Trade Ideas

July 2020

Considerations on a conservative portfolio – Bonds vs Equities

Summary

A long-term and unavoidable trend among developed economies in decreasing interest rates has made it very difficult to achieve a satisfactory remuneration of capital in the fixed income asset class, the pillar of all conservative portfolios. Since 2008, three main trends have taken place:

1. Bond prices of high quality names tend to spike faster than before as fixed income-focused investors pile larger positions into them;
2. A trend of re-allocation between bonds and equities has taken place on a very large scale, and;
3. Central banks' and government authorities' support for their own economies and capital markets has created a case for ever-increasing equity valuations.

This state of things imposes to even a very conservative investor to consider an increasing allocation to selected equities from what was previously a 100% allocation in fixed income.

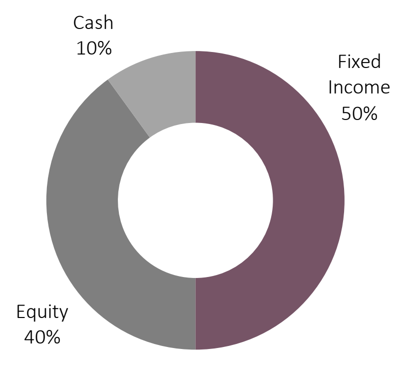
While it is true that equity valuations look stretched by any metric and historical trend, there is little in the way of a continued growth in prices. Among the threats to the current market optimism there are the following:

1. US election turmoil – a victory of Trump in November would see a continuation in the isolationist stance of the country against foreign competition, especially against the Chinese, thus giving enough material to markets to worry about diminished global trade; a victory by Biden would rattle markets more, since uncertainty on economic policy would definitely kick in;
2. Renewed systemic failure due to further lockdowns – despite what markets think, we are not out of the woods in economic terms. Any further disruption to jobs or specific economic sectors such as housing could have the effect of delaying recovery in the developed world, especially in the US.

However things go from here, introducing selected and high quality equities into any conservative portfolio would bring a higher potential capital appreciation than the one obtainable from a portfolio made of only bonds, while still maintaining a satisfactory dividend yield.

Find below our current interpretation of what once was a 100% fixed income-based conservative portfolio.

Capital Allocation



Security selection criteria

Bonds

- High ranking seniority;
- High rating (AA+ to A-);
- Solid economic and credit fundamentals;
- Very long maturity;
- Industries to avoid: global aviation and developed economies' finance.

Equities

- Solid economic fundamentals;
- Conservative debt exposure;
- Global businesses;
- High and stable dividend.

Portfolio details

Industries: insurance, utilities, transports, basic materials, hospitals, pharmacies, e-commerce, emerging economies' banking, waste disposal, telecoms, consumer staples.

Main features:

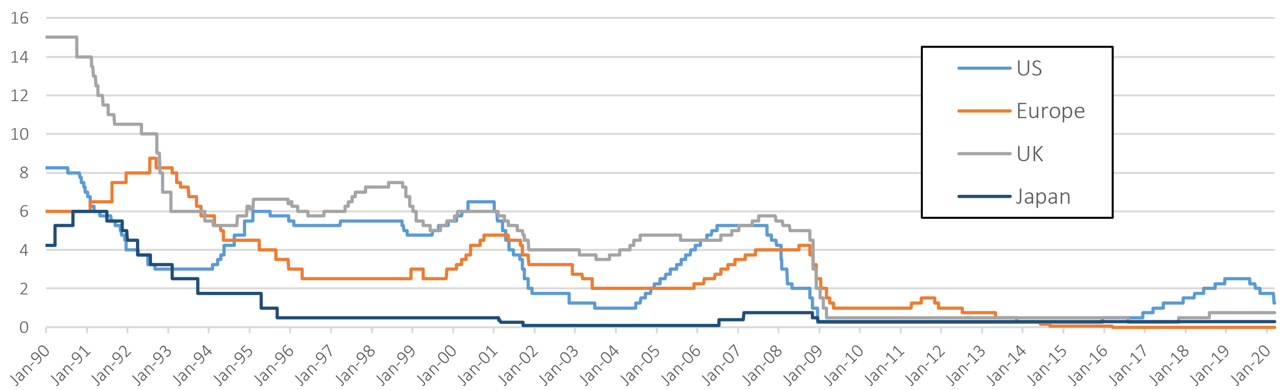
- Maturity: 30 years
- Bond yield: 3.58% p.a.
- Equity dividend yield: 4.03% p.a.
- *Combined yield: 3.40% p.a.*

