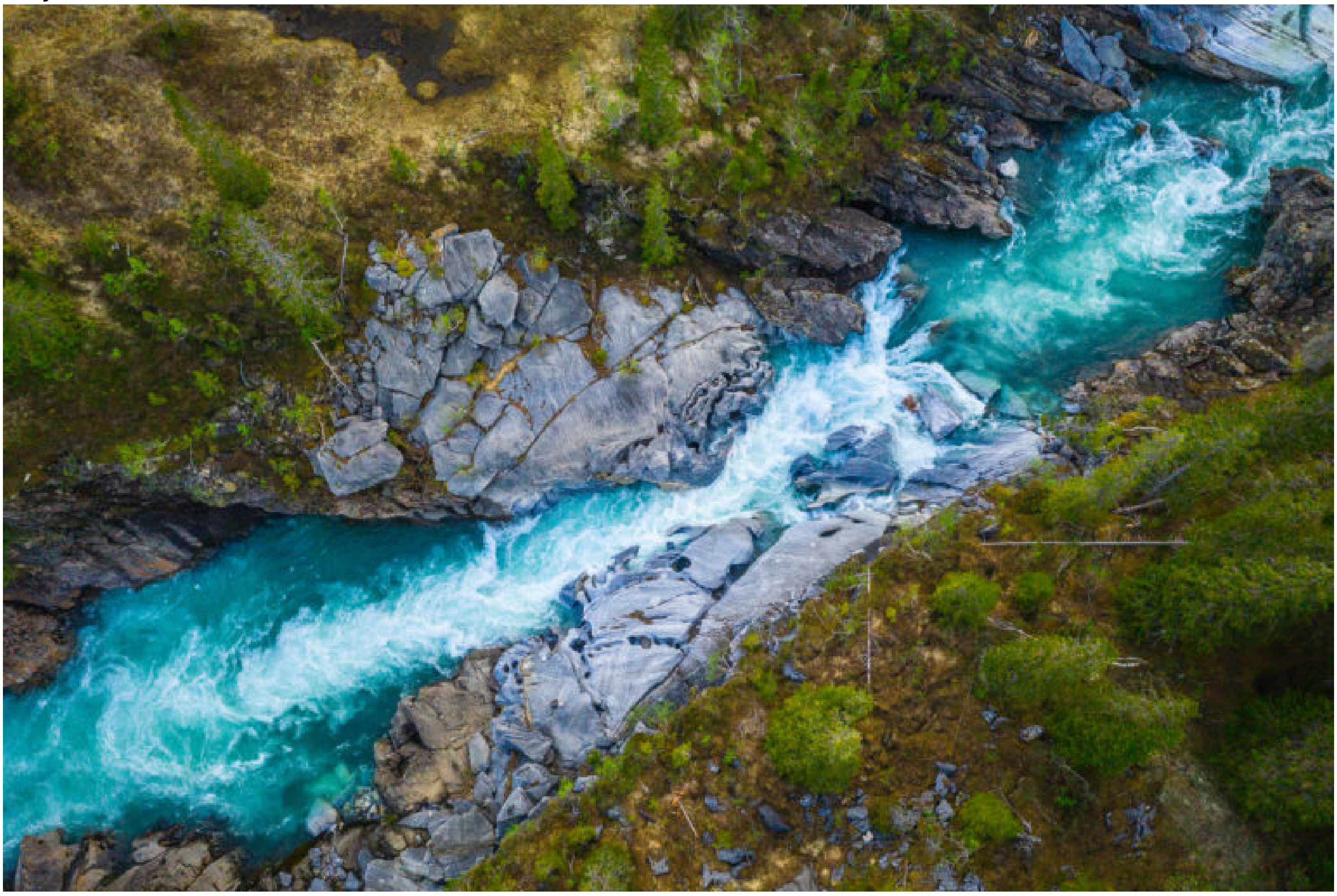
A diamond in the rough

May 25, 2022



Global Fixed Income strategies could provide a (increasingly rare) refrain from the beleaguerment faced by institutional asset managers.

We've said a lot about the challenges institutional managers are going to face over the next decade; margin compression, increased competition, performance tests and internalisation, among other things, make for an industry that's not for the faint-of-heart (or ill-prepared) – and the industry now broadly accepts this.

However, always the optimists, we thought it worth highlighting an area we see as providing opportunity for well-placed managers over the medium term: Global fixed income (FI).

There are two main reasons that we see cause for medium term optimism for Global FI managers*:

1. Global FI will not be as exposed to internalisation as other asset classes
2. Fixed Income has a natural structural benefit in terms of contestable flow

*Note: we are very aware of the impact of interest rate cycles for FI managers, however, we see this as a longer-term opportunity that will persist as rates normalise.

