The EFG Asset Management 'Wealthy Nations' Approach to Fixed Income

Bonny Tse, Director of Sales & Distribution for Asia at EFG Asset Management, took the floor for a fascinating presentation at the Independent Wealth Management Forum to give her insights into anomalies smart investors can exploit by being benchmark agnostic and buying into the fixed income only of the countries around the globe with the strongest balance sheets. Yield is only one part of lending, so offering credit to a net lender for a slightly lower than benchmark yield, she argued, is far better than obtaining a marginally higher yield and then worrying if a net borrower can repay.

TSE BEGAN BY REMARKING HOW BENCHMARKS, REGULATIONS AND RESTRICTIONS CAN DRIVE INEFFICIENT BEHAVIOUR IN FIXED INCOME MARKETS, creating opportunities that can be exploited by smart, flexible investors. An efficient portfolio, she reported, should be focused on the key drivers and degree of risk rather than replicating a benchmark, line by line. The EFG Asset Management (EFGAM) 'Wealthy Nations' approach to fixed income, she told delegates, reflects active selection and high conviction ideas, with a focus on valuation and fundamental credit quality.

Why follow benchmarks and lend to the heavily indebted?

"With yields so low, and spreads so tight," she noted, "we are all looking to generate incremental returns from fixed income.

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We have found a way to generate that extra return by exploiting inefficiencies in the fixed income market, with one such inefficiency being benchmark investing, as global bond indices are skewed to the most indebted countries, so remembering that yield is one factor, we must also remember that we need to be paid back, so why lend to the most indebted?"

The EFGAM solution is to calculate the net foreign assets to evaluate the wealth of a country, or economy. "We look at both the assets as well as the liabilities of the economy, then calculate the net foreign assets of each sector of that economy, and we include the government, corporate, banking and household level. The final figure we divide by the country's GDP and thereby achieve a ranking."

Net lenders are the best risks

She pointed to slides to illustrate which countries are net lenders and which net borrowers. "The latter category," Tse reported, "are reliant on foreigners to lend them money when they encounter a financial crisis, economic downturn, in the face of political risks, external and even domestic factors that impact their financing."

But countries with the excess savings have much more financial flexibility because, in the event of problems, they will be able to either sell their assets or repay their debt or leverage on their assets.

"With fixed income," she remarked, "the return profile is asymmetrical, unlike equity where the upside can be unlimited. For fixed income, the upside is limited even if all goes well, but the downside can be huge, so avoiding debtors could be one of the ways to at least protect your return."

Turkey: a case in point

Tse then looked in detail at Turkey, which when all was going so well attracted floods of money to its debt. "But if you look at the balance sheet strength of Turkey, you see that since 2016 it has been deteriorating, and it was not that great to start with. Then when the growth that investors were expecting did not materialise plus the political spat she had with the US, credit spreads as a result widened out substantially last year."

The conclusion, Tse explained, is that investors have neglected the balance sheet strength of an economy of the debt issuer,

focusing too much on the positives that appear in the shorter-term. "Hence what we call our 'wealthy nations' approach," she stated.

She then pointed to the yield of the collective emerging markets, noting that stripping out high-risk countries such as Argentina and Venezuela as well as the poor liquidity markets such as Africa, the yield of the JPMorgan emerging market bond index drops from 5.24% to 3.71%. While at the same time, EFGAM's 'wealthy nations' bond strategy has an average credit profile of A3 and a yield of 3.44%.

What this means, Tse observed, is that if investors look at a portfolio of high yield credit quality offering 3.71% versus a far better-quality portfolio offering 3.44% yield, then the decision should be clear.

Value on top of worth

The next step for EFGAM after identifying the strong balance sheet countries is to then look for value, and here, for example, Qatar stands out with its AA-rating, but a yield in line with Kazakstan, a BBB-rated country. And compared to a similarly rated, high-quality emerging market like Malaysia, Qatar is trading at a significant discount.

"Qatar," Tse reported, "is one of the wealthiest countries by the measure of net foreign assets, it has a lot of excess savings, it is a net creditor to the rest of the world. But we also like Qatar for other structural catalysts on the horizon, so it is an LNG producer, not an oil producer, therefore not in OPEC, and therefore fully able to control its production volume, which it plans to, by 42% and by 2024. The fiscal budget will improve in the next several years, the 2022 World Cup spending is already done, and then Qatari foreign bonds have been included in the JPMorgan Emerging Market Bond Index from this year. In short, if Qatar were to trade back in line with its AA and single-A peers, it would make a capital return of 11%."

Contrarian allocation

Tse then highlighted asset allocation for the 'wealthy nations' bond strategy. "What we see is very different to the emerging markets benchmark allocations, or investment-grade indices, and while we are benchmark agnostic, we are quality and value-driven, so we are not being different at the expense of credit."

She then turned to performance, stating that looking back in time the strategy has proven to work in the long run, as well as in the short run. "For the past decade during which we have been running such a fund, performance is actually in line with emerging markets but with less volatility," she reported. "And if you look at the more recent 18 months performance, we performed more in line with investment grade. In short, we believe that this is a very effective long-run strategy, but it can also outperform in a weak market."

Tse concluded her talk by reiterating her thesis that strategic exposure to countries with strong balance sheets and excess savings can provide stability, help avoid the downside risks and identify the winners in fixed income. "This alternative approach can offer you diversification and alternative sources of return in fixed income, which is ideal in this low yield environment," she said, on closing the presentation. ■

EFGAM’s New Capital Wealthy Nations Bond Strategy

EFG Asset Management (EFGAM) is part of EFG International and is a specialist asset management firm with a range of rather unique strategies. Its clients include financial intermediaries and institutional investors all over the world that are attracted to its active and very often innovative investment strategies.

The firm’s differentiated New Capital Wealthy Nations Bond strategy, devised in-house by EFGAM, invests into investment-grade bonds only, and only of the "wealthy" nations.

The idea is from a fixed income investment standpoint, EFGAM does not invest according to the benchmark. Most traditional fund managers have the majority of their bond allocation to the most indebted countries, but EFGAM uses data and analysis to sift out the weaker countries and then to buy only into those nations that have the best capability to pay back the money.

The New Capital Wealthy Nations Bond strategy has a stated objective of seeking long term appreciation, through a combination of capital growth and income, through investments in a broadly diversified range of debt securities issued by governments, institutions and corporations in both developed and developing markets.

The strategy is actively managed, holds debt securities with investment-grade ratings and has no maturity limitations.

EFGAM is part of Swiss private bank EFG, which began life in 1995 in Zurich and ten years later listed on the SIX Swiss Exchange. In 2016 the bank took another leap forward by combining forces with one of the oldest private banks in Switzerland, BSI, in a nearly CHF1 billion deal.

Today, the combined entity has a growing global footprint with 40 locations worldwide, and through offices in Hong Kong and Singapore is on an ambitious expansion trail in Asia. EFGAM currently has a team in Hong Kong, as well as in Singapore.

EFGAM is well-differentiated in what is, of course, a competitive space, aiming always to avoid launching what might be termed a "me-too" product and instead of offering innovative products that are uniquely positioned in the market. ■