See bond and equity security selection in the next pages

Market considerations

During the late 1980s, Japan was the first among developed economies to begin decreasing interest rates toward zero in order to stimulate growth. The Eurozone began with the same monetary policy in early 1990s, with a sudden acceleration both after the US tech bubble of 2001 and after the global financial crisis of 2008. The US has tried to increase rates since 2017, but the economy failed to produce enough consumer inflation.

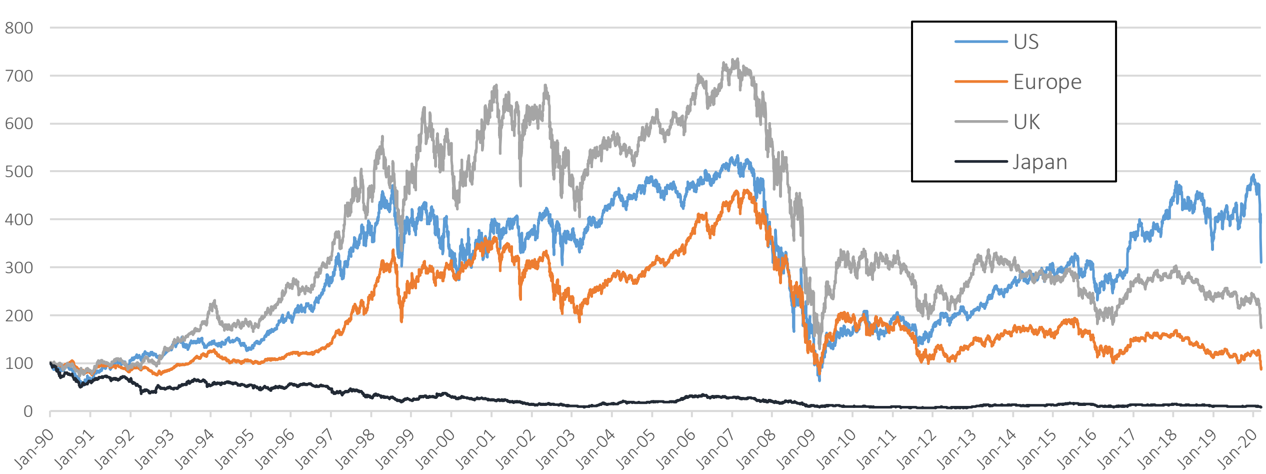
Going to zero – Central banks' base rates



This monetary state is really only the result of a secular plateauing of economic growth. This is not unusual, as any developed economy is destined to touch the ceiling of its own potential. Fiscal and monetary policies are only designed to maintain an internal economic balance between inflation and growth.

In such an environment, one of the most severe consequences is that banking businesses began suffering at their very core. This model is of course implanted on the possibility of borrowing at a cheaper cost than the rate earned by lending capital out. In a zero interest rate environment, this mechanism reduced profits to zero. Consequently, the equity valuation of Japanese banking aggregate reduced by 90% over time, as shown below. Europe and the US are simply following in the same footsteps in both rates and equity valuations.