Global FI as an internalisation play

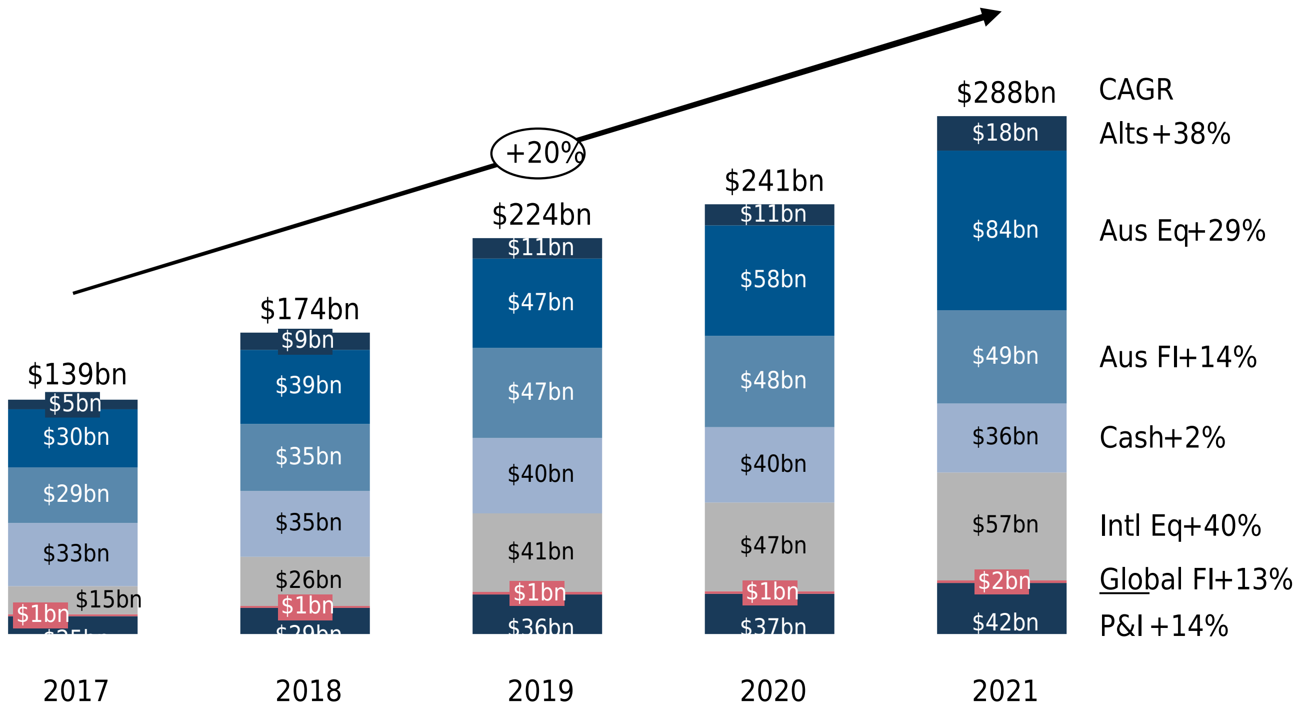
As we discussed in a previous Trialogue, internalisation will not hit all asset classes evenly.

Global FI has a natural advantage here, the dispersion of the underlying exposures, and the local knowledge needed to be successful are – and will continue to be – very difficult to replicate at scale.

As you can see in our first graph below, super funds have so far been hesitant to try their hand at Global FI in any meaningful manner.

Exhibit 1: Internalised assets by asset class

Global FI has so far been protected from mass internalisation (*June 2017 – 2021, $bn*)



Source: NMG Super Funds Review, 2021

The practical impediments to implementing an internal Global FI function at scale are likely to see this remain the case over the medium term – the fact is, there is still a lot of low hanging fruit before this becomes an area of focus for most internal teams.

Global FI as a portfolio rebalancing play

One of the realities of life for FI managers is that they are rarely afforded the same limelight as their counterparts in other asset classes. An allocation to fixed income is *usually* viewed as a defensive play and is expected to underperform most other asset classes through the cycle.

Whilst this may keep your average FI manager from ever appearing on the front page of the Fin, it does provide them advantage when it comes to contestable flow.

