A fixed income portfolio or soccer team?

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Soccer can bring a form of togetherness and appreciation of differences. Appreciating the culture, national anthem, the players and most importantly the soccer by other countries. And to win a big match as a player and for your country is the 'thing of dreams'.

Although luck can play its part, a winning team in a match can often be compared to a balanced portfolio. A match winning team needs balance, the optimal balance between defence and offence. Each player has a role to play, working as a team for a common goal. Furthermore, the opposition can never be underestimated, so a well-balanced team needs to be able to adjust to both positive but especially negative surprises and shocks.

Within a balanced portfolio, these concepts firmly apply. A balanced portfolio is designed in a way that every component of that portfolio contributes to an investor's long term goal whilst being complementary – put simply, the sum of the parts should be greater than the parts themselves.

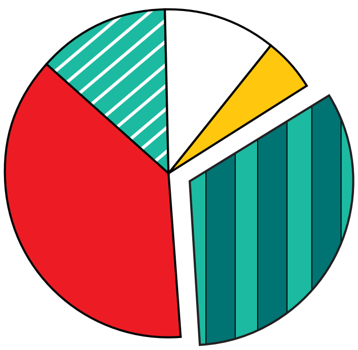
Just like an unexpected opponent, a balanced portfolio should be able to navigate unexpected market shocks.

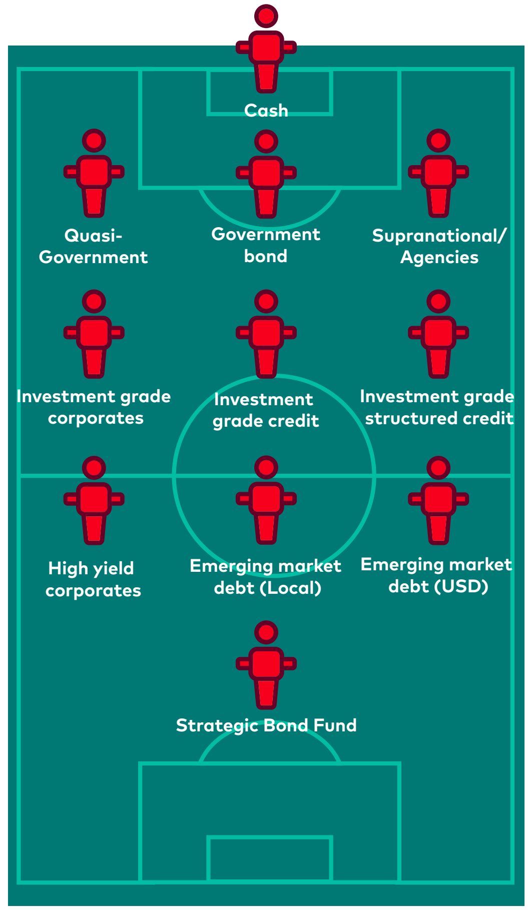
Johan Cruyff famously said: "Playing soccer is very simple, but playing simple soccer is the hardest thing there is". And this is why having a skilled and experienced manager is indispensable for both a winning team and a balanced portfolio to achieve success.

As we consider the component parts of a portfolio, fixed income becomes a key area of focus. Fixed income is often looked at from an asset class level perspective but due to the breadth of different nuances and categories that fixed income has to offer, the importance of how these different types of fixed income are combined in a portfolio cannot be overstated since it can hugely impact how a portfolio behaves, especially alongside equities. As such, the below seeks to explore how each component of 'liquid' fixed income would play a role in a portfolio and what role they would play in the 'soccer team'.

Investors cannot predict the future, but with a balanced portfolio they can prepare for it.

A fixed income portfolio is like a soccer team – it's about balance





Source: Vanguard

Goalkeeper: What is the role of cash in a portfolio?

Goalkeepers ('Goalies') are often one of the most pivotal roles in winning teams. Such is the importance of Goalies that many are Captains of their national teams. As well as being effective communicators, goalies typically act as a point of stability in soccer. Long gone are the days when soccer was punted out to the strikers, more often in the modern game the goalie starts the passing momentum from the back and that momentum is then built on as the ball effectively makes its way up the soccer pitch.

