The Quest for Safe and Reliable Income in Today's Uncertain World

On March 2 in Dubai, Hubbis held its first live event since the pandemic struck in early 2020. It was also the first live manager meeting for our exclusive partner for the event, GAM Investments. The objective was to learn from key individuals in the Middle East wealth management community about their needs and the expectations of their increasingly sophisticated HNW and UHNW clients. In particular, the discussion centred on the need and quest for income in an increasingly uncertain world, scanning the world of public equity and fixed income markets, and also of private and alternative assets. Offering his particular perspective to the assembled guests, Gregoire Mivelaz, Fund Manager and member of Atlanticomnium's Management Committee at GAM Investments, gave a fascinating insight into the logic of buying into subordinated debt issued by highly rated European banks, a strategy that he reported had produced stable and high returns with minimal risk for many years. Also present as hosts for the discussion were Jill Barber, Global Head of Institutional Solutions, GAM Investments, and Philip Rosenberg, Managing Director and Head of Distribution - Middle East, GAM Investments.

GET IN TOUCH

View Philip Rosenberg's LinkedIn Profile

View Jill Barber's LinkedIn Profile

Find out more about GAM investments

Exclusive Partner

INTRODUCTORY WORDS FROM PHILIP ROSENBERG

"Greetings, and thanks to all for coming today in person. I have been with GAM Investments for more than 11 years, responsible for our clients in the Middle East. We manage some USD100 billion worldwide, mostly for investors in Europe, the Middle East, and Asia. But we also have clients further afield, including the USA and Latin America.

At GAM, we believe in being independent, being creative, to come up with ways to truly enhance and personalize the investment experiences for clients. And we do so within a very robust operational and risk management model driven by bottom-up analysis and curation.

We are historically famous for our multi-asset business, but that is only a part of what we do. Our key focus is long-only growth equities and fixed income, as well as liquid alternatives, and in that regard, we have Gregoire Mivelaz with us today. Gregoire will offer his views on fixed income, especially subordinated debt issued by European banks. And knowing him, he will paint a very interesting picture and offer us some great ideas.

We also have Jill Barber with us today. Jill is the global head of institutional solutions at GAM. She came to GAM about 18 months ago following an impressive asset management career.

We take an institutional approach with private wealth relationships such as the private banks and independent wealth management firms gathered here today.

Today is GAM's first manager roadshow in more than two years. It's great to be here in Dubai, with our friends at Hubbis. Tragically, the backdrop for all of us in this world is not the ongoing pandemic, but the tragic crisis in Ukraine, and I am sure our thoughts and hearts go out to anyone caught up in this terrible war."

SETTING THE SCENE IN THE MIDDLE EAST WEALTH MARKET - INSIGHTS, OBSERVATIONS & COMMENTS FROM THE GUESTS

Private clients in the region increasingly seek tailored, personalised and highly relevant solutions

A wealth management leader in the region opened the discussion by reporting that clients in the region – both locals and wealthy expatriates – seek solutions that are increasingly tailored to their personal objectives. Regarding fixed income, they tend to prefer actively managed mutual funds, as well as ETFs, rather than specific individual bond purchases.

"We work hard to assess the track record of the managers and understand exactly what they and the fund can offer clients," she explained. "The relationships we want to build are where we can help educate and guide clients, so they understand our approach and personalisation, and so they stick with us for many years ahead. Highly relevant solutions are required, as clients are increasingly sophisticated in their expectations nowadays."

