

Institutional Demand for Global Bond Funds

Research Findings
Final Report

27 September 2011

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Part 1 Summary

Global bond managers are looking for new risk & return opportunities outside of developed markets; this entails a commensurate decline in the use of established benchmarks

Summary of Findings

- The poll and subsequent interviews established clear trends in demand for absolute return and emerging market bond funds
- The most popular benchmarks were quite evenly split between 5 leading providers with no clear favourites among them
- An overwhelming majority of respondents preferred a medium level of tracking error of between 1 and 4%
- Demand for currency class was restricted to the three main reserve currencies in (EUR, USD & GBP) with over 40% naming EUR as their preferred currency

Implications

- This poll was carried out a time of extreme turbulence in Euro area sovereign fixed income markets. However, in follow up interviews with six of the respondents, the turbulence of August 2011 does not appear to have significantly biased the respondents views.
- In fact, for many it simply underlined the longer term trend for managers to continue diversifying away from established western European and US sovereign debt towards emerging market sovereign and corporate debt. It also helped push active alpha seeking managers to accelerate their search for absolute return when “return **of** capital rather return on capital” was in doubt.
- In terms of product development, this poll, although by no means conclusive, would suggest a new era in fixed income has opened up with many more opportunities for return and alpha seeking investment managers than in the past.
- It is also a more level playing field with room for new entrants and specialised managers offering new asset classes beyond sovereign debt

Part 2 Introduction

Spence Johnson set a brief to conduct research on current trends of Global Fixed Income investment strategy

Research Methodology

- The approach is to carry out a quantitative survey among Western European and UK institutional asset managers as a proxy for demand of institutional investors in Europe
- This was followed up by a small number of telephone interviews with selected respondents

Respondent Universe

- 1,759 members of the Linked in Group European Asset Management Distribution and 600+ professionals from personal networks of the three *Spence Johnson Directors*

Poll results

- 31 completed surveys representing 29 firms from 12 separate locations

Respondent Profile

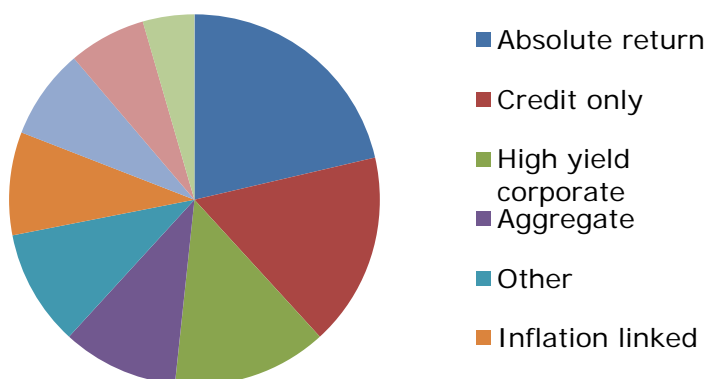
- Individuals in marketing, sales and product development roles in asset management firms in the UK, US and Continental Europe (see appendix for complete listing)

Part 3 Investment Strategies

Question 1

Based on demand you see across all of your institutional clients in Europe, what are the most popular *investment strategies* for global bond funds at present ?

Absolute return	21%
Credit only	17%
High yield corporate	13%
Aggregate	10%
Other	10%
Inflation linked	9%
Government only	8%
Corporate only	7%
High yield government	4%
	100%



Implications

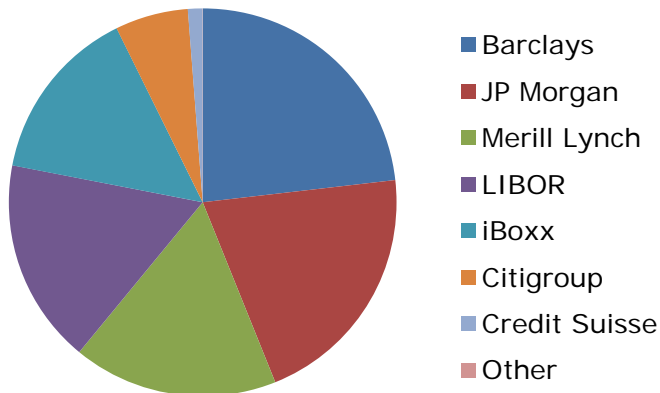
- There were 19 mentions of absolute return strategy out of 89 representing 21% of the total.
- There were no options offered for a geographic or credit rating allocation of assets so we must assume that the verbatim comments in question 5 are directed to one or more of the first five headings.
- In other words, when respondents say Absolute Return, they may not always mean LIBOR + derivative based strategies but could mean Credit only, High yield corporate, Aggregate or Other.
- We also can't say for certain whether the low vote for high yield government is a barometer of low appetite for Southern Euro area sovereign risk or frontier market sovereign risk.
- Given the popularity of TIPS securities in the USA and the extensive monetary action in Europe, the low vote for inflation linked strategies may be indicative of the markets focus on sovereign risk at the moment rather than inflation risk