Like a goalie, cash plays that role of stability – it doesn't typically provide much offensive (positive) return but it does provide a basis to build your portfolio from. Notwithstanding, whenever your team is having a collective dreadful performance... the goalkeeper (Cash) can save you from an ever bigger defeat!

Looking at historical cash rates, post the financial crisis and with significant accommodative monetary policy, cash returns have been negligible at best with many countries having negative cash rates. But as **Figure 1** shows, this has begun to change especially since the start of the year. Further, the forward cash rates (expected cash rates 1 year from now) also show that they are likely to increase further.

What does this mean?

Cash is often seen as the minimum return an investor should receive. Cash returns should increase as rates increase, but in recent years cash has not delivered positive real returns (returns after inflation).

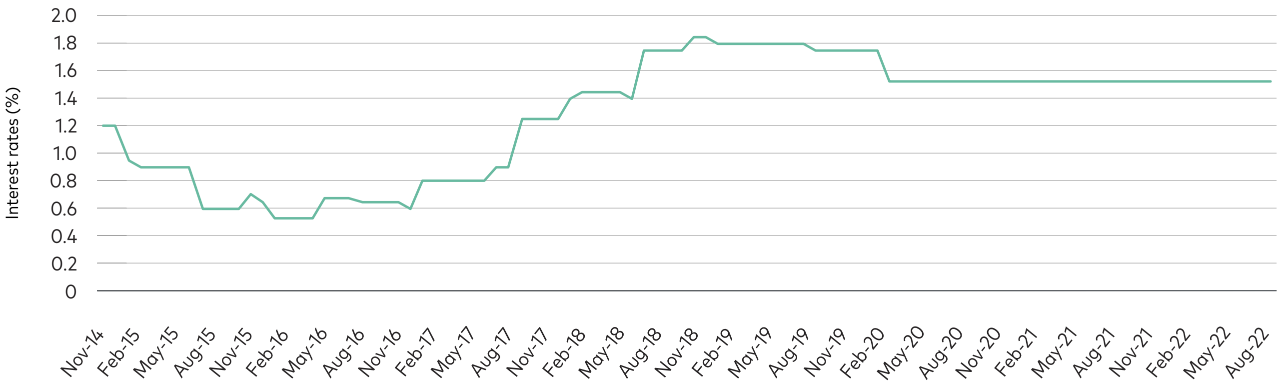
Cash assets still bear risk linked with the depositor institution and should therefore be diversified, especially higher cash levels. Many countries offer compensation schemes for cash held in bank accounts but these are often up to a certain limit and only those authorised and regulated by the Prudential Conduct Authority (PRA) and the Financial Conduct Authority (FCA). In Canada, the

CDIC guarantees up to $100,000 should a bank fail, for example.

Further, unless investors' liabilities are in a different currency, it's often more prudent to keep cash in one's home currency.

There is no optimal level of cash in a portfolio, it is based very much on investor requirements. Cash should be sufficient to meet management fees and very short term liabilities in order to avoid selling down investments and incurring unnecessary transaction costs.

Figure 1: Canadian cash rates



Source: Vanguard

Advisor's Corner

The goal of cash is to meet 3 key objectives:
1) Emergencies,
2) Very Short Term Goals and
3) Income.

As a Planner we would always recommend an amount in cash for emergencies such as unexpected expenditure or loss of job. Typically, this would be between 3-6 months expenditure but very dependent on a circumstances (i.e. if they lost their job how easy would it be to get a replacement).

For short term goals, (1-2 years typically) a higher cash allocation is recommended to remove market volatility. An example being if a client needs a set amount for a house deposit in two years time, taking investment risk opens them up to the possibility of realizing lower than anticipated values on the sale of the investments, so holding cash, potentially in a Guaranteed Investment Certificate (GIC), would be recommended.

Income – If a client is in retirement and was using the pension for income, it may be appropriate to hold an amount in cash for this income to avoid the need to sell investments if markets fell. This could be 12-24 month's worth and would be a discussion with the client on the advantages of having the certainty of cash against the drag that cash holding would then have on returns.

