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Investment intelligence

The importance of cash as an allocation decision

M&G INVESTMENTS

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Fixed income investors often underrate the value of patience as an investment strategy. Positioning portfolios defensively may be most appropriate when few viable opportunities are obvious, keeping powder dry in cash and lower risk assets, for use when opportunities are clearer. Senior fund manager, **Richard Ryan**, explains.

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Wherever past performance is shown, please note that this is not a guide to future performance.

A multi-asset credit (MAC) investment style typically gives investors access to a variety of asset types across the fixed income markets. That may include holding government debt, investment grade and high yield corporate bonds, asset-backed securities, leveraged loans and real estate debt, among others. The freedom to select investments across the fixed income universe allows the manager to capture value in a broader, less-constrained universe.

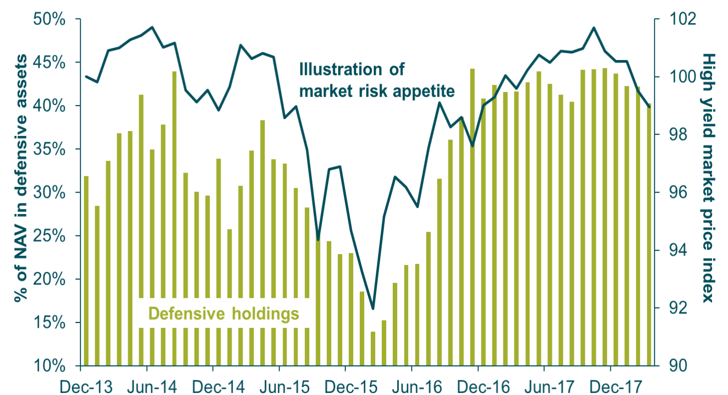
Flexible approaches to fixed income, such as MAC, may benefit from the added diversification that a spread of different asset types brings, designed to provide an attractive risk and return profile. Holdings of short-dated government debt and cash are also likely to be permitted. They represent lower-risk, defensive assets that usually exhibit less volatility than assets with longer maturities.

We often use the price index of the European high yield market to illustrate the market's appetite for risk, as shown in the chart. Typically, valuations begin to get stretched as prices rise. As part of our value-driven approach, our fund managers may take what others consider a contrarian view, if they sell into the market's strength. They generally increase holdings of defensive assets when they believe that insufficient upside remains available for the risk being taken.

Defensive assets are typically proxies for cash that can include gilts, AAA-rated mortgage-backed securities and asset-backed securities, foreign government and quasi-government securities, which have a low correlation with market moves and low volatility. With reduced risk in the portfolio, our fund managers can be patient, waiting until more compelling opportunities arise.

As the chart shows, holdings of defensive assets have been increased and decreased over time, ranging from less than 15% to almost 45% between the end of 2013 and the beginning of 2018. When we feel that markets have reached valuations where there is little scope for further upside, but there is increased risk of material downside, we typically increase the amount of cash and other defensive assets in portfolios. We do not try to predict what will happen, nor do we know where the next negative event will occur, but by having cash available, we are ready to react wherever it does. Where selective opportunities can be identified, we look to put that cash to work, often at the time when other market participants may appear to be panicking.

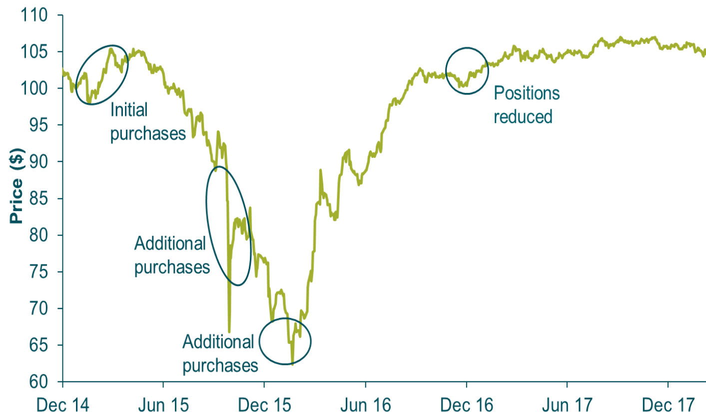
Defensive positioning reflects estimates of risk appetite



Source: Illustration of risk appetite is represented by the price index of ICE BAML Euro Non-Financial 2% Constrained index (Ref. HPIC), normalised, 31 December 2013 =100. M&G Alpha Opportunities Fund, defensive assets include Cash, T-Bills, short-date government bonds, AAA-rated ABS, AAA-rated Floating rate RMBS and AAA Quasi and foreign govt securities. M&G estimation. As at 31 March 2018.

For example, in 2015, we built a position in Glencore, a diversified commodities, mining and energy company. We believed the weakness in Glencore bonds, brought about primarily by declining commodity prices was unjustified, and felt that they were being undervalued. Concerns about economic weakness in the emerging markets were helping to depress commodity prices. The same concerns were also a factor in the broad credit market weakness, as investors began to question the ability of companies to sustain earnings. As the market experienced further weakness into 2016, we again added to our position, confident that Glencore was fundamentally sound and that the bonds offered compelling value and were likely to rebound.

Using cash as value opportunities arise: Glencore bonds



Source: M&G, Bloomberg GLENLN 4.625% 29/04/2024 $ bond, as at 28 February 2018.

The broader market recovered throughout the rest of 2016, as did the Glencore bonds, the price of which had been driven down well below what we considered to be fair value.

As the fundamentals reasserted themselves, the price of the bonds moved higher. The market gradually rose to levels where the potential for further rewards no longer justified the risks, at which point the manager decided to reduce the position and re-establish a more defensive stance. The yield on the European high yield index steadily declined to just 3% by the end of 2016 and continued to make new lows, declining to little more than 2% at the end of 2017. We have been content to retain a defensive stance in our MAC strategy throughout, periodically selecting value opportunities, but aware that valuations in general remain stretched.

We believe long-term investors recognise the value of being patient and retaining a defensive stance, possibly for an extended period, when there is an absence of compelling value.

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