Global Dynamic Bond Fund in 2020

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Today, more than ever, fixed income portfolio managers need to demonstrate flexibility in their approaches to both seeking returns and hedging the all-too-apparent risks.

In the 5 years ending 30th June 2020, Nomura's Global Dynamic Bond Fund delivered annualised returns to investors of 6.7%, despite a volatility of just 4.2% p.a. (net of fees, in USD). The low level of volatility is due to consistent use of the Fund's highly flexible remit to mitigate downside risks.

But, if attractive levels of return are to be achieved, risks cannot be fully mitigated and sometimes losses are inevitable.

Markets in March 2020 were so extreme that the Fund experienced its greatest monthly drawdown since inception, dropping -8.3%. Yet two months later, that loss had been entirely erased, with returns positive over all time horizons.

This document describes how that result was achieved – the decisions taken, the mistakes made, the successful strategies. I am biased, but I think it sounds like what you should expect from a truly active, "unconstrained" fixed income manager. Please let me know if you agree.

Summary

- The Fund had a relatively cautious stance going into 2020, but still with some risk positions including exposures to Emerging Markets and subordinated Financials.
- Protection – We responded to the crisis by adding layers of duration and equity put-option based hedging.
- We reduced hedging too early in March to prevent all of the downside.
- In late March, we actively deployed risk capital to Investment Grade markets – and recaptured all of the downside in just 2 months.
- Hedging in late May and early June helped to dampen the impact of the short-term sell-off after the strong bounce-back.
- Expect risky assets to rally further with so much stimulus - But not in a straight line.

The world before Covid-19

Last year, risky assets posted huge positive returns despite no appreciable improvement in the global economy. The US continued to have strained trade relations in particular with China and the EU, and the issue of Brexit still hung over Europe. It is a small wonder as we headed in 2020 that the GDBF team, headed by Richard Hodges, believed that capital markets offered fewer opportunities for sourcing attractive returns. However, the reason for the huge returns in 2019 remained – central banks remained highly accommodative, with no prospect of interest rates rising in major markets. In such an environment, with politicians in the UK, parts of Europe and certainly the US talking of greater fiscal spending, the outlook for risky assets was still benign.

Pockets of value remained in selected Emerging Markets (the Fund held allocations of 6% and 5% respectively in Russian local currency and Egypt hard currency sovereign debt) and subordinated European Financials debt (the Fund had an allocation of 11% to contingent convertible bonds). However, the Fund held far less risk than at the start of 2019, when the turnaround in US monetary policy had not yet been fully anticipated by markets and the opportunities available justified greater portfolio risks. In fact, the Fund held a 25% allocation to short dated US Treasuries – a pool of liquidity that could be tapped into if volatility led to greater return opportunities. Fund duration was just 2 years.

The Virus Arrives

By January 15th, the virus had led to lockdowns in Wuhan and it was clear that the impact on the economy in China would be severe. We also believed that there would be significant implications for global supply chains, so many of which pass through China. For this reason, we took the first action to protect the Fund: duration was raised from 2 to 7 years in a single day. As yield curves collapsed globally in the second half of January and into February, this helped to underpin strongly positive returns in those months.