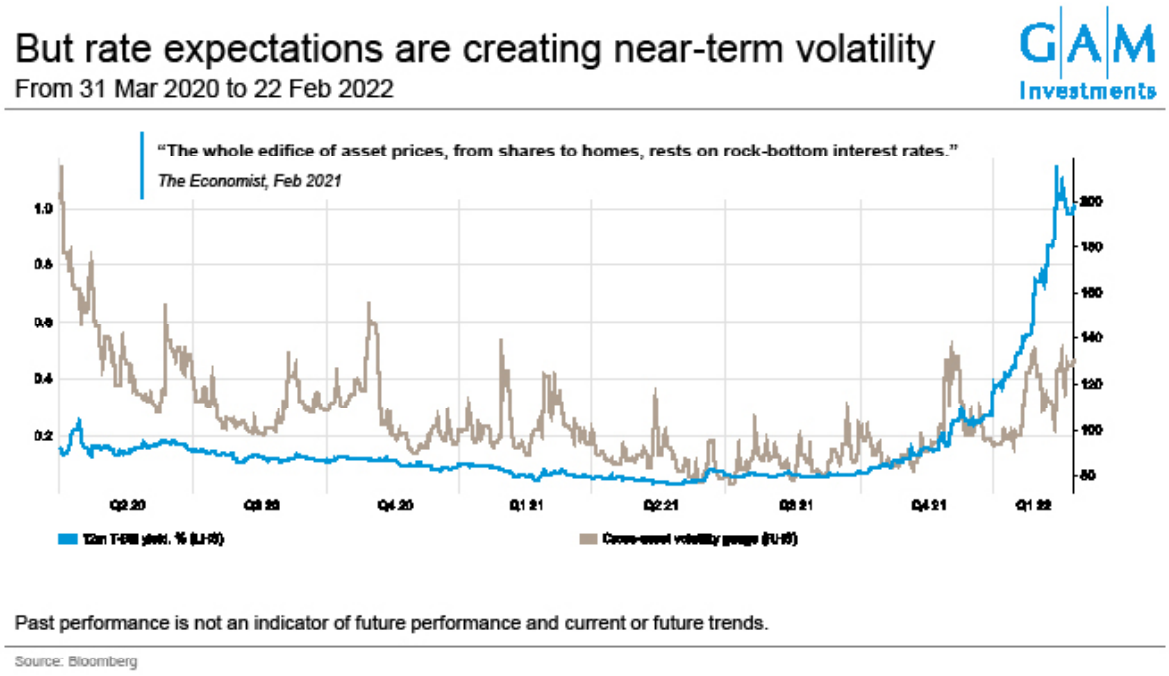
In our view the good old days of balanced portfolios being 60/40 debt and equity are gone; it is clear to us that the clients of today need diversified solutions, and private markets are increasingly popular with wealthy clients

A private banker plying his trade in the region reported that from the perspective of the South Asian and Middle East markets he covers, the typical 'balanced' portfolios that used to be 60/40 in favour of fixed income are now gone in favour of more evolved and diversified allocation across asset classes and across public and private markets.

He noted the difficult 2020 for fixed income and an even more problematic 2021, with the unwelcome arrival of inflation and rising rates, as well as unforeseen events such as the clampdown on some sectors and other surprises in places such as China.

"We were very bullish on the Asian high yield, which has bitten us badly because of China, although there is good value in Asian high yield currently," he commented. "But clients have generally been looking to reallocate some of that fixed income, but not into more equities, instead preferring more alternatives, keeping volatility in private assets, trying to stay more market neutral. We have done especially well through our private markets group, shifting clients' focus to real estate and other investments that generate income that are not necessarily correlated to the capital markets."

He added that for 2020 and 2021 their reviews had shown private markets actually performed much better than the traditional markets. "Yes, fees for us private bankers are higher, but there is more due diligence, more structuring, so that is natural," he said. "Clients need to appreciate that there is lower or little liquidity [in private assets] for



perhaps a holding period of four or five years, or more, but they do get the robust income streams. Clients understand the pluses and minuses, and it has been a very good business for us."

