

THE CASE FOR TOTAL RETURN FIXED INCOME INVESTING

Henderson
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For professional investors only

The case for total return fixed income investing

Hide and seek

There are growing signs that we have passed the peak of monetary policy impact and have seen the low in global bond yields, with the focus turning more towards the reflationary effects of fiscal policy. Divergent economic policies across the globe create different risks. In the US, where the rate cycle is more advanced, protecting against the potential impact of rising rates is paramount. Contrast that with the eurozone, where the European Central Bank (ECB)'s policy of negative interest rates has left an entrenched hunt for yield.

This is a challenging environment, but one in which funds that employ **total return** strategies, focusing on capital growth and income, have scope to both **shelter capital** during stormy conditions in the bond market and use their wide remit to **seek higher return opportunities** outside of traditional sectors.

Ignore the index

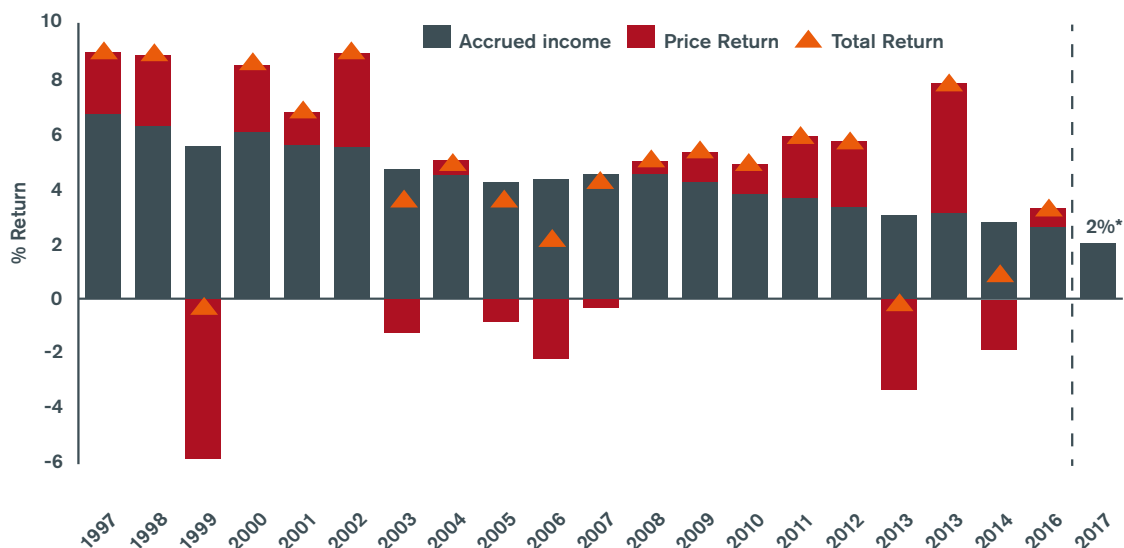
Traditional investment grade funds, tied to a market value weighted bond index have performed well in the past due to falling long-term interest rates, which act to boost the prices of fixed income assets. Standard benchmark indices are now dominated by low yielding (and thus expensive) government or quasi government debt and as a result are highly correlated to the interest rate cycle. For investors in these types of strategies, there is limited value opportunity given the current and foreseeable market conditions. By virtue of market value weighting, these are more heavily skewed to the most indebted issuers and to lower yielding bonds where prices have increased the most. Moreover, they reflect the issuance motives of borrowers seeking to minimise their interest costs — not the objective of bond investors, which is to maximise returns.

In these conditions it is important to assess how the low starting point for yields can undermine the benefits of a bond allocation. This is demonstrated in the chart below, which shows the decline in income available from traditional bonds. Historically, income has provided a buffer against swings in bond prices, helping to provide a more consistent return profile. Broad bond market yields are currently near all time lows, but alongside it, the negative impact on prices from a change in yields (duration) has never been higher. As a result, there is little income buffer to offset even a small rise in underlying rates markets.

Pursuing returns in a low yield world

To counteract these challenging conditions for fixed income investors, we believe risk-adjusted returns can be enhanced by combining multiple sources of return across government, corporate and secured credit markets. Moreover, adopting an index agnostic, multi-sector approach does not necessarily mean taking on more risk.