Defence: What is the role of government bonds in a portfolio?

Like goalkeepers, defenders act like a source of stability for a team. Defenders are present to ensure goals are not conceded and to allow midfielders and strikers to move up the pitch to mount an offensive move. Winning defenders can act as points of stability for their teams and often set the tone for rest of the team.

The skills required to be an effective defender can vary depending on the positions they play in, for example central defenders are typically strong and tall. Left and right wing backs are typically strong and fast. But whatever their differences are, the key objective is to protect the team from conceding and losing the game.

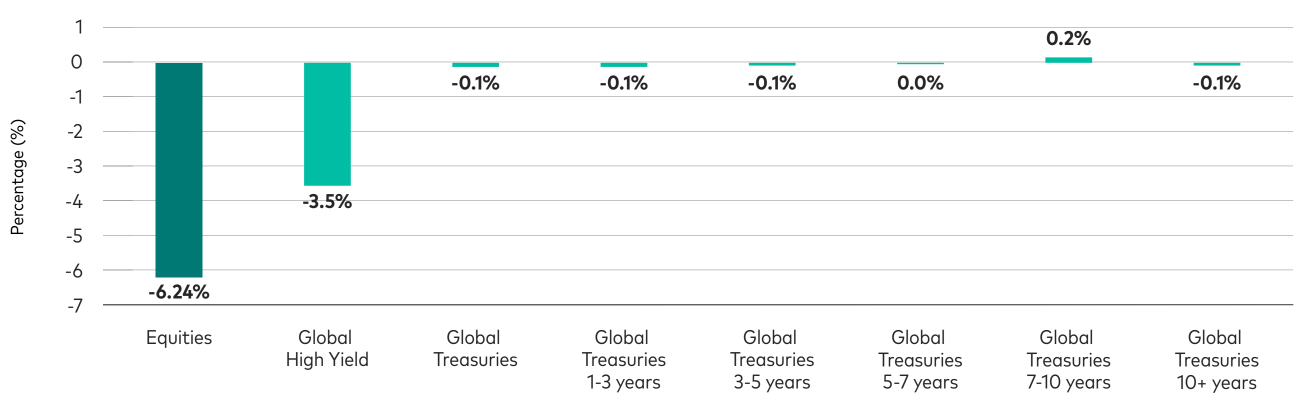
This is precisely the role of government bonds in a portfolio. A key benefit of government bonds is to act as the portfolio's shock absorbers, to be a source of stability, to provide diversification to equities and to bring a risk dampening impact to the portfolio. But, in a similar fashion to wing backs, bonds can also contribute positively to overall portfolio returns – they are a valuable source of income.

The below chart (**Figure 2**) shows how yields have increased year to date - providing higher income - and the next two charts (**Figure 3** and **Figure 4**) illustrates how government bonds can be effective shock-absorbers and diversifiers in portfolios amidst increased market volatility, especially during equity markets' sell-off.

