

MARKETS & INVESTING

Fixed income. Test of time

Rally in Austria's century bond highlights long-term appetite



Pension funds and insurers pursue strategy to match the movement of their liabilities

ROBIN WIGGLESWORTH

Two years ago, Austria issued a rare “century bond” to derision from some market watchers who saw it as the height of folly.

They scoffed that the country was only 62 years old in its present incarnation and the debt was denominated in a currency that has been around for just two decades. Lending €3.5bn for 100 years at a miserly annual coupon payment of 2.1 per cent – barely above the eurozone’s inflation target – seemed an example of the bond market taking leave of its senses.

Instead, it is investors in the century bond who are laughing. The Vienna-backed security is trading at 178 cents on the euro, having hit a high of 210 cents in August. On an annualised basis, this year’s gain would come to 87 per cent – better than any US stock market performance on record. The rise in price has beaten the yield to maturity down to just 0.9 per cent and allowed the country to sell more 100-year debt this summer at an even lower cost.

The extraordinary rally highlights one of the biggest forces that is powering the global bond market – an intense demand for longer maturity debt, especially from pension funds and insurers.

“It’s been fascinating to see how powerfully the long end of the bond market has rallied,” said Gaurav Saroliya, a strategist at Oxford Economics.

Much of the buying has been driven by the dimming economic outlook and

Soaring Austrian century bond shows appeal of duration
Price of Austria’s government bond maturing in 2117



rising expectations of easier monetary policy, which encourage investors to hold safer, highly rated government debt. But some analysts and investors say long-term bonds are being further juiced by demand from pension funds and insurers pursuing a strategy that seeks to match the path of their liabilities.

Historically, pension funds made a rough assumption of the investment gains they needed to meet their obligations, and bought a mix of assets to achieve it. For decades this was tilted towards equities, which should offer higher returns, as well as smaller allocations to fixed income and property. But stocks are prone to big drawdowns that can wreak short-term havoc with a pension plan’s funding status.

Since the mid-2000s, many plans have moved to a strategy that tries to match the movement of their liabilities, which are calculated using the yields on highly rated corporate debt or government paper. These investors – mostly “defined benefit” pension plans that

promise members a certain level of retirement income – have as a result bought more fixed income assets to make their portfolios less risky.

That might make more sense than the previous ad hoc approach, but most of these liability-driven investors have not yet “de-risked” their portfolios with enough long-term debt and other hedges such as inflation swaps, so the collapse in bond yields has caused funding deficits to balloon. This forces such investors to buy even more long-term bonds, pushing yields even lower and compounding the problem.

“It became a perverse feedback loop,” said Mr Saroliya.

As institutional investors have piled into fixed income, they are left open to the greater interest rate risk posed to long-duration bonds. Duration is measured in years and is different – but linked – to a bond’s maturity. Broadly speaking, duration indicates how long it takes for investors to regain their principal through coupon payments. Thus, if two bonds have the same maturity the

The Athena fountain in front of Austria’s parliament – the country is only 62 years old in its present incarnation

one with the higher coupon has the lower duration, as it takes less time for holders to get their money back. When interest rates go up, it makes existing lower coupon, longer term bonds less valuable as investors can shift into freshly issued debt with higher interest payments. When interest rates fall, it makes them more valuable. Higher duration bonds are therefore acutely sensitive to interest rates.

Austria’s century bond has a duration of 55 years, explaining its huge return as yields have sagged, but this is a broad phenomenon. US Treasuries maturing in 10 years or more returned more than 20 per cent over the first eight months of the year, their best performance since at least 1987, according to Paul Hickey of Bespoke Investment Group.

But Rene Martel, head of retirement at Pimco, argued that the impact of liability-driven investors this year is overstated. He said most of them attempt to increase their duration when bonds are selling off and yields are rising – such as in 2016 and parts of 2018 – and therefore act more as a stabilising force on markets. Nonetheless, some investors are fretting about the longer-term implications of pension plans loading up on low or even-negative yielding debt that would get thrashed if interest rates were ever to rise. While this would cause pension fund liabilities to narrow, it could be offset by falls in other assets, according to Lisa Shalett, chief investment officer of Morgan Stanley Wealth Management.

“Their rationale is that the wealth destruction of their assets will match the decline in their liabilities. It’s perverse. It’s really perverse,” she said. “When people start really thinking about it they’ll start realising the risks.”

Equities

US small-caps back on the shopping list as investors go in search of bargains

PETER WELLS — NEW YORK

Bargain hunters have piled back into US small-cap stocks, taking advantage of their cheapest relative valuation to large-cap peers in a decade and a half as concerns about a recession ease.

Investors last week poured \$1.5bn into the biggest exchange traded fund that tracks companies with a smaller market capitalisation, the iShares Russell 2000 ETF, for its largest weekly inflow in almost a year. That followed a \$340m inflow in the final days of August, which put an end to four consecutive weeks of net withdrawals – the longest streak of outflows since early 2018.

The rebound came amid a broader rotation into cheaper equities and away from “defensives” and bond-proxy stocks that built up momentum over a tumultuous summer.

In the past months, nervous investors had dumped riskier assets and sought havens such as US Treasuries.