Hurdle for negative returns has never been lower



Source: BofAML Global Broad Market Bond Index (GBMI), as at 31 December 2016

* Expected income for 2017

Breadth and flexibility

A 'total return' strategy should be able to access the full spectrum of fixed income asset classes, including inflation-linked debt, emerging markets and floating rate secured debt. This offers a higher return potential and a more diversified return profile with less concentrated exposure to a single region or risk factor.

In our view, it should include floating rate assets, such as asset-backed securities, where coupon payments are not fixed but linked to short term cash rates, and inflation-linked government bonds, which give a more attractive alternative to the low rates available on fixed interest government bonds. Moreover, from a security selection perspective, we believe it is important to be able to implement high conviction positions on individual sectors and securities; such as the insurance sector and emerging market corporates in Latin America.

The chart below shows the wide dispersion in returns in fixed income asset classes. A total return strategy, with its actively managed approach and freedom to roam across the full spectrum of asset classes, can make good use of these opportunities.

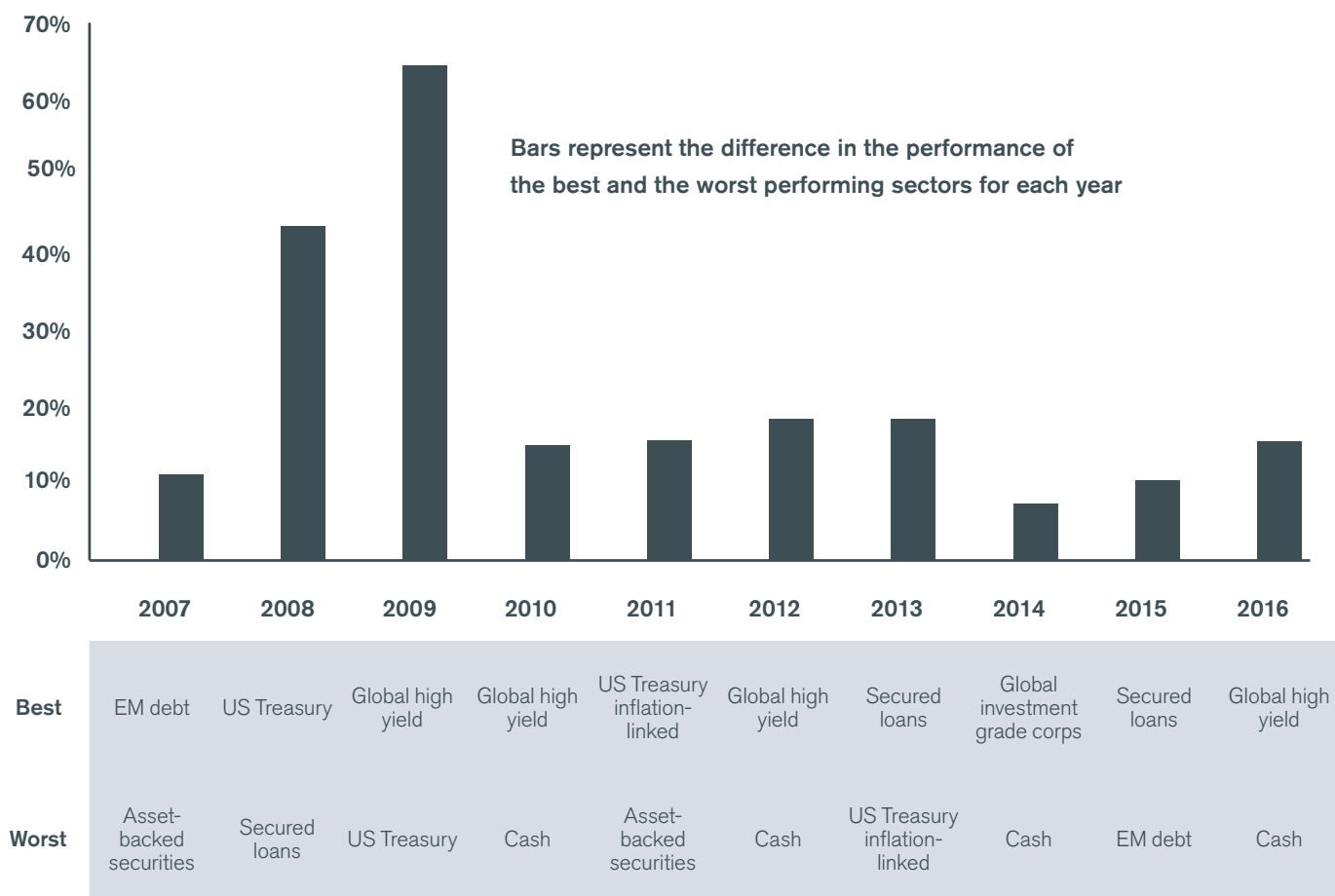
Risk management

At the core of a 'total return' strategy is the ability to move away from an index-relative mindset but it is important to do this while maintaining moderate volatility. In doing so, managers of these types of strategies should have the freedom and flexibility to access a wide range of investments and avoid sectors that do not offer value irrespective of their size or weight in global bond indices. For example, managers should consider investing in more specialist areas of the corporate bond (credit) markets, such as high yield debt.

The breadth of the 'total return' opportunity-set involves taking on more credit risk than many restricted investment grade strategies. However, it is crucial to have experienced teams able to carry out in-depth analysis of which issuers to lend to from a grass roots perspective, in protecting against credit losses over the long term.

This approach, when implemented successfully within a total return strategy, has typically been well-rewarded. For example, this may include going down the credit spectrum and combining high yielding credit with more interest rate sensitive investments such as government bonds, since these asset classes typically have a low (and often negative) correlation.

Significant dispersion of returns within fixed income



Source: Merrill Lynch, Credit Suisse, Barclays, as at 31 December 2016