Figure 2: Global Agg yields YTD

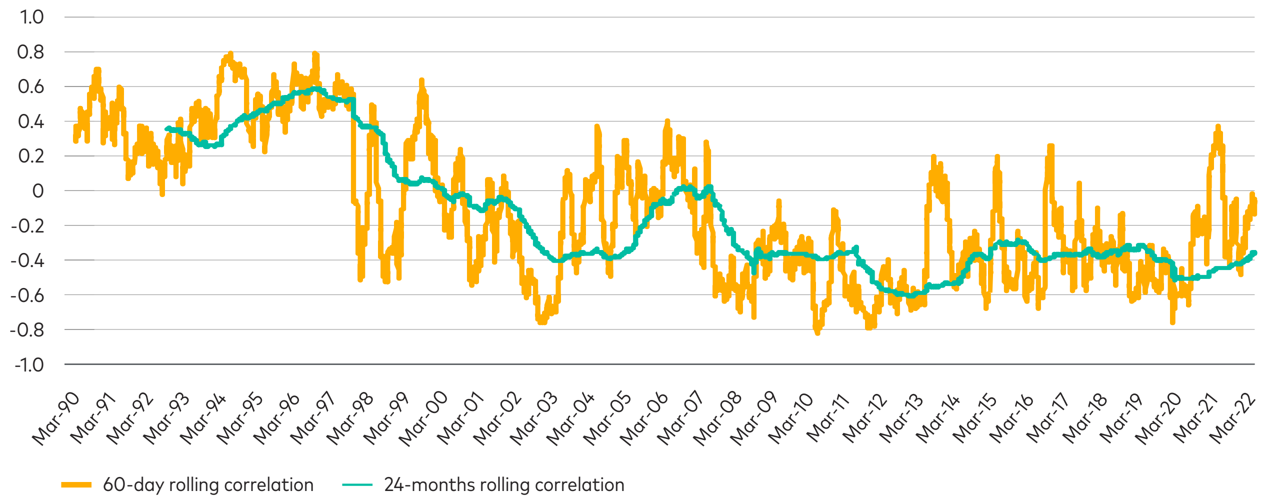
Source: Vanguard

Figure 3: Drawdowns vs equities



Source: Vanguard

Figure 4: Longer-run correlation coefficients between equities and bonds remain negative



Source: Vanguard

Midfield: What is the role of credit bonds in a portfolio?

In most soccer teams, the midfield is the most difficult to get right. The midfield is not typically just about scoring or defending goals, it's about both. It's about having the right balance to ensure you do enough of both attacking and defending to support other areas of the team.

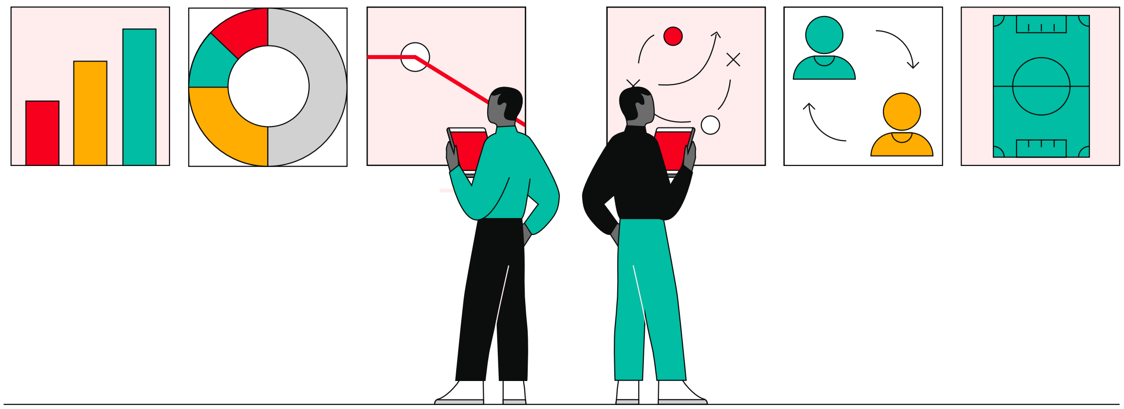
The best midfielders are those that link up well with the rest of the team, acting as its ballast. The composition of a strong midfield can be quite varied, depending on the philosophy of the manager. It is often organised with defensive, central and attacking midfielders. This makes their roles more specific and also illustrates how diversified a midfield can be.

The midfield in a soccer team draws some parallels to the 'credit' market for bonds. Credit bonds are defined as those that have a degree of credit risk

Advisor's Corner

The goal of government bonds in a portfolio is to provide income, diversification and risk absorption over the long term. Over the long term. Returns are lower than equities however with less volatility and help smooth out the long term portfolio risk-adjusted returns, providing an element of diversification. In the long-term, expectations are for bonds to move in the opposite directions to equities and even when they don't quite have that relationship, bonds typically fall less than equities.

Within fixed income, government bonds are seen as the lowest risk and typically have lower yields and income relative to corporate or credit bonds. Since one of the primary goals of investing in government bonds is to reduce portfolio risk , when global ones are bought (those outside your home nation) the currency is typically hedged back to the investors home currency to avoid unnecessary foreign exchange volatility.



i.e. default risk. This is in contrast to 'core' (such as those issued by Germany, UK, the United States and Canada) government bonds which are defined as 'risk free'.