Part 4 Benchmark Providers

Question 2

Based on demand you see across all of your institutional clients in Europe what are the most popular *benchmark providers* used for global bond funds at present ?

Barclays	23%
JP Morgan	21%
Merrill Lynch	17%
LIBOR	17%
iBoxx	15%
Citigroup	6%
Credit Suisse	1%
Other	0%
	100%



Implications

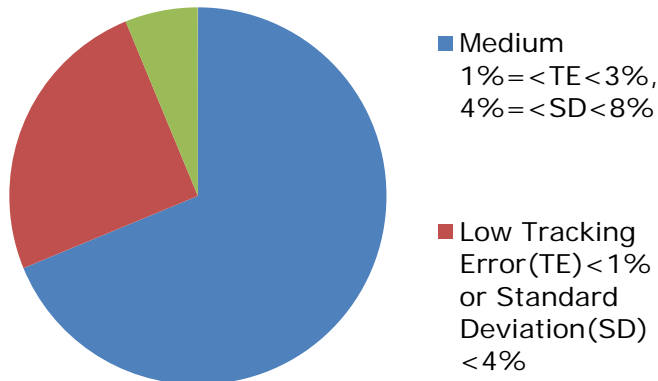
- Lehman Brothers was traditionally the largest fixed income index provider so Barclays acquisition of Lehman may explain the high score they received
- JP Morgan manages the largest number of emerging markets indexes which gives them an important role in the trend towards diversifying risk away from Western government indexes
- LIBOR may be rising in popularity due to it being the base for most absolute return strategies
- It is possible that with the paradigm shift away from established fixed income markets to the newer fixed income markets, some new indexes will emerge as more popular in the future

Part 5 Risk Profiles

Question 3

Based on demand you see across all of your institutional clients in Europe what is the most popular risk profile for global bond funds at present ?

Medium 1%= \leq TE \leq 3%, 4%= \leq SD \leq 8%	69%
Low Tracking Error(TE) \leq 1% or Standard Deviation(SD) \leq 4%	25%
High 3%= \leq TE, 8%= \leq SD	6%
	100%



Implications

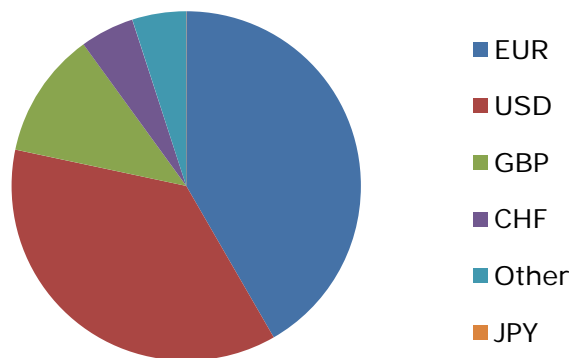
- There appears to be strong consistency of response in demand for a medium level of tracking error between 1 and 4%
- Only 6% of respondents expected clients to ask for strategies with the highest level of risk profile
- This is consistent with the portfolio uses of fixed income as a lower risk asset class that helps to diversify higher risk equities
- What is not clear is how demand for newer absolute return strategies which require more alpha than beta can be managed in a low to medium risk way

Part 6 Currency Class

Question 4

Based on demand you see across all of your institutional clients in Europe what are the most popular currency classes for global bond funds at present ?

