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What is your favourite fixed income risk?

Close-to-zero yields on many Euro bonds push investors to look for alternatives to keep earning reasonable returns from fixed income investments. What fixed income risk is worth taking on for a European investor?

Targeting extra returns by just taking on more duration risk is a solution of the past. European bonds are surfing another QE wave again, and interest rates are dipping below zero for an ever increasing stretch of the yield curve. These QE waves break sooner or later, as the last years have taught us. The only way for rates in the next years is up, even if slightly, the direction that the Fed has taken at the end of last year.

Extra return from credit risk is worth considering. Corporate issuers do pay a premium over sovereign issuers to investors to take on their debt notes. Spreads are large and positive at the start of 2016 due to macro-economic uncertainty. Spread risk represents opportunity. The USD and EUR credit markets are very large, with issuers from developed and emerging markets around the globe. Careful selection of country, sector and issuer exposures in a well-diversified portfolio can provide extra return as long as risks are correctly and systematically priced.

How much credit risk? Recent developments in the high yield sector already serve as a caveat. In search for yield, many investors took a bold step into large credit risk exposure to issuers below investment grade, partly in well-diversified portfolios, or partly in ETFs. Since the start of 2016, high yield recovery rates have been historically low, especially in the energy sector. In plain English: in the 'new normal' oil price range below 50 dollars, several US energy companies defaulted on their debt, and the subsequent selling off assets returned much less capital to investors than the historical average. Specifically in the high yield energy sector the credit risk is clearly under-priced, even at yields of around 8pct that are seducing many investors. Again, in high yield investments only an extremely careful selection of issuer and sector exposures limiting the risks can produce long term returns.

What about concentration risk in credit? It can be a dangerous game as well. High conviction portfolios ultimately bear the risk currently seen in its extreme equity form in the Valeant stock saga. As of end of March, the verdict was still out if buying that stock one or two years ago, and betting on a new, smarter business model undervalued by the market, ultimately will pay off. At this point the yes/no debate is actually irrelevant for an institutional investor with a fiduciary duty. The risk question should prevail: are you comfortable when your high conviction position loses 60-90% of its value before delivering any? In a free adaptation of the famous saying: would you allow your investment manager putting your money where his mouth is, up to flirting with your solvency?

Investments in private loans are 'en vogue' and expose to concentration risk as well. These loans have the advantage of securing extra interest by lending to smaller corporate lenders not being served well by banks (any longer), and have also the advantage of not being subject to moody market spread swings in daily mark-to-market portfolio valuations. Still, the implied bet is taking on more concentration risk and ultimately, default risk.

So what fixed income risk should one pick going forward? Maybe the question is wrong. Important lessons can be learned from first years of 'smart beta' investor experience on the equity side, more correctly labelled 'alternative beta' in the US. It shows there is also a risk in selecting just a single factor or risk premium to invest in, e.g. consider that

2015 ETF star ‘Japan Hedged Small Cap equity’ lost about as much return in Q1 2016 as it made in 2015. Such single factor or risk premium investments are not expected to work always and everywhere, extrapolating from a back test that is optimised for marketing purposes. In addition, when passively tracking a very narrow strategy index, there can be issues with capacity, as it is unknown how much money is tracking the index.

In summary, I put forward a high conviction idea: in the coming years actively and systematically managing a balanced portfolio of fixed income risks will bring an asset owner closer to achieving decent returns while navigating the stormy investment seas.