The credit market is made up of corporate bonds (both investment grade and high yield), Emerging market bonds and those defined as structured credit (asset backed securities, commercial mortgage-backed securities and municipal bonds amongst others). Credit bonds make up approximately 50% of the Global Bond market (based on the Bloomberg Multiverse Index as of June 2022).

Within a portfolio, the integration of credit bonds can be the difference between the success and failure of a balanced portfolio. The differing levels of risk, the differing correlations to other assets, and the risk/return differences can be pivotal.

In the parallels to a soccer team, due to the differences in risk, we see corporate investment grade and high quality structured credit as more 'defensive' and corporate high yield and emerging markets as more 'attacking'.

Corporate investment grade and high quality structured bonds typically have lower default rates and lower levels of volatility. Further, correlations to equities tend to be lower and income/yields are lower.

In contrast, emerging markets and high yield corporates have higher yields/income but also have higher volatility levels and default rates.

Similar to soccer, the quality of each individual segment of the bond market should not be looked at in isolation but rather on how it integrates with the rest of the midfield and if it is aligned with the investors end goals.

Advisor's Corner

The goal of credit bonds is to enhance the portfolio yield and diversify unsystematic sources of risk whilst at the same time increasing returns and overall fixed income resiliency. Typically a combination of government and credit bonds offers a diversified mix of fixed income. The weights within credit will partly be down to the investor's risk appetite, ability to take risk, willingness to take risk and time horizon. Other factors like market conditions/ tactical views will also influence the choice of government and credit bonds mix.

Forwards: The role of emerging market and high yield bonds

Forwards are often the most well-known individuals of winning teams, they are often the highest paid and most popular. The role of the striker is to score goals, they go for the win and are so pivotal they are often the difference between winning and losing.

Within a portfolio, like forwards, emerging market and high yield bonds (EM/HY) are there to provide growth and the returns bringing you closer to your end goal. In an ideal world investors would like consistent EM/HY returns but as the below illustrates this is not always the case.

These can be more volatile players, capable of magical moments when inspired but can sometimes be a source of disappointment.

Striking the right balance between both attack and defense is crucial to reach the ultimate goal of winning every fan's dream!

Figure 5: Sector returns heat map

	USD HEDGED					
	GLOBAL AGGREGATE	GLOBAL TREASURY	GLOBAL AGGREGATE - CORPORATES	GLOBAL HIGH YIELD	EM USD AGGREGATE	EM LOCAL CURRENCY GOVERNMENT (UNHEDGED)
Oct YTD	(12.12)	(10.72)	(16.99)	(14.50)	(20.99)	(14.36)
Dec-21	(1.39)	(1.86)	(0.79)	2.53	(1.65)	(1.59)
Dec-20	5.58	5.12	8.26	5.73	6.52	5.34
Dec-19	8.22	7.25	12.51	13.34	13.11	9.47
Dec-18	1.76	2.82	(1.00)	(2.72)	(2.46)	(3.40)
Dec-17	3.04	2.14	5.70	8.42	8.17	14.27
Dec-16	3.95	3.86	6.22	15.60	9.88	5.86
Dec-15	1.02	1.40	(0.24)	(0.69)	1.29	(10.38)
Dec-14	7.59	8.14	7.60	2.58	4.76	(1.91)
Dec-13	(0.14)	0.08	0.07	6.47	(4.12)	(4.32)
Dec-12	5.72	4.49	10.92	19.25	17.95	15.09

Source: Vanguard

Summary

A balanced portfolio should be designed to navigate unexpected market shocks. As such, every component of the portfolio should play its 'role' and be complementary to other parts of the portfolio. This will allow the value of the whole to be greater than the sum of the parts.

This is similar to that of a winning soccer team. The team should be able to navigate any opposition and strike the right balance between defending, attacking and the midfield. The midfield is most relatable to the fixed income market and the balance in a team, like a portfolio, is often critical to long term success.

No one put it better than Sir Alex Ferguson when he said: "There's a lot of satisfaction that comes from knowing you're doing your best, and there's even more that comes when it begins to pay off."

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