



Allianz Strategic Bond Fund: Controlled Risk Taking

Stockholm (HedgeNordic) - Allianz Strategic Bond Fund is a relatively unconstrained global bond fund that aims to beat its benchmark - the Bloomberg Barclays Aggregate Global Total Return- by an average of 2% per year, but has done so by much larger margins: 2.8% in 2018, 5.1% in 2019 and 25.4% in 2020 up to November 17th, net of fees of 0.42%. Manager Mike Riddell (*pictured*), who has run the strategy since June 2016, would appear to be “shooting the lights out” in performance terms, but there are many areas where he is not making wagers either relative to the benchmark, or indeed the peer group (the fund sits in the UK Investment Association’s “Strategic Bond” category, and in Morningstar’s “Flexible Global Bond” category) - and also some areas of the benchmark he is not invested in.

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In terms of credit ratings, the fund’s average of A- is, and always has been, pretty close to the benchmark. Though the fund can allocate up to 50% into high yield debt, this includes “crossover” paper at the higher end of the high yield spectrum or the lower reaches of investment grade, and the benchmark will anchor the

fund to higher quality paper. Therefore, yield has not been a significant driver of returns this year. Investment grade debt yields are, on average, near zero in October 2020, though for this substantially currency hedged strategy, the currency share class is more relevant: “nearly everything we own has a positive yield when hedge back to British Pounds, and a negative yield when hedge back to Swiss Francs”, he says.

Yield Curves and Rates

In any case, Riddell is targeting total return and in the current climate yield curve shape is more important than yield for investment grade. Riddell forms a view on what expectations are priced into curves and how outcomes could differ. For instance, he owns 15-year German Bunds, because the curve is very steep at that point and he expects it to flatten, and also owns some longer dated Norwegian government bonds.

As well as pinpointing his favourite spots on the yield curve for long positions, Riddell can construct yield curve steepeners and flatteners, which are short one part of the curve and long another section. “In 2018-2019, a US steepener and a European flattener were important contributors”, he says.

In 2020 the collapse in interest rates post-Covid means that an aggressive interest rate duration bet would have been the most obvious way to outperform, but the fund is constrained to overall duration of between 0 and 12 years versus the benchmark at just over 7 years.

Countries

But within this framework, Riddell can take long or short duration bets relative to the benchmark in individual countries, of plus or minus 2 years, or up to 3 years if there are hedges elsewhere. For example, Italian sovereign debt was a notable contributor from the third quarter of 2018 to the third quarter of 2019, based on its wider spread and confidence in the politics of Matteo Salvini and the ECB actions. Notably, this was not a broad bet on peripheral Europe as the risk of a replay of the 2011 Eurozone crisis was hedged in two ways. Riddell was short of ten-year Spanish sovereigns, and was also long of tail risk protection through out of the money put options on the Euro versus the Japanese Yen, which tends to rise during phases of risk aversion. In October 2020, he is slightly net short of Eurozone duration, including a short in Italy, and also has shorts in Poland, Czech

Republic in Eastern Europe, as well as a short New Zealand position.

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Riddell is selective over where he wants to take emerging market country risk. “A huge consensus trade this year that we have avoided has been owning Chinese government bonds and hedging the currency risk. This has been a disaster as the Renminbi has done very well but government bond yields have steadily risen as the economy recovered”. In previous years, he has sometimes taken a more sanguine view of Chinese risks: “In late 2018, around 8% of the fund was allocated to Chinese real estate developers, with credit ratings between B and BBB, which were yielding as much as 10% even as house prices were accelerating. This trade was exited by the summer of 2019 as macro stimulus from the Chinese central bank helped to fuel a recovery in the paper”, he recalls. This was USD denominated debt (he can also access local currency paper through Bond Connect).