A dying business model – Normalized equity performance of bank aggregates by country/region

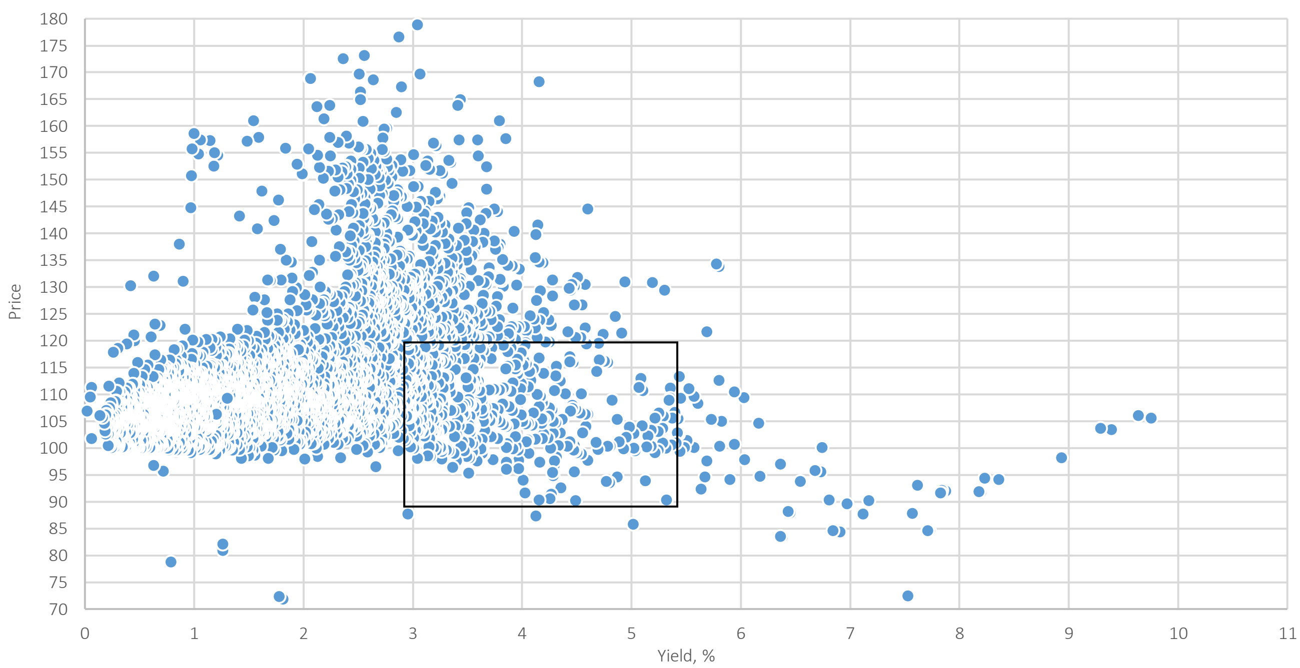


Another most severe consequence is that a zero-interest rate environment in major economic blocs has also considerably shrunk remuneration across the board for bonds. This means that today yields are so low that they give, on average, hardly any remuneration for the risk assumed by investors. This is true for any rating segment, in any geography and industry. The section below goes into more detail.

Bonds

Within the investment grade world for US dollar denominated bonds (i.e. the currency in the developed world that carries the highest interest rate), today bonds of all maturities are yielding less than 2% on average. The range of bonds yielding more than 3% per annum corresponds to 18% both in number of existing issues and in amount issued of the total investment grade rating segment. Of this group, only 61 securities have a price below par, while 330 securities are below the 120 bond price. Of the 120s group, 57% of securities falls into financials and energy, both very battered sectors not just during recent troubles of COVID-19, but in secular decline due to both zero interest rates and a perennial oversupply of fossil fuels.

All-maturity USD investment grade bonds – distribution by price and yield



Our selection falls within the black square on the graph above and has been done following the below principles:

1. *Senior ranking* – we prefer to focus on bonds that get paid first in case of bankruptcy;
2. *Quality of the name* – in order to minimize the risk of a negative credit event, we like to choose among names rated AA+ to A-;
3. *Entrenched business with solid fundamentals* – debt over EBIT ratio no higher than 8 times (8 years), debt over assets ratio no more than 50%, EBITDA growth of more than 5% per annum over the past 5 years (with the exception of government and semi-government entities and one distressed play);
4. *Maturity* – investors today prefer very long durations of 30-50 years, with securities in this maturity bracket being as liquid but more expensive than those in the 5-15 year maturity bracket;
5. *Industries to avoid* – global aviation and developed economy finance, but insurance looks attractive.