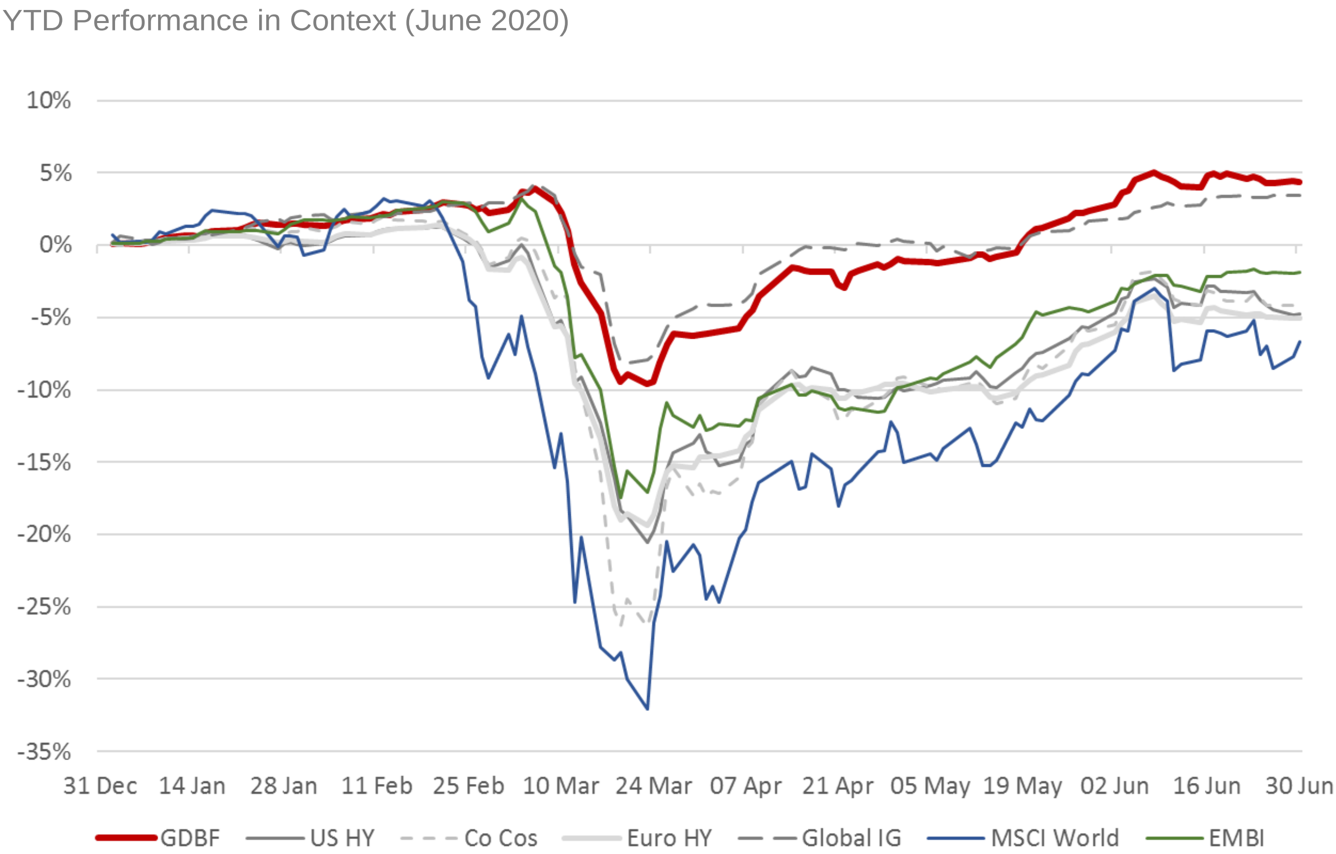
However, in February, much to our disbelief, equity markets were still trading at all-time highs. We could not understand why – surely the market was making an (in our view dangerous) assumption that there would be massive stimulus applied by central banks globally and a V shape recovery in Q2. Again, we acted to protect the Fund, offsetting the credit risks inherent in our positioning with exposure to equity put options.
Put options are the only equity-related securities the Fund can buy (if you exclude convertible bonds). The Team uses these options to hedge the portfolio against broad risk-off moves in markets. The equity indices that underlie the put options are far more sensitive than the credits the Fund holds, so a relatively small allocation to equity puts can achieve a very powerful hedge. By late February, our notional allocation to equities through these puts was reaching minus 15%, and the options were growing increasingly sensitive as they moved further and further into the money. Our physical bonds, particularly the Emerging Markets and contingent convertible allocations were suffering, but the hedges were helping to greatly offset that volatility.

Then, in early March, we reduced the protective power of the hedge in expectation of the ECB joining other major central banks and governments in delivering huge, much-needed stimulus to ease liquidity problems. We were too early. The ECB disappointed, before correcting their mistake some 8 days later. Markets nosedived, and we had insufficient hedging in place to avoid a negative return.

Reducing a hedge to recoup cost and reduce Fund exposure to a sharp reversal of the initial move is very much in keeping with our investment strategy. Although it is difficult to be certain of this, we suspect that in a similar situation again, we would do the same again.

Performance in Context

The chart below shows the performance of the Fund against indices of some of the bond markets in which we can invest, and the S&P500 for context. The index that looks most similar is the Investment Grade index in March, in terms of the scale of the fall, although the recovery of the Fund from the end of March is steeper than that index. The Fund was, on average, at the bottom end of Investment Grade (BBB-rated) throughout the period, so falling in line with broader and higher quality index is evidence of the hedges working to mitigate risk.



Full list of indices used: ICE BAML US High Yield Index, ICE BAML Euro High Yield Index, Bloomberg Barclays Aggregate Corporate USD Hedged Index, ICE BAML Contingent Capital Index, JPMorgan EMBI, MSCI World Index. Compared with return in USD terms of the USD I Share class of GDBF.