According to the guests, the jury is out on whether this time around represents the onset of rate normalisation or if perhaps inflation and rising interest rates are more of a temporary phenomenon

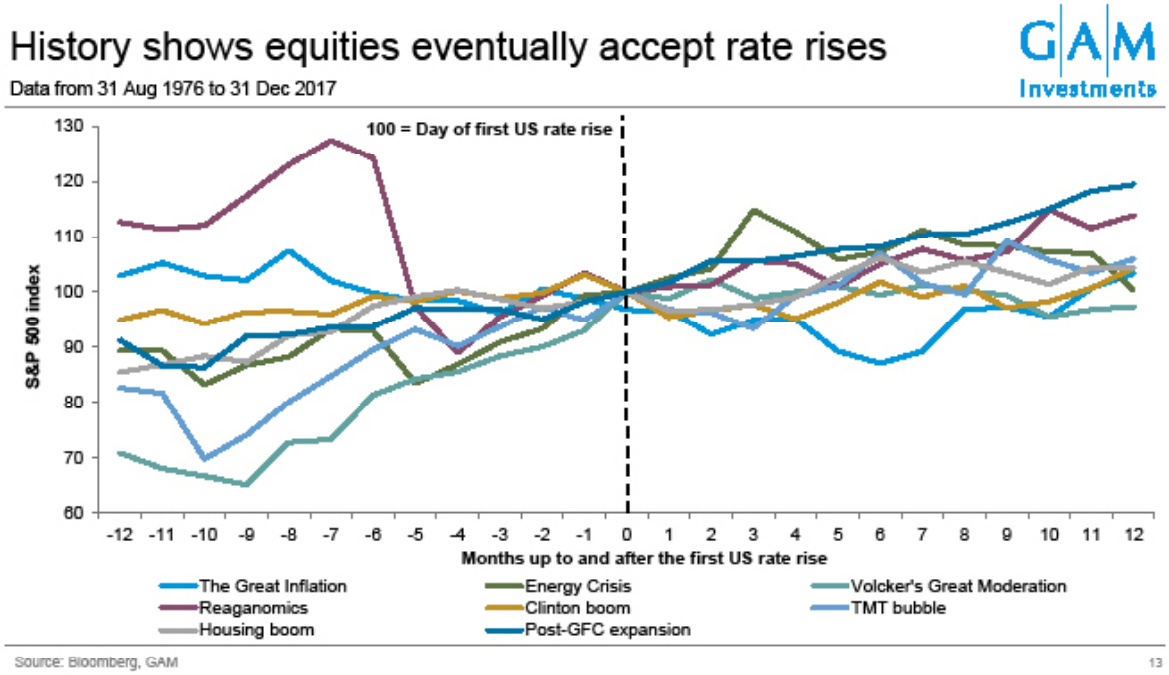
A guest pondered if the world is at a tipping point where you start seeing normalisation of rates. Or if inflation is temporary and rates will not rise significantly or for long. The guests agreed that everyone has different views on this, and the jury remains very much out. Time will tell...

With fixed income prices down, some believe the time is coming to buy back in, but incrementally and cautiously

Another banker commented that yields are actually quite reasonable today on selected fixed-income funds, at 4% to 4.5%, perhaps even 5%, but the problem for clients is the mark to market prices.

"When we do a portfolio review at the end of the day, if I go to the client and say 'you're still making the 4.5% coupon' but if the price is significantly down, the clients really do not like it," he commented. "And the corrections in the fixed income space have been far greater than we have been used to for many years because of the rising interest rate environment that we're emerging into. I myself think the price reactions are somewhat extreme, and I think they will stabilise later on."

He said that where some six months ago, it would have been a bad time to build exposures, right now prices are down, and by the second half



of the year, it might well be a better time to enter, to build exposures back up.

He said although prices therefore look quite good right now, he advised a step-by-step approach or tranche-by-tranche approach. "Bond funds tend to be held for some three to five years," he said. "I would still look to go about it in a tranche-by-tranche basis, so go in but slowly and incrementally."

And he remarked that fixed income funds are generally preferred in the region to single line bond investments. "The kind of clientele in this region are more inclined to go for income through funds, especially these days, so single line bonds definitely constitute a small portion of the money in fixed income, from what I see."