Any more recognizable and global name in tech, semiconductors, consumer staples or media carries substantially lower yields, hovering around 2.20% and with prices also in the 120s.

Selected bond list

Issuer Name	ISIN	Industry	Sub-sector	Country	Maturity	First Call Date	Yield	Ask Price	Amt Out ($m)
First Abu Dhabi Bank PJSC	XS1546411650	Financial	Commercial Banks Non-US	AE	20-Jan-47	20-Jan-22	5.37	100.50	885
Saudi Electricity Global Sukuk Co 3	XS1054250318	Utilities	Electric-Integrated	SA	8-Apr-44	-	4.13	120.54	1,000
Waste Management Inc	US94106LBC28	Industrial	Non-hazardous Waste Disposal	US	1-Mar-45	1-Sep-44	3.83	104.27	750
Northwell Healthcare Inc	US667274AC84	Consumer, Non-cyclical	Medical-Hospitals	US	1-Nov-47	1-Nov-46	3.54	112.29	848
Simon Property Group LP	US828807DH72	Financial	REITS-Regional Malls	US	13-Sep-49	13-Mar-49	3.51	95.25	1,250
Corp Nacional del Cobre de Chile	USP3143NBF08	Basic Materials	Non-Ferrous Metals	CL	30-Jan-50	30-Jul-49	3.51	103.49	1,900
Biogen Inc	US09062XAD57	Consumer, Non-cyclical	Biomedical/ Genetic	US	15-Sep-45	15-Mar-45	3.32	131.45	1,750
AIA Group Ltd	US00131MAE30	Financial	Life/Health Insurance	HK	16-Mar-46	16-Sep-45	3.30	120.40	750
Cigna Corp	USU1716AAX55	Consumer, Non-cyclical	Pharmacy Services	US	15-Jul-46	16-Jan-46	3.19	127.99	1,407
Tencent Holdings Ltd	US88032XAW48	Communications	Internet Content-Info	CN	3-Jun-60	3-Dec-59	3.17	102.58	750
Union Pacific Corp	US907818FL73	Industrial	Transport-Rail	US	5-Feb-70	5-Aug-69	3.12	115.81	750
Alibaba Group Holding Ltd	US01609WAW29	Communications	E-Commerce/ Products	CN	6-Dec-57	6-Jun-57	3.02	130.68	1,000

The average maturity of this selection is just above 30 years and yields 3.58% per annum.

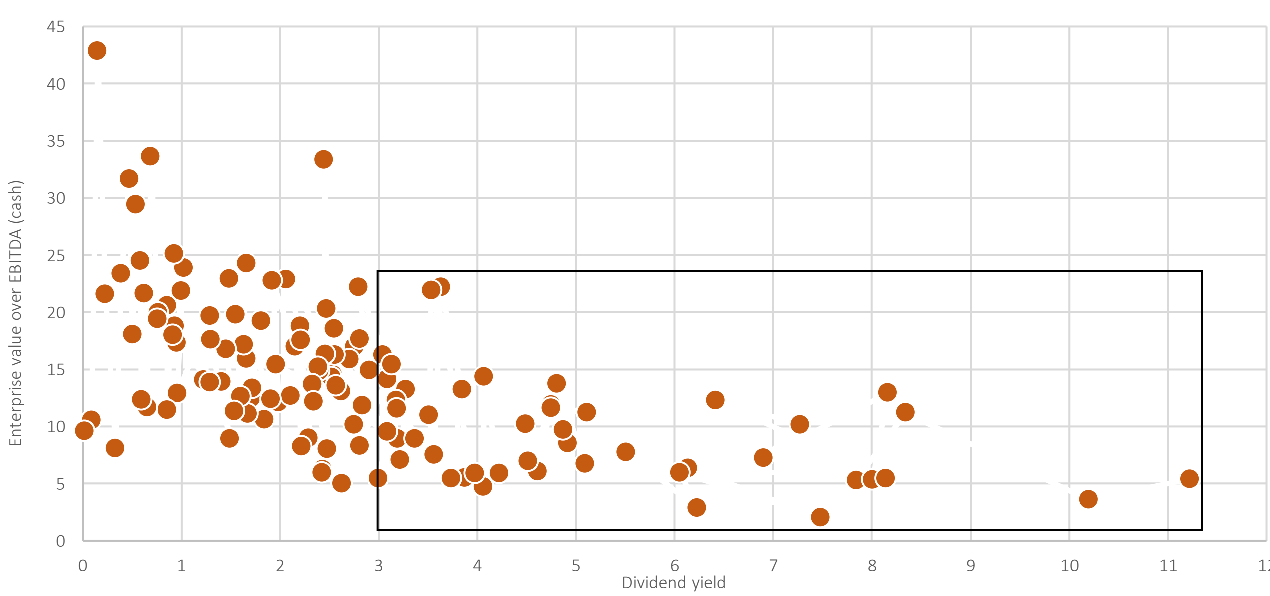
The selection highlights how skewed towards duration the fixed income play has become in the search for yield. In other words, an investor needs to take a very extended exposure to time and credit risk in order to obtain any meaningful return.