Participation in the Recovery

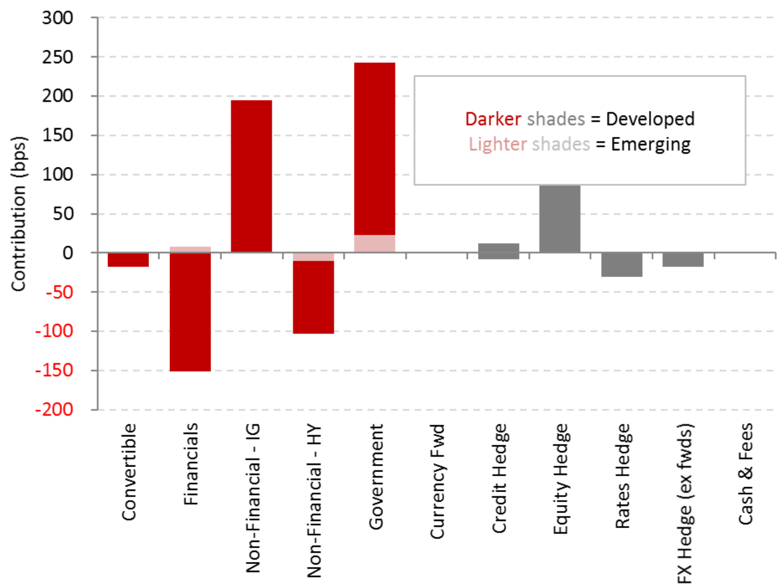
The nadir of markets fell on 23rd March. Two days earlier, the vast majority of the remaining equity put options had expired, leaving the Fund with only very limited hedging. In order to have the confidence to re-enter the market and participate in the expected rally, the Team re-established a modest hedge to protect against further waves of chaos. Their next move was to take the Investment Grade exposure from 2% to 20%. They began on March 21st.

The 10-fold increase in Investment Grade exposure was achieved through buying new debt issuance from a broad range of companies whose primary goal was survival through this challenging period. Why choose investment grade? The Fed and the ECB were most directly acting as a back-stop to markets in these areas, with their asset purchase programs. *Don't fight the Fed.* In addition, companies were offering significant discounts from secondary market prices in order to ensure those new bond issues were successful.

The allocation was far from static. The team repeatedly recycled capital by collecting the new issuance premium, then rotating out of newly acquired holdings to participate in yet more new issuance. It was a time of huge activity on the Team's (virtual) desks.

The new Investment Grade allocation performed strongly. The equity puts dragged, and proved unnecessary. The Fund's EM, High Yield and contingent convertible holdings all rebounded. Nothing had been sold. As liquidity returned to markets, the Fund bounced hard.

Performance Attribution – YTD (May 2020)



Financials allocations present in the portfolio throughout 2020 remain underwater and offer attractive spreads

Emerging market sovereigns initially detracted from performance but have rallied strongly, and US duration exposure through the crisis was positive

Equity puts helped to mitigate volatility in February and March

IG new issuance participation has been strongly positive

Calendar 2020 to end May. Source: UBS Delta, NAM.

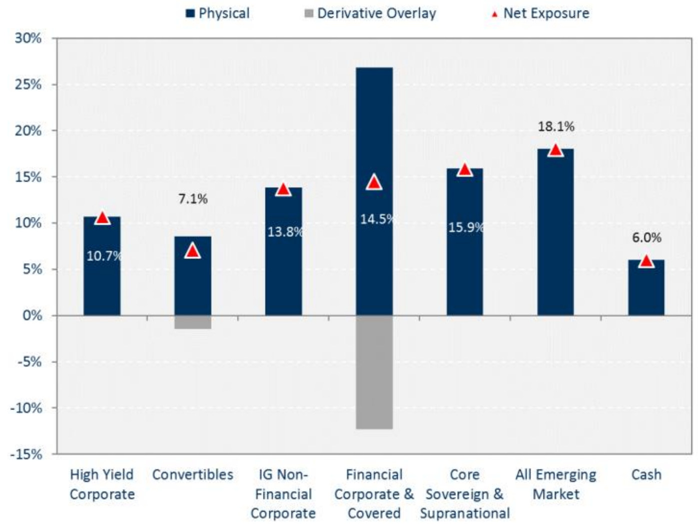
A rally too far?