The HNW and UHNW market is evolving in the region, and there is a greater focus on risk management

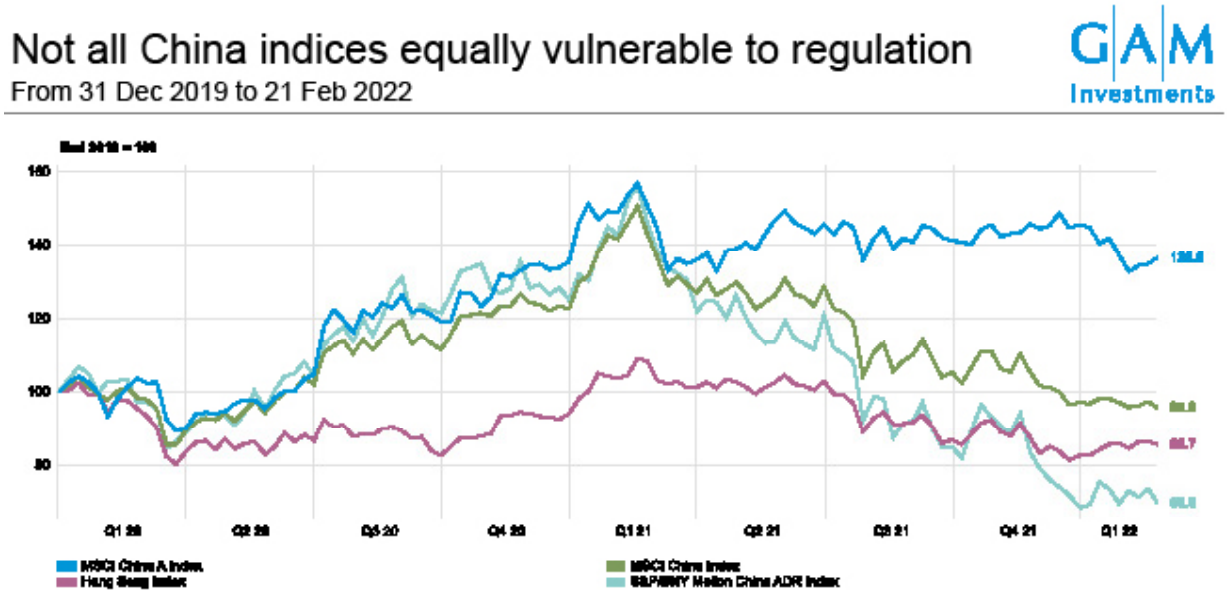
Another guest reported that amongst the larger family office type private clients, they are today less concerned about whether assets are private or public and more interested in the risk management framework.

"There are very concerned about capital preservation first and foremost," he reported. "Capital is the stake, gains or income only incremental, but first they need to see their capital is safe, whatever they invest in. They also like liquidity."

Another guest reported that their wealthier clients were also taking up a blend of debt and equity through structured products.

A leading executive from a major regional Islamic bank reported that they currently boast some 3500 private HNW and UHNW clients and another roughly 40000 mass affluent and priority banking clients. Of all of these, roughly 80% are local clients, and the other 20%are wealthy expats in the region.

"Our clients are largely invested in real estate, either through funds or REITs," he reported. "Equities are very important, mostly centred on this region. Then they have money in Sukuks, because as an Islamic bank, we only handle



Sukuks as opposed to bonds, and the rest is in cash. The wealthier clients tend to like controlling their investments directly, hands-on, while the mass affluent investors tend to need more guidance and more diversification."

He reported that with globally rising rates and easy and cheap money ending, clients are shifting more towards equity.

"They're still sticking to the quality bonds, the big names, mostly regionally, but there is a shift to equity and more diversified funds," he reported. "That will probably continue for a while. The Ukraine crisis has worsened the situation, bringing even more uncertainty. Clients are also bracing themselves for a slowdown, and it looks like the expansionary economies of the world over the past seven to eight years are gone. People must expect much more moderate returns."