Contrarian Positioning

Tactical and contrarian positioning have also been important drivers of returns. The fund naturally calculates Value at Risk (VaR) but does not target constant volatility or VaR because Riddell finds this would force him to take too much risk in calm market conditions and might prevent him from taking advantage of market selloffs. In early 2020, Riddell judged that, “markets were complacent with high yield spreads the lowest since 2007 and currency volatility at all-time lows. We accumulated long option positions in both while keeping nearly 100% of the fund in investment grade sovereign debt”. In contrast in early 2019 and in March 2020, he took the view that “risk assets were cheap and bought some single name corporate debt, including long dated investment grade names in the second quarter of 2020. We are more defensive when risk premiums are low and take more risk when most investors panic”.

Off Benchmark Bets

The main areas where Riddell has invested outside the benchmark are currencies

and inflation linked debt, which are part of an overlay strategy. He has in 2020 been long of US and European inflation, and short of UK inflation. The long US inflation position was partly based on US policy changes that allow future inflation to overshoot in compensation for historical undershoots. “This was cheap when we bought it but has richened considerably. The short UK inflation position was based on the UK being a massive outlier pricing inflation well above target that we think is unlikely. The reason is a technical demand/supply imbalance as a consultation about a possible adverse changes to the inflation measure used for UK index linked gilts has led to a dearth of issuance, artificially restricting supply”. Riddell does not expect a 1970s style inflation spike, and points out that Japan’s very aggressive QE programmes have not managed to re-ignite inflation. The inflation views have sometimes been expressed through inflation linked bonds, and sometimes via inflation swaps, which isolate the market implied inflation rate and eliminate the real interest rate risk.

Off Limits Bets

Riddell is cautious on liquidity risk and cognizant of the potential for liquidity mismatch risks in daily dealing vehicles. He has never held more than 5% in single name high yield corporate debt, preferring to use indices for larger exposures. He has also avoided asset backed securities - a significant part of the benchmark - altogether. “ABS was very cheap in the second quarter, but we were concerned about liquidity risk”, he says. He has also never held leveraged loans, which have in 2020 been deemed ineligible for UCITS by the Luxembourg regulator. Riddell is of the opinion that, “some funds would have had difficulty meeting redemptions in March 2020 if central banks had not flooded the markets with liquidity. We could barely sell government bonds let alone investment grade or high yield corporate debt then”. If he wants to express a more risk on view, he is happy to own investment grade corporates or peripheral Eurozone bonds, which have been somewhat correlated with other spread products anyway.

Late 2020 Outlook

Having pivoted to a somewhat more risk on stance in the second quarter of 2020, Riddell is now taking a more circumspect view of risk in general, with the exception of emerging markets. After the US Presidential election, he has taken some profits on credit. “Our general macro outlook is that global economic momentum should start falling. We are particularly worried about Europe, though

there are also growing US lockdowns. However high yield is now tighter than the past 10 years, which is very complacent about recession risk, while government bonds are priced for a great depression. These two markets are pricing in very different outcomes and the truth is probably somewhere in between”.

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“Yet Asia is a bright spot and we have positions in local currency interest rates and currencies, which are also undervalued. Emerging markets have lagged the global reflation trade and though the carry is not so appealing after rate cuts, EM assets are too cheap to ignore. Having been short of EM FX in the second quarter, we have now started rotating into EM assets”. The credit exposure is mainly sovereign though Riddell has identified a quasi-sovereign, stated owned Columbian oil company Ecopetrol, that offers some yield pickup. All of this is within limits however: a maximum 25% net exposure to EM currencies, within the overall currency risk constraint of between 80% and 120% of the benchmark currency exposure.

Team Strategies

Riddell’s team run around EUR 8 billion across four strategies: UK government debt, UK inflation linked debt, the Strategic Bond fund and the Fixed Income Macro fund. The last of these is a pure hedge fund strategy that is not subject to the constraints applying to the Strategic Bond fund. All of the strategies have access to an extensive toolbox of derivatives - including futures, interest rate swaps and swaptions - to express views more precisely both for hedges and alpha positions, though Riddell does not sell volatility nor options. The strategic bond strategy started in June 2016 in a UK OEIC and launched a Luxembourg SICAV in November 2019. Allianz is now opening SEK and NOK currency share classes in response to demand.

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