkshire Dales were going missing. (Bardens couldn’t have been responsible). They were surprised to discover that it was because these sheep had learnt to get over cattle grids by doing ‘commando rolls’ on their back!

This is a good reminder that even the most humble animal or asset class can exceed expectations. It just takes a bit of lateral thinking and imaginative implementation.