EUR	42%
USD	37%
GBP	12%
CHF	5%
Other	5%
JPY	0%
	100%



Implications

- These percentages of currency preferences are consistent with the typical weighting of a European domiciled global fixed income portfolio
- The preference for EUR is to be expected as many of the respondent firms are EURO area based and they would be issuing EUR share classes for their clients
- Some hedging of the local currency or USD back into the currency of home country domicile is a feature of most global fixed income markets
- The strength of the USD preference may be a reflection of both USD Government debt and Corporate credit as well as emerging market hard currency issuers

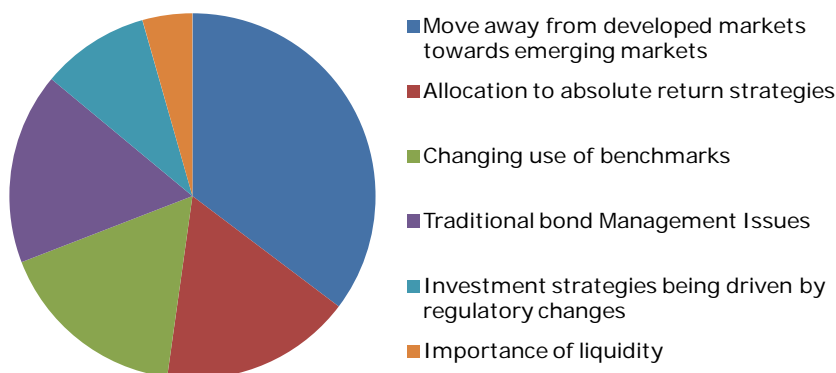
Part 7 Future Demand (1)

Question 5

What overall prediction/comment would you make about likely future demand for Global Bond Funds among your institutional clients in Europe and other regions in the coming year ?

Responses fell into six categories with many responses covering more than one category:

1	Move away from developed markets towards emerging markets	48%
2	Allocation to absolute return strategies	23%
3	Changing use of benchmarks	23%
4	Traditional bond Management Issues	23%
5	Investment strategies being driven by regulatory changes	13%
6	Importance of liquidity	6%



Implications

- Almost half of all respondents made comments about a move away from developed to emerging market strategies. This is confirmation of both a longer term trend and an acceleration of the short term trend seen over the last two months
- The responses made about increased allocation towards absolute return strategies reflects several trends happening at the same time; high yields (low returns) on the most liquid benchmark bonds; the increasing search for new sources of alpha; an increasing search for value in credit risk as against interest rate risk; an increased use of fund liabilities rather than nominal returns as a performance benchmark
- The comments made about the changing use of benchmarks highlights how the established indexes may no longer be useful for measuring performance in some of these new trends
- The comments about regulatory changes reflect the importance of Basle III and Solvency II on demand of medium term securities by banks and insurance companies respectively
- In light of the volatility of Euro Area bond markets in August, it is surprising that liquidity was not a bigger issue

Part 7 Future Demand (2)

Category 1. Move away from developed markets towards emerging markets (15 comments out of 31)

"Movement away from developed to EM"..... "EM bonds will see inflow"

"Global bond managers will need to start looking beyond developed markets to start looking for ways to generate returns"

"Emerging Market bonds, both Government and Corporates seems to gain increased interest"

"I believe EM bonds, particularly corporates will see an increased demand as they are not any more risk in the Solvency II framework than developed market corporates are, by may have higher expected returns"

"Increase in Emerging Market Bonds Local Currencies and increase in Asian Bonds"

"There is only moderate interest in US bond funds as a stand-alone asset class"

"We're seeing lots of interest in Asian Fixed Income and believe this part of the long-term rebalancing from western markets given the relative debt positions of western and Asian economies"

"The shift towards emerging debt will become a growing trend"

"They will look for access to specialist fixed income managers that they cannot find from their aggregate managers"

"Aggregate buying is into EMERGING MARKET DEBT (local currency)."

"Expect more demand for a "safer" sovereign mandate"

"seeking to add value through active allocation across emerging fixed income asset classes"

"We expect demand to remain high for Global Bond Funds investing partly or mainly in emerging market local currencies"

"Demand for Sovereign (esp Euro Sov) low due to concerns of PIIGS defaults and excess demand for AAA"

Part 7 Future Demand (3)

Category 2. Allocation to absolute return strategies (7 comments out of 31)

"Funds that demonstrate an absolute return strategy but with some alpha will be the most successful"

"At some stage, global rates / absolute return will become more important."

"Absolute return and EM bonds will see inflow"

"The value of specialist managers has risen in these very volatile markets"

"Absolute return fixed income for a DB plan as it gets closer to 100% funded"

"As well as the obvious LDI requirements, there are funds who are using absolute return bond funds as a general diversifier across their whole portfolio to reduce volatility. Or they may want to capture some more specialist bond portfolios within their growth or alternative assets."