He added that they are directing clients towards more balanced real estate holdings, including commercial. "We actually have a very young population here in the Middle East, and as we see from the US, they are often steering away from actually committing to buying an asset, preferring something that is easy to take on and let go of if they have to move. There's a lot more geographical mobility amongst young people now, and they like flexibility."

And he agreed that more investors are looking at private equity, but not single funds, more a group of funds or fund of funds. And he noted that investors in the region still like IPOs, focusing their attention on regional listings, where they understand the markets and economic trends.

Equities, real estate and alternatives also all produce income

Another guest from an independent wealth management firm told delegates how they focus only on equities in Saudi Arabia and take a dividend yield strategy. Mature, safe, defensive stocks there offered yields of 5% to 7% not so long ago, he reported, but the significant rally in the market there had seen those yields drop sharply, with around 2.5% for the overall market, even though some yields of 5% or more are still possible.

He explained they also focus on real estate and other alternatives. "Real estate has been popular for many years and remains a preferred asset class for investors in this region," he said. "Then we see more alternatives such as venture capital debt funds that provide high yields of 10% plus. They come with risks, but selectively some are relatively safe with very good yields."

ETFs make for easy diversification of portfolios

A representative from a robo advisory firm that is now competing in the region highlighted their personalised approach to portfolio curation via ETFs, based on client profiles and expectations. "Based on our findings, we will then construct a portfolio of ETFs diversified across multiple asset classes, for example, equities, fixed income, commodities and also REITs," she

reported. "These are asset diverse and geographically varied, and we offer access at very low entry levels. In doing so, we have built AUM of more than USD500 million since 2019. We're the fastest robo-advisor in the world to reach that certain milestone."

A banker agreed, noting that they like fixed-income ETFs as they are easy to manage and offer low-cost entry.

A banker representing a major Singapore bank in the region also agreed, noting that clients are more cost-conscious today and drawn to ETFs partly because a surprising number of the active equity funds had failed to outperform the indices.

And on the fixed income side, he said they had been offering access to ETFs through their own in-house DPM offering, curating the right ETFs for clients as part of a discretionary mandate, and making sure that the yields and returns deliver for the clients.

He noted that their DPM offering had also skewed more towards equity in the past two years roughly, and also towards more liquid alternatives. A fellow guest concurred, noting the decline of fixed income in portfolios in favour of income generating equities and alternatives.

Closing remarks from Jill Barber

"I am pleased that we have had such an interesting discussion, and hope that you have enjoyed meeting in person. We attach great importance to in-depth and open discussions, thereby achieving a deeper understanding of what you, as actual or potential clients in the region, want and expect from your asset management partner," said Barber.

"We have greatly appreciated hearing your views. I hope you enjoyed Gregoire's insights on the quest for safe and reliable income in today's uncertain world and his interesting perspectives on how to approach the markets." ■

THE VIEW FROM GAM INVESTMENTS: THE COMPELLING CASE FOR THE SUBORDINATED DEBT OF HIGHLY RATED BANKS & FINANCIALS

Armed with slides, Gregoire Mivelaz, Fund Manager and member of Atlanticomnium's Management Committee, GAM Investments, then offered these views, which we have summarised and presented on-the-record here:

Gregoire Mivelaz: "Quite simply, we invest in high-quality bonds because we like the predictability of income. And we like high income. And as we see it, owning bonds is firstly about capital preservation and less so about the search for yield. The central banks have forced investors to search for yield, but central banks are again changing the game right now, so your investors will be asking more about capital preservation and perhaps less about the returns.

High income with minimal risk

We have been in the market for 30 years. All the financial sector companies we own are investment grade, including names such as HSBC, Allianz, AXA, and others. We buy their subordinated paper, which offers high income but remarkably low risk.

We launched the UCITS strategy in 2011, and the combined return per annum since 2007 is about 8% per annum, which derives mainly from income.