This pushed yields on the latter to record lows in August and prompted one indicator of an impending recession to flash its strongest signal since the financial crisis as the two-year bond

yield exceeded its 10-year equivalent. The market unease drove the valuation of the Russell 2000 to its lowest relative to large-cap equities since June 2003, according to Jefferies.

The investment bank forecast that small-cap stocks would outperform their larger cousins by 6 percentage points over the next year, following a 14 percentage point underperformance

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during the past 12 months. “They’re down on their butts,” said Steven DeSanctis, equity strategist at Jefferies. “But you get a bit of positive reprieve around growth globally and no recession for the US and [small-caps] are going to do well.”

The trade war has added to volatility over the summer as has confusion over the Federal Reserve’s rates outlook. “We wouldn’t want to be fighting a Fed that is looking to be more accommodative over

Fixed Income

Mexico injects another \$5bn into Pemex on launch of debt swap

JUDE WEBBER — MEXICO CITY
COLBY SMITH — NEW YORK

Mexico has given another \$5bn in aid to state oil company Petróleos Mexicanos as the former monopoly launched a bond swap designed to stave off the risk of a catastrophic debt downgrade.

The cash injection came just days after the leftist nationalist government, which has been cutting government spending to free up cash for Pemex and to fund flagship social programmes, announced 86bn pesos (\$4.4bn) in cash and tax breaks for the company in its 2020 budget.

The bond swap, expected to be in the order of \$15bn, is designed to ease a looming repayment crunch on Pemex’s \$10bn debt with an estimated \$44bn due in the next four years.

The finance ministry, which is grappling with an economy teetering on the brink of recession, said it would fund the additional \$5bn in aid from unspecified “financial assets deposited in the federal Treasury”.

The aid would not impact Mexico’s net debt or public sector borrowing requirements, it added.

President Andrés Manuel López Obrador has ordered the government

‘If you look at the budget, it is making heroic assumptions around the volume of production’

and Pemex – which has been struggling to raise production and relies on state aid – not to raise borrowing.

Pemex said the \$5bn would be used to refinance bonds due from 2020-23 and that proceeds from the new offerings would support the refinancing of short-term debt. Pricing was expected today.

Tim Jagger, head of emerging markets debt at Columbia Threadneedle, said the operation “kicks the can down the road a little more” and could delay a Pemex downgrade by 12-18 months.

Fitch Ratings downgraded Pemex to junk in June. A second downgrade is threatened by the company’s low production and reserves.

Two junk ratings could spark forced selling by institutional investors and hit Mexico’s sovereign rating.

Pemex appointed Citigroup, Goldman Sachs, HSBC, JPMorgan, Bank of America Merrill Lynch, Credit Agricole CIB and Mizuho Securities to run the market operation. Under the deal, Pemex would offer seven-year, 10-year and 30-year paper “to support the refinancing of short-term debt”, Pemex said.

But one investor who asked not to be named said the fact that Pemex was returning to markets after telling investors in the past weeks that they had no plans to do so “raises some yellow flags”.

“The market is going to extract a premium” the investor added. “They’re running out of cash and, if you look at the budget the government released this week, it is making heroic assumptions around the volume of production.”

Asset management

AllianceBernstein sends investment staff to climate school for risk lessons

BILLY NAUMAN — NEW YORK

US fund manager AllianceBernstein is sending its investment staff back to school by developing a training course with New York’s Columbia University on the financial risks of climate change, which the firm’s analysts and portfolio managers will be required to attend.

A pilot group of 35 portfolio managers and analysts at the \$58bn fund attended sessions at Columbia’s Lamont-Doherty Earth Observatory this year to learn how to factor climate risks, such as rising sea levels, wildfires and extreme weather, into their investment decisions.

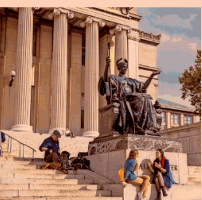
In the coming months, another 75 investment professionals representing all of the firm’s “senior risk takers” across all asset classes, including equities, fixed income, real estate and alternatives, will take part in the training, said Gerry Paul, AllianceBernstein’s chief investment officer for North American value equities.

“We are interested in having everyone understand how they will probably be affected by climate change from a cash flow perspective,” said Mr Paul.

The investment management industry is shifting quickly to take into account the impact of environmental risks on clients’ assets and vice versa.

Four years on from the 2015 Paris agreement on how nations could work together to combat climate change, the number of institutional investors committed to cutting fossil fuel stocks from their portfolios recently passed 1,100.

The education initiative forms part of that larger trend of investment managers adapting to climate risks.



Portfolio managers will be required to attend the course at Columbia

This week, Wellington Management and Calpers, the \$360bn California state employees’ pension fund, said they had been working with the Woods Hole Research Center since 2018 to quantitatively assess climate risks. The three announced a new framework for companies to report their exposure to the physical effects of climate change.

Wellington has found that companies often do not release the information investors would need properly to assess their exposure to different physical climate risks, such as rising sea levels.

The new framework aims to improve how companies relay information on climate risks to investors, as well as adapting to those risks.

The AllianceBernstein programme also looks at “transition” risks – such as how carbon pricing laws might affect a company’s cash flow – and “market” risks, where an asset may need to be repriced because of climate-related factors such as increased exposure to hurricanes or wildfires.

“Our concern is not just that a risk materialises, it’s that a perception of the risk materialises,” said Paul DeNoon, a fixed income fund manager at the firm.