"Global bond managers will need to add new types of instruments (eg active currency, long/short etc)"

Category 3. Changing use of benchmarks (7 comments out of 31)

"The most important comment we would make is that the choice of benchmark has never been more important and the understanding of the impact of this on the overall risk profile in context of the objective is key"

"Movement away from standard debt scoring to alternative scoring"

"Neutral benchmark bonds (eg G7) have massive wealth destruction risk - as prices get higher so does the potential wealth loss"

"Create an environment for all DB plan where the trustees manage the fund on a liabilities plus basis rather than benchmark plus"

"Clients need Global Bond funds with Aggregate Benchmark and managed with as much as possible with flexible strategies and allocation between Government and Corporates and in terms of Duration risk"

"Less and less benchmark driven"

"Also expect there to be more demand for a "safer" sovereign mandate with some previously included countries being excluded and some with big weights being capped out"

Part 7 Future Demand (4)

Category 4. Traditional bond Management Issues (7 comments out of 31)

"Movement away from governments and into credit"

"People look for spread products and as soon as expected inflation picks up, inflation linked bonds"

"Best credit/yield balance is in investment grade credits where underlying issuer is financially strong"

"Possible increase in Global Convertible Bonds"

"Bond investors will be caught long duration when global rates rise"

"I expect significant interest in credit and high yield"

"Sovereign only and credit to be separate mandates post credit crisis"

Category 5. Investment strategies being driven by regulatory changes (4 comments out of 31)

"The future Solvency II implementation will to a certain degree drive demand, as focus on risk contribution - reward from bonds increases. Here I believe Emerging market bonds, particularly corporates will see an increased demand as they are not any more risk in the Solvency II framework than developed market corporates are, by may have higher expected returns."

"Demand remains high primarily due to regulatory restriction"

"Continued strong demand in light of regulatory drivers"

"Limited demand for global product in fixed income space - still very locally-oriented due to different regulatory regimes"

Category 6. Importance of liquidity (2 comments out of 31)

"Liquidity and transparency are huge influences as well as the domicile of the fund/strategy"

"Diversification and maximizing liquidity are key"

Part 8 Additional Comments (1)

In follow up interviews with 6 respondents, three themes emerged:

Theme 1: Loss of confidence in traditional benchmarks

Comment:

Given the poor track record of established benchmarks in benchmarking performance and tracking risk, it is quite likely that we will see new indexes emerge in the future.

Quotes:

"People are changing their views on what is capital preservation and what is capital at risk; risk-on and risk-off definitions are changing"

"Bond indexes are no longer representative; in the MSCI index, the third highest issuer is Italy and therefore weighting – the traditional benchmarks are aligned to too much risk"

"GDP based benchmarks may rise as issuer weighted benchmarks decline"

Theme 2: Changing perception of credit risk

Comment:

First the financial crisis, and now the Euro area sovereign crisis, have changed investors perspective on credit risk. This recent trend may kick-start a wholesale change in how asset managers assess risk across the entire credit spectrum.

Quotes:

"We are seeing the beginning of a trend towards a new investment market where investors become much more familiar with new issuers and new markets and new currencies – this whole new world is opening up"

"The quality of risk and diversification in the EM bond market is key to creating a popular fund"

"In terms of high yield, there is a new understanding of what constitutes risk in a corporate – just look at Soc Gen which used to be a highly rated issuer and is now high yield"

"In terms of emerging markets, it is obvious to investors that Asian rim countries are not going to get downgraded in the near future whereas some western European countries are being downgraded"

"Investors are increasingly Looking at corporates on their own merits rather than by their geographic location"

"EM sovereigns have improved their fiscal and monetary positions. – they have the ability in local currency debt on these improved ratings. But hard currency is usually the first step and then local currency for EM issues"

Part 8 Additional Comments (2)

Theme 3: Adoption of active management strategies in fixed income portfolios

Comment

The rise of both passive management and hedge fund management in the equity space is spilling over into fixed income. But threats to established 'risk-free' benchmarks is adding a new momentum to active management in global fixed income with a commensurate focus on generating alpha rather than simply tracking indexes.

Quotes

"The level of participants is much more sophisticated now; in the past it was simply buy 2 year gilts and hold until maturity"

"The use of absolute return is being driven more by the equity market than the bond market; there is very little alpha available in fixed income and it takes a very good manager to generate alpha"

"Absolute return means taking more credit risk rather than simply playing the yield curve; more alpha and less beta, but this is a much harder strategy to implement"

Part 9 Appendices

Institutional Investors' demand for fixed income funds: a short poll

Please fill in this form on your screen by typing in the boxes below. When finished, please click on the red button, follow the brief instructions and your answers will be emailed to Spence Johnson.