By the end of May, risky asset markets were fast approaching levels achieved at the beginning of the year, pre-crisis. Our belief that the trajectory would be upward was undiminished, but we felt that the risk-reward dynamic had shifted in the short term, and that the potential for volatility had increased. Not only was there the possibility for a second wave of infection in a number of locations (not least the US, where violent protests were on the streets of many cities) but there were question marks over US/China trade policy, political dithering in Europe over the stimulus packages required and little progress in the Brexit negotiations.

The path to higher asset prices was never likely to be a straight line.

The team took profits on a number of the stronger positions (Investment Grade exposures were reduced by one third, and long-dated Russia was cut). They also added hedging to the portfolio. Primarily in the form of equity put options, the notional exposure to the underlying equity indices amounted to -18% of the Fund at the end of May and the size was increased further in the first week of June. Equity markets did then experience volatility and the puts delivered the protection required, increasing in value even as our physical holdings suffered once more. Following the equity falls, profits were taken on the hedge.

Current Asset Class Allocation (June 2020)



Pre-crisis exposures to EM, HY and Subordinated Financials continue to be held and now offer a substantial return opportunity in the months ahead

IG positioning remains elevated if reduced from the post-Covid peak of 20% – investment grade bonds' newly-acquired attractive spread levels have come under pressure

Equity put option hedging was reduced in June to take profits on the hedge and allow the portfolio to benefit more fully in a resumption of the rally.

Interest rate risk is controlled by interest rate swaps, government bond futures and futures options (notional principal of interest rate derivatives is excluded from the chart)

Source: Nomura Asset Management as at 30/06/2020

The outlook

The massive levels of stimulus we have seen thus far will be maintained and added to. They are fiscal as well as monetary. As a result, we will see money flowing into the real economy rather than simply financial markets, which is what we have seen with quantitative easing. Risky assets will rise as the economy makes its (very slow) recovery. Yield curves will steepen and inflation will appear, but not yet. For now, the disinflationary impacts of the economic downturn and lower oil prices are too strong.

Steeper yield curves will feed bank profitability and incentivise those institutions to lend real money into the economy further aiding the recovery. This too will take time but markets will look through the more temporary aspects of the virus to a time when the economy does start to improve. Additionally, they will be supported in the meantime by the buyer of last resort – the Central Banks – who will focus their gaze on investment grade and government debt purchases, rather than subordinated or high yield debt.

A genuinely strategic bond fund

Attractive, stable returns in a low yield environment	Global government bonds now offer near-zero yields, yet investors need fixed income to diversify their equity exposures and to offer some stability in volatile markets.
A highly flexible and dynamic approach	An active, flexible approach is the only solution to allow clients to participate in those fixed income areas, which still offer attractive total returns, but also to achieve the desired stability of returns.
Navigating Challenges	If you require a fund that navigates nimbly through challenging bond markets adding significant value for clients while avoiding large drawdowns, the Nomura Global Dynamic Bond Fund provides a compelling opportunity.

Performance – June 2020

Returns (%) I USD share class, net of fees in USD	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2020	1.41	0.82	-8.28	5.59	3.35	1.96							4.34
2019	1.58	1.55	1.34	1.28	0.51	3.41	1.41	1.38	0.91	1.04	0.12	1.57	17.30
2018	1.41	-0.55	0.30	0.23	-0.49	-0.42	0.87	-0.05	-0.12	-0.79	-0.36	0.45	0.45
2017	0.43	1.25	0.14	0.79	0.86	0.12	0.82	0.45	0.98	1.21	-0.24	0.19	7.22

I USD share class	Return
1 Year	11.22
3 Years	8.35
5 Years	6.72
Since Inc. 30/01/2015	5.69

Returns (%) I EUR H share class, net of fees in EUR	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2020	1.21	0.68	-8.62	5.43	3.23	1.86							3.23
2019	1.27	1.34	1.07	1.02	0.20	3.16	1.18	1.09	0.69	0.77	-0.04	1.28	13.79
2018	1.19	-0.69	0.02	0.03	-0.79	-0.66	0.66	-0.30	-0.33	-1.06	-0.60	0.13	-2.41
2017	0.20	1.20	-0.06	0.65	0.68	-0.08	0.63	0.26	0.79	1.05	-0.43	-0.10	4.89

I EUR H share class	Return
1 Year	8.45
3 Years	5.43
5 Years	
Since Inc. 05/11/2015	5.13

Source: Morningstar Direct as at 30th June 2020. Data presented for the Nomura Funds Ireland plc Global Dynamic Bond Fund I USD and I EUR H share classes in their respective currencies, net of fees. Performance greater than 1 year is annualized.

Awards and Ratings

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