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Paid for your Holiday yet?

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ADVERTISMENT FEATURE

Portugal. Lovely place to go on holiday. Cheap as chips, friendly people and regular flights. From sun, sea and golf on the south coast to spectacular ravines and wildernesses in the north.

If you had bought their bonds last year, you could have paid for that holiday. The graph below shows how Portuguese Government Bond yields have tightened down on to German yields. If you bought them in early 2017, you would have made a 3.5%+ yield, with price appreciation of around 10%.

We did buy them – in April, and we took approximately a 10% position to the country as a whole. Not right at the peak of the yield, but still above 3.5%. The reasons we bought the bonds are not exciting (improving fundamentals, likelihood of ratings upgrades, ECB support backstop) but the returns we were able to deliver to investors were – the Nomura Global Dynamic Bond Fund ("the Fund") returned 5.95% in GBP terms net of all fees in 2017, with a volatility of 1.81%.

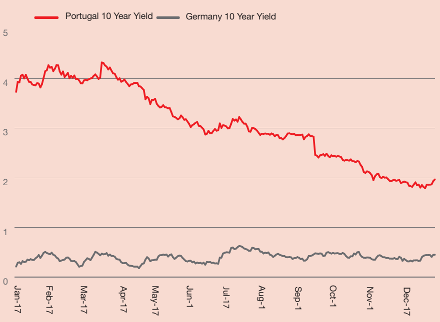
We might have an unconstrained mandate, but on this occasion we found an attractive opportunity relatively close to home, and with a sovereign issuer to boot. But we will go further from home.

In mid 2017 we invested approximately 8% of the Fund in several "masala" bonds – offshore-issued, US dollar-settled bonds of Indian companies. At the time, the bonds yielded 7% to their maturity in 3 years, but they came with risks; the bonds might settle in dollars, but the exposure was to the Indian rupee and, of course to the issuer. We had (and have) faith in the resilience of the economy in India, so we believe that the rupee will be supported. Moreover, the issuers to which we took exposure were quasi-government-backed companies. Finally, there was technical support for the bonds due to a ban on further sub-3 year masala bonds, imposed by the Indian government. Three year, government-backed bonds with technical support offering 7% yields. We gleefully accepted.

We benefited from other exposures too: European bank debt in the risky realm of contingent convertibles ("co-cos") that are so deep in the capital structure they are close to equities. These bonds are issued to help banks meet regulatory capital requirements and quickly become too expensive if they no longer serve that purpose, leading them to be called – a quick return of capital to the investor. We again profited from their attractive yields in 2017. UK inflation-linked bonds that temporarily reflected ridiculously low inflation expectations. Japanese convertible bonds that combined upside exposure to that country's under-valued equity market with downside protection from the underlying bond structure.

Each of these opportunities had different catalysts, risks and time horizons. Combinations like this give us faith in the diversification they offer, allowing us far more conviction than correlations (which all tend to one at times of crisis) alone. Sometimes, however, we need to go further and hedge our investors against the risks of our strategic positioning.

PORTUGAL OVER GERMANY



Source: Bloomberg, NAM.

Returning to Portugal, with German 10 year yields essentially range-bound, we frequently hedged against German yields when they touched the low points of the range. To do this, we outright shorted German bunds, but we also used options to control the cost of the hedge and to vary its strength over the year, sometimes removing it completely.

These pages may be packed with reasons to avoid benchmarks, free-up your investment manager to take risk on your behalf. All valid, no doubt but ultimately what investors need is attractive returns with controlled volatility. What we have attempted to provide is real-world examples of how we use discretion to target attractive return opportunities, yes, but more importantly to use any strategy or security we can to control the risks of those return opportunities This is what unconstrained investing means to us.