Stable returns on the table

Fixed income is all about income and getting your money back, so make the right decisions on credit and risk, and go for the high income, but avoid additional leverage. In short, our nearly four decades of experience shows that subordinated paper can produce stable income from investment-grade companies, and usually with a duration on average of four years or below.
The financial sector is highly regulated. Subordinated debt is a structurally important element of the financial system. When you buy a bond from a major global bank, it is not only their credit metrics that support the decision; the regulatory ecosystem aims to stabilise the system in place.

The banks in Europe have plenty of capital

During the pandemic, it is worth noting that the banks did not need any government or central bank support. They arrived at the pandemic with excess regulatory capital, and actually banking is the most regulated market. Some 15 years ago, according to GAM's opinion, it was all about prop desk and big risks, but now banks are all about compliance and risk management. For bondholders (of bank paper), that's good.

By the way, underlining the stability of the sector, it is important to understand the banks are not actually issuing this paper for funding. It is the regulator who demands they have lower-rated subordinate debt, because if you don't have that layer, you do not have sufficient regulatory capital to carry your risk-weighted assets. That would mean you have to provide more equity, which is, even more expensive.

Tough regulatory demands on the banks

So, for the issuer, there's a real incentive to issue that and pay investors the high price. And for the bondholders, you are taking the default from an investment-grade issuer in a well-rated bank or other institutions, but you get the high income.

We have delivered a compound return per annum of 8% for US dollar paper since 2005. We take 2005 because, since that time, we have had a number of crises, including of course the GFC, the biggest crisis we have experienced, and then the COVID-19 pandemic, the second biggest crisis in terms of price volatility.

Sailing through the pandemic

Look back to the global financial crisis, and you can see there was considerable stress on this paper, but today we are in a different world, and the banks came through the pandemic stress tests easily. I think this is one of the most 'real' and robust of markets today.

If you are looking for attractive yields, for example, if you want to outperform high yield owning a major bank such as HSBC, in my view you won't achieve that by owning senior bank paper. But with sub-debt it is possible.

Too good to be true?

Historically over the past 10 years, we're getting a higher yield than even (European) high yield with less than 10% of the default rate of high yield. That seems almost too good to be true. But it is true. There is real safety with subordinated debt.

To explain further, in the past 20-plus years in the financial sector (of the portfolio), we have had no defaults. Yes, we have seen a few idiosyncratic events, and that is the name of the game. But the beauty of financials and their sub debt is their track record.

Default-free curation

To reiterate, since the GFC, there's been a huge strengthening of the financial sector. The pandemic has been a stress test and the sector came through well. Today, we are getting paid five times more now than in 2007 in terms of spreads on subordinated debt.

So, here we are in a world where everything seems expensive and over-priced, where central banks' flood of liquidity over many years has been driving prices ever higher. Yet we are getting spreads of close to 500 basis points on this paper. Back in 2007, the spreads were less than 100 basis points, in other words, a mere 1% above the risk-free benchmarks.

A deep and diverse market

And the market today is deep, and there is plenty of diversity in the names we can buy. Subordinated paper in Europe is worth about the equivalent of half a trillion dollars, just for the bank sector. Mutual funds are only 10% of that in terms of ownership, so this represents one of the juiciest markets to buy into.

More about Jill Barber:

Jill Barber is Global Head of Institutional Solutions.

Jill has over 25 years experience in investment management and joined GAM Investments in November 2020 from Jupiter Asset Management where she was Global Head of Institutional. Prior to that, Jill held senior distribution roles at Franklin Templeton Investments and Hermes Fund Management. Jill spent more than 10 years at Fidelity International in a range of business development and client relationship management positions. Jill holds a postgraduate diploma in European Management from the Royal Holloway University of London, a BA in French from the University of Kent, the Licence de Lettres Modernes from the University of Grenoble and the Investment Management Certificate (IMC) qualification . She is based in London.

Disclaimer regarding forward-looking statements