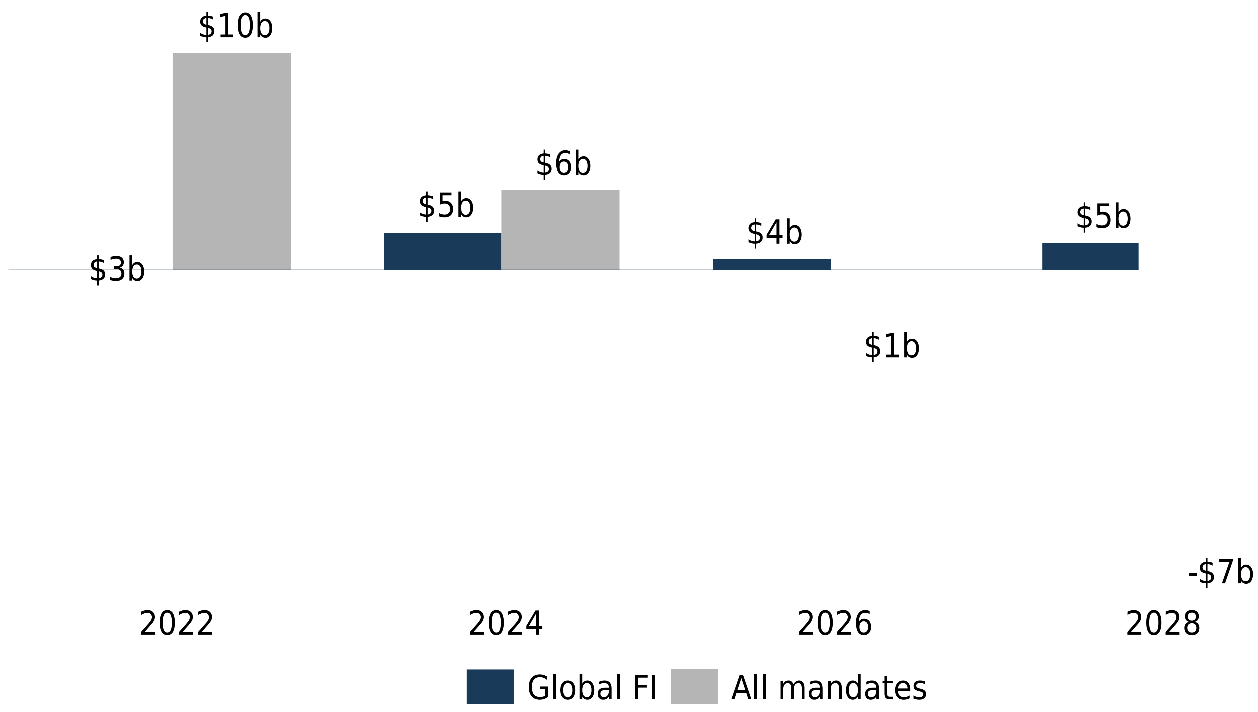
The reality is, strategic asset allocations do not change quickly, and fixed income exposures are core to most funds' propositions. This means that to keep within SAAs, CIOs need to direct additional 'top-up' flow into FI exposures as outperformance in other asset classes skews a fund's allocation.

This 'top-up' creates additional contestable flow for Global FI managers, and as shown below, creates significant opportunity against a backdrop of declining flows to mandates.

> *Portfolio rebalancing will continue to provide a steady stream of flows into Global FI mandates, against a backdrop of declining flows for mandates generally*

Exhibit 2: Netflows to Global FI mandates compared to all mandates

June 2022F – 2028F, $bn



Source: NMG Stock and Flow Model, 2021

So what?

The key takeaways here are that there is a lot to play for in the institutional space for well-placed Global FI managers, and this is likely to persist over the medium-to-long term. The challenge for managers is going to be where to play in this space.

The bluntness of the YFYS performance tests is driving CIOs to look beneath traditional asset classes into sub-asset classes to drive alpha, however, increased tracking error awareness means CIOs are going to be very selective about where they take a swing.

So, whilst there remains appetite for more vanilla Global FI exposures, there is a real opportunity for more specialist strategies where there may not have been previously (think; EM bonds, global high yield, regional credit, etc), but second-rate product is not going to cut it. Engagement models must be designed with this in mind.

The increase in internal management in other asset classes is also going to see CIOs tilt more and more toward investment selection, rather than just asset allocation. Managers should expect this to result in CIOs being much more hands on with their mandates.

All of this means that success is going to be driven, in large part, by a manager’s ability to shift their mindset from investment capabilities to (bespoke) solution development. Managers should view this as an opportunity to embed themselves in the decision-making processes of their clients, and must recognise that this has significant implications for operating models, BDM capabilities and product development.

Note: *We haven't forgotten about our friends in the retail market, so stay tuned for our thoughts on that space*.

By Lachlan Reardon