A good way to mitigate the duration risk that exists even on quality and government names is to expose part of the capital to high quality equity names that pay dividends – with a further industrial diversification effect too.

Equities

While equities provide less protection and insurance of repayment to investors than bonds, the selection in this department gives the opportunity to expose capital to solid, global businesses that pay a stable dividend.

All USD dividend-paying Equities – Distribution by dividend yield and cash valuation



The point of holding equities in a conservative portfolio is to both receive a steady dividend and participate in the future earnings growth. In the limited firmament of dividend-paying stocks, we selected industries that are fundamental to human life such as pharmaceuticals and consumer staples, and therefore counter-cyclical.

Other sectors of a counter-cyclical nature, such as telecoms, provide a utility-like diversification towards the conservative side.

Selected equity list

Ticker	Name	mkt cap ($bn)	Industry	Subgroup	Div Yield	2021 P/E	EV/ Sales	EV/ EBITDA
CHL US Equity	CHINA MOBILE LTD-SPON ADR	146	Communications	Wireless Telecommunication	6.23	9.17	1.15	2.86
BHP US Equity	BHP GROUP LTD-SPON ADR	120	Basic Materials	Diversified Metals & Mining	5.09	15.84	3.38	6.74
GSK US Equity	GLAXOSMITHKLINE PLC-SPON ADR	100	Consumer, Non-cyclical	Pharmaceuticals	4.75	12.86	3.11	11.57
VZ US Equity	VERIZON COMMUNICATIONS INC	225	Communications	Integrated Telecommunication	4.51	11.12	2.71	6.96
PFE US Equity	PFIZER INC	188	Consumer, Non-cyclical	Pharmaceuticals	4.49	11.34	4.22	10.22
AZN US Equity	ASTRAZENECA PLC-SPONS ADR	141	Consumer, Non-cyclical	Pharmaceuticals	3.53	21.26	5.28	21.92
UL US Equity	UNILEVER PLC-SPONSORED ADR	140	Consumer, Non-cyclical	Personal Products	3.28	17.90	3.04	13.20
CSCO US Equity	CISCO SYSTEMS INC	197	Communications	Communications Equipment	3.09	14.80	3.32	14.14
MRK US Equity	MERCK & CO. INC.	194	Consumer, Non-cyclical	Pharmaceuticals	3.18	12.81	4.47	12.24
PEP US Equity	PEPSICO INC	187	Consumer, Non-cyclical	Soft Drinks	3.04	22.76	2.56	16.23
BMY US Equity	BRISTOL-MYERS SQUIBB CO	130	Consumer, Non-cyclical	Pharmaceuticals	3.13	7.71	4.99	15.42

The selected names are global businesses with solid fundamentals that translate into low exposure to debt, an ability for the companies to repay quickly their existing debt and a reasonable market valuation.

In time, all these companies should benefit from a recovery towards their steady-state earning power, thus providing further boost to capital growth in the coming 2 years.

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