Note: Merrill Lynch indices: ML US Treasury master (G00Q); ML US Treasuries inflation-linked (G00I); ML Global broad market corporates (G0BC) hedged to USD; ML Global High Yield (HW00) hedged to USD; ML US 3-month constant maturity overnight Libor; Credit Suisse Western European Leveraged Loans Index; Barclays Pan European 50/50 AAA/AA ABS FRN Composite Index (EUR); Emerging market debt is 50/50 blend of JPM GBI EM local currency index in USD and JPM EMBI Global Diversified Index

The case for total return fixed income investing

One stop shop for bond exposure

At Henderson, our 'total return' strategy maintains the majority of its exposure in investment grade and, while it has flexible duration parameters, operates within a band of six to zero years. The aim here is to give significant scope to shelter capital during sell offs in the bond market by reducing interest rate exposure — but not betting against the bond market (going net short). Currency risk is also limited to ensure it does not overwhelm the bond return. Studies show that unhedged currency exposure roughly doubles the volatility of global bonds, with little return benefit. As a result, we view currency risk independently from bond risk, and limit the risk contribution to ensure it does not dominate the return profile.

The result is a strategy that has some correlation to traditional bond markets and similar volatility, but credit and duration exposures that are actively managed so they are not the dominant drivers. The Henderson

'total return' fixed income strategy harnesses the analysis and ideas of the teams we have specialising in credit, secured credit, rates and emerging markets.

We characterise this strategy as a one stop shop for fixed income exposure, and a potential substitute for a broad aggregate mandate, something that may merit particular consideration given the current backdrop for the asset class.

Management strength in depth:

Fixed Income Investment Strategy Group



Phil Apel
Chair of Investment Strategy Group
28 years' investment experience
Joined Henderson 2005



Stephen Thariyan
Global Head of Credit
25 years' investment experience
Joined Henderson 2007



Colin Fleury
Head of Secured Credit
30 years' investment experience
Joined Henderson 2007



Mitul Patel
Head of Interest Rates
12 years' investment experience
Joined Henderson 2005



Steve Drew
Head of Emerging Market Credit
25 years' investment experience
Joined Henderson 2014



Andrew Mulliner
Portfolio manager
10 years' investment experience
Joined Henderson 2007



Kevin Adams
Director of Fixed Income
33 years' investment experience
Joined Henderson 2003



Paul O'Connor
Head of Multi-Asset
21 years' investment experience
Joined Henderson 2013

Source: Henderson Global Investors as at 31 December 2016

Past performance is not a guide to future performance.

The value of an investment and the income from it can fall as well as rise and you may not get back the amount originally invested.

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