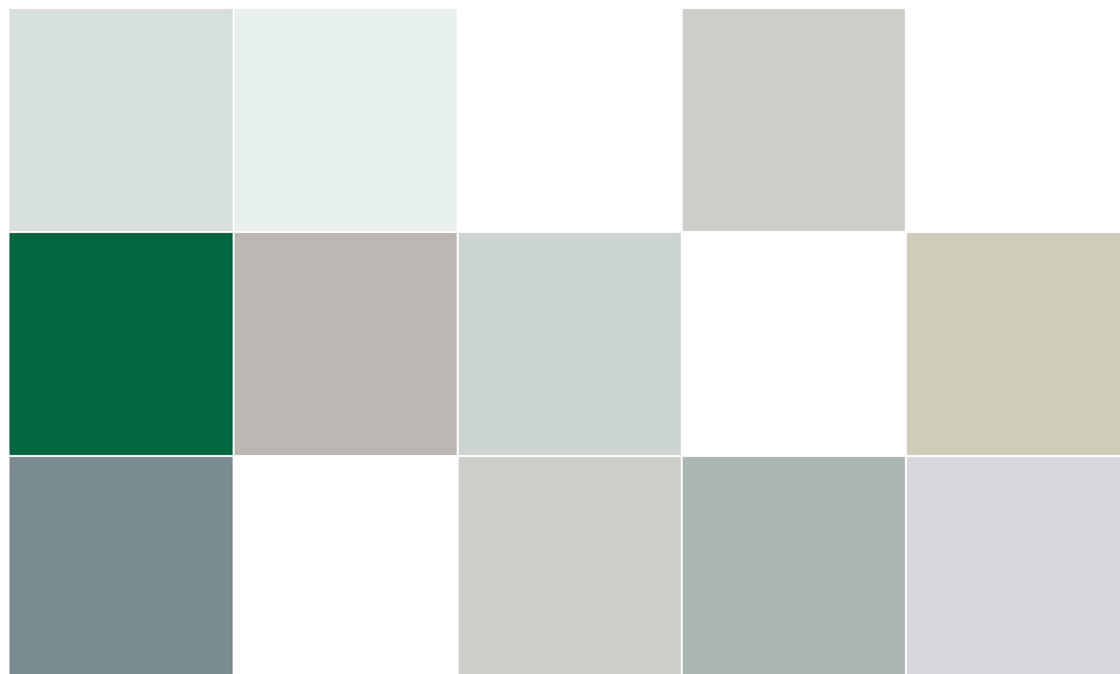
Manulife Asset Management™



Fixed income investing under Abenomics

How active management can help to maximise returns

August 2014

Manulife Asset Management's Abenomics research series

Manulife Asset Management's Japan fixed income team comprises nine investment professionals managing about US$12 billion in fixed income assets under management (as at 31 March 2014).The team has produced three in-depth research reports on Abenomics and its implications for Japanese fixed income investment. These reports are available at www.manulifeam.com.

In an environment of historically low Japanese government bond yields under Abenomics, Keisuke Tsumoto, Head of Japanese Fixed Income for Manulife Asset Management, believes that pursuing an active investment approach with multiple sources of potential return is key to maximising risk-adjusted returns.

Abenomics, Prime Minister Shinzo Abe's ambitious economic stimulus policy aimed at revitalizing the Japanese economy by achieving sustainable growth and stable inflation, has seen the Bank of Japan (BoJ) implement unprecedented qualitative and quantitative monetary policy easing. The injection of US$960 billion[1] into Japanese capital markets since April 2013 has so far spurred a jump in inflation to the current 1.4%[2] and has left virtually no asset class untouched.

Japanese capital market dynamics under Abenomics

The scale of the quantitative and qualitative monetary easing implemented by the BoJ in April 2013 exceeded market expectations. Equity markets climbed to new highs and the Japanese bond market entered a period of turmoil, with prices fluctuating violently. Bond market conditions did not normalise until June 2014, by which time the new monetary policy had been largely priced in and the 10-year JGB yield had stabilised at around 0.8%[3].

"By this time market consensus was that qualitative and quantitative monetary easing would keep Japanese Government Bond (JGB) yields low and credit spreads narrow for an extended period of time," explains Tsumoto. "In this low-yield environment, we feel that active portfolio management that exploits multiple sources of potential return and multiple investment approaches is the key to achieving sustainable attractive returns on Japanese fixed income.

Portfolio risk/return and the market index

The leading Japanese fixed income index – and the benchmark for a wide array of Japanese fixed income investment funds – is the Nomura BPI Index. However, the Index actually comprises a fairly limited range of bond types, as all constituents must have fixed coupons (with maturity of one year or more) and must be rated A or higher by at least one of the major credit rating agencies .

Under these strict criteria, JGBs account for about 80% of the Index and its price volatility risk closely mirrors JGB yield volatility risk.

This would be a simple discussion if taking on JGB yield volatility risk would allow a portfolio manager to attain sustainable attractive investment returns. However, in the current low-yield environment under Abenomics only marginal investment returns can be achieved by simply matching the Index's – ie, essentially the JGB's – level of yield volatility risk.

[1] Bank of Japan, June 2014.
[2] Nationwide CPI ex-food and ex-effect of consumption tax hike, Statistics Bureau, Ministry of International Affairs and Communications and Bank of Japan, May 2014
[3] Bloomberg.

Diversifying sources of return

Therefore, in order to uncover potential sources of attractive investment return and effectively diversify risk, we feel that investors may want to consider bond types and financial instruments that fall outside of the Index.