The form cannot be saved, so please send the answers before closing the file.

Your responses will be treated in strict confidence and will not be shared with anyone else.

Your name

Your firm

- 1** Based on demand you see across all of your institutional clients in Europe what are the most popular investment strategies for global bond funds at present?

Please select the most popular **three** in your opinion

Absolute return

Aggregate

Government only

Credit only

Corporate only

High yield government

High yield corporate

Inflation linked

Other

- 2** Based on demand you see across all of your institutional clients in Europe what are the most popular benchmark providers used for global bond funds at present?

Please select the most popular **three** in your opinion

Barclays

Citigroup

Credit Suisse

JP Morgan

Meril Lynch

iBoxx

LIBOR

Other

- 3** Based on demand you see across all of your institutional clients in Europe what are the most popular risk profile for global bond funds at present?

Please select the most popular **one** in your opinion

Low

Tracking Error(TE) < 1%
or Standard Deviation(SD) < 4%

Medium

1% = <TE < 3%, 4% = <SD < 8%

High

3% = <TE, 8% = <SD

- 4** Based on demand you see across all of your institutional clients in Europe what are the most popular currency classes for global bond funds at present?

Please select the most popular **two** in your opinion

USD

EUR

GBP

JPY

CHF

Other ()

- 5** What overall prediction/comment would you make about likely future demand for Global Bond Funds among your institutional clients in Europe and other regions in the coming year?

Please write as much as you like

Thank you very much. We will acknowledge your response and send you the results in September.

If you have questions please contact me.
Emily Greenwood
emily@spencejohnson.com
01473 722 792

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Part 9 Appendices

Summary of Survey Results

			Percent of mentions
1	Based on demand you see across all of your institutional clients in Europe what are the most popular investment strategies?	Absolute return	21%
		Credit only	17%
		High yield corporate	13%
		Aggregate	10%
		Other	10%
		Inflation linked	9%
		Government only	8%
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		LIBOR	17%
		iBoxx	15%
		Citigroup	6%
		Credit Suisse	1%
		Other	0%
		100%	
3	Based on demand you see across all of your institutional clients in Europe what are the most popular risk profile for global bond funds at present?	Medium 1%=<TE<3%, 4%=<SD<8%	69%
		Low Tracking Error(TE)<1% or Standard Deviation(SD)<4%	25%
		High 3%=<TE, 8%=<SD	6%
		100%	
4	Based on demand you see across all of your institutional clients in Europe what are the most popular currency classes for global bond funds at present?	EUR	42%
		USD	37%
		GBP	12%
		CHF	5%
		Other	5%
		JPY	0%
		100%	
5	What overall prediction/comment would you make about likely future demand for Global Bond Funds among your institutional clients in Europe and other regions in the coming year ?	Move away from developed markets towards emerging markets	48%
		Allocation to absolute return strategies	23%
		Changing use of benchmarks	23%
		Traditional bond Management Issues	23%
		Investment strategies being driven by regulatory changes	13%
		Importance of liquidity	6%

Part 9 Appendices

31 Respondents, 29 firms, 12 locations

Respondent Firms *

Aberdeen Asset Management
ABN Amro
Allianz Global Investors
Allianz Global Investors
Baring Asset Management
BlackRock Investment Management
BNP Paribas Asset Management
Cardano
DWS Investments
Emirates NBD
Gemini Investment Management
HBOS Pension Scheme
JP Morgan Chase
Legal & General Investment Management
Linde Group
LV=Asset Management
March Gestion
Nomura Asset Management
Pioneer Investments
Principal Global Investors
Rogge Global Partners
Royal Liver Assurance
Russel Investments
SEI
Spar Invest
Standard Life Investments
Standard Life Investments
State Street Global Advisors
T. Rowe Price
TCI GmbH
Vanguard

Respondent Locations

Amsterdam, Dubai, Dublin, Edinburgh, Frankfurt, Liverpool, London, Luxembourg, Madrid
Milano, New York, Philadelphia

Nils Johnson

Director

nils@spencejohnson.com

07766 916120

SPENCE
JOHNSON

15 Abchurch Lane London EC4N 7BW UK

Telephone +44 (0) 20 7112 2131

www.spencejohnson.com

xxx@spencejohnson.com