According to Tsumoto, "In order to achieve excess returns, we believe it is necessary to adopt an active approach to investing, in the process taking on higher levels of both credit and liquidity risk. This entails reducing JGB exposure and carefully increasing exposure to non-JGBs, emphasising corporate credit and potentially including off-benchmark bonds such as inflation-linked bonds and financial instruments such as Credit Default Swaps (CDS)."

This reweighting essentially skews a portfolio's price volatility risk profile away from JGB yield risk and has the potential to deliver excess investment returns. "That being said," cautioned Tsumoto, "it is imperative to consistently monitor the level of excess risk being added to the portfolio to ensure that it is matched by sufficient potential excess returns."

Employing multiple investment approaches

Tsumoto explained, "It is also possible to achieve excess investment returns by applying multiple investment approaches within a single portfolio. A good example would be a strategy of combining an active sector selection strategy with a yield strategy."

Active sector selection, coupled with active individual bond selection in each sector – including off-benchmark bonds and financial instruments, as discussed above – delivers the potential to achieve excess investment returns by modifying a portfolio's levels of credit and liquidity risk versus that of the Index.

Meanwhile, a yield strategy involves pursuing excess investment returns by modifying the portfolio's level of yield risk. Under this strategy, a portfolio manager adjusts the entire portfolio's level of yield risk by overweighting bonds and financial instruments that are intrinsically undervalued.

"In particular, we believe a yield curve strategy that focuses on carry and roll-down yield has the potential to deliver stable excess investment returns," remarked Tsumoto. "In our view, this strategy can be effective in the Japanese bond market even alongside the BoJ's continued zero interest rate policy and ongoing quantitative and qualitative monetary easing."

Japanese bond market outlook

The 10-year JGB yield is now hovering at 0.6%, down from just above 0.8% in June 2013[3], and the average credit spread has narrowed approximately 10 basis points over the same period, suggesting that Japanese bond market returns are likely to be lower in the coming year than over the past year.

Tsumoto reiterated, "That being said, we believe that active portfolio management employing diverse bond types and investment approaches has the potential to deliver stable excess returns."

Tsumoto also shared the Japan Fixed Income team's general views on selected major bond types:

- Nominal JGB yield – The 10-year JGB is expected to range from 0.50% to 0.75% as the yield curve is seeing continued downward pressure from Abenomics. In our view, it is premature to expect a rate hike.
- Inflation-linked JGBs – Market-implied inflation is expected to rise due to BoJ inflation-targeting policies. Japanese pension funds are likely to start investing in inflation-linked JGBs, supporting supply-demand balance.
- Corporate bonds – Spreads are expected to remain stable for at least six months based on continued aggressive monetary policy easing by the BoJ, a favourable supply-demand balance and generally sound corporate finances
- Yen-denominated foreign bonds - Spreads are expected to remain stable at low levels due to lower potential growth for the global economy. In particular, financial markets could feel a ripple effect if China's property market weakens.

This material, intended for the exclusive use by the recipients who are allowable to receive this document under the applicable laws and regulations of the relevant jurisdictions, was produced by and the opinions expressed are those of Manulife Asset Management as of August 2014, and are subject to change based on market and other conditions. The information and/or analysis contained in this material have been compiled or arrived at from sources believed to be reliable but Manulife Asset Management does not make any representation as to their accuracy, correctness, usefulness or completeness and does not accept liability for any loss arising from the use hereof or the information and/or analysis contained herein. The information in this document including statements concerning financial market trends, are based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons. Manulife Asset Management disclaims any responsibility to update such information. Neither Manulife Asset Management or its affiliates, nor any of their directors, officers or employees shall assume any liability or responsibility for any direct or indirect loss or damage or any other consequence of any person acting or not acting in reliance on the information contained herein. All overviews and commentary are intended to be general in nature and for current interest. While helpful, these overviews are no substitute for professional tax, investment or legal advice. Clients should seek professional advice for their particular situation. Neither Manulife Financial, Manulife Asset Management™, nor any of their affiliates or representatives is providing tax, investment or legal advice. Past performance does not guarantee future results. This material was prepared solely for informational purposes, does not constitute an offer or an invitation by or on behalf of Manulife Asset Management to any person to buy or sell any security and is no indication of trading intent in any fund or account managed by Manulife Asset Management. No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment. Unless otherwise specified, all data is sourced from Manulife Asset Management. Issued in the United Kingdom by Manulife Asset Management (Europe) Limited. Manulife Asset Management (Europe) Limited is authorized and regulated by the Financial Conduct Authority to carry on regulated activities in the United Kingdom.

Manulife Asset Management
Manulife Asset Management™ is the institutional asset management arm of Manulife Financial. Manulife Asset Management™ and its affiliates provide comprehensive asset management solutions for institutional investors and investment funds in key markets around the world. This investment expertise extends across a full range of asset classes including equity, fixed income and alternative investments such as real estate, timber, farmland, as well as asset allocation strategies.

Manulife Asset Management has offices with full investment capabilities in the United States, Canada, the United Kingdom, Japan, Hong Kong, Singapore, Taiwan, Indonesia, Thailand, Vietnam, Malaysia, and the Philippines. In addition, it has a joint venture asset management business in China, Manulife TEDA. It also has operations in Australia, New Zealand, Brazil and Uruguay. Additional information can be found at ManulifeAM.com. Manulife

Asset Management™, Manulife and the block design are trademarks of The Manufacturers Life Insurance Company and are used by it and its affiliates including Manulife Financial Corporation.

Additional information about Manulife Asset Management may be found at ManulifeAM.com

194803

Manulife Asset Management™