Bond Market Strategy: Ten Key Questions

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Abstract. The paper considers general issue, relative to securities portfolio management – evaluating risks at bond market. There is a clearly defined classification of risks. These are credit, interest rate, currency, liquidity and concentration risks. Existence of all risks mentioned above makes investors look for protection in the form of a strategy. To help investors develop their own strategy each week, Bridport Investor Services publishes a reflection based on ten key questions. The main body of this paper contains a summary of the questions and the answers which have been reached over the last months and years.

Key words: bond market, investment risks, interest rates, inflation, exchange rates.

Although stock markets have been falling since early 2000, it has taken them about two years for it to "sink in" with both private and institutional investors so the easy profits of the 1990s now belong firmly in the past. With seriously burnt fingers from playing with fire, investors are becoming cautious, thoughtful and risk-averse.

There was a time when the dominant argument to hold bonds was safety and the certainty of future cash flows that could be matched against liabilities. Bond investors might worry about movements in yields of a few tens or even hundreds of basis points, while "dot.com investors" would sneer at such boring investments and enjoy making gains of several percentage points per day.

Today, when a stock portfolio is considered well managed with the losses of only a few percent points, the modest but positive performance of fixed-income instruments is proving, after all, not so unattractive. Moreover, the effort involved in achieving even marginally additional yield is well worthwhile when, on average, yields are so modest.

Nevertheless, investors must not fall into the trap that bonds are all equally safe and solid. They carry risk, too: credit, interest rate, currency, liquidity and concentration. Such risks have always existed, but the motivation to seek protection against them is now higher than ever. Moreover, it is only in recent years that the means has been available to analyse the risks and reduce them.

Defence against bond risks has to be built around two dimensions:

A strategy reflecting the state of the economy and its outlook, the behaviour of financial markets and the mood of central bankers

A tool to monitor a bond portfolio to ensure it reflects one's strategy and to make adjustments as necessary.

To help investors develop their own strategy, our company, Bridport Investor Services, publishes a weekly reflection based on ten key questions. Below we summarise the questions and the answers we have reached over the last months and years.

Question 1: what is the state of the "rea" economy in the USA ?

For us, any recovery based on very low interest rates is fundamentally weak. If the economy does expand, rates will have to go up to combat inflation. Indebtedness in the USA, both of household and corporations, is so high that only low interest rates let it be carried. None of this is surprising after the excesses of the 1990s.

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Question 2: are other major economies independent in their performance ?

Unfortunately, not. A large part of the world has become dependent on the American economy and its tendency to consume a huge proportion of world's resources, capital and production (and not just its own!). Any concept that Europe, for example, could become the motor of the world economy is pure wishful thinking, at least for any foreseeable future. As for Japan, it does not even have a motor, as its consumption, just opposite to that of the USA's, is always less than its production.

Question 3: Inflation ! What is the outlook ?

During a period measurable in years (possibly this whole decade), inflation will be low. This is because the recovery will be very modest as so much production capacity lies underused and unemployment remains high. Moreover, the competition of Asian countries and the price transparency provided by the Internet will give little pricing power to producers or retailers.

Question 4: what policies are the Central Banks following ?

- The Fed is more worried about the economy and stock prices than it is about inflation, and will keep interest rates low as long as these two are under-performing;
- The ECB is obsessed with keeping inflation down, to the point of setting itself a ceiling of 2% that many judge to be too severe and which is likely to slow economic growth;
- The Bank of England is also focused on inflation, but has a target set by the Government of 2.5%, a level both more realistic and more flexible than the ECB's "ceiling" (which does not prevent the UK from running some of the same risks as the USA, such as a house price bubble);
- The Bank of Japan has simply lost control! To make matters worse it has now decided to buy stocks held by commercial banks to prevent their capital adequacy ratios falling below 8% as the Nikkei goes further down.
- All of the Central Banks seem to be fighting yesterday's war against inflation, when the main risk today is deflation.

Question 5: what is the outlook for interest rates ?

Our analysis of central banks and the economy first led us (until August of this year) to the conclusion that the next movement in bank rates would be upwards, but delayed as long as possible. As of the last month or so, we have become convinced that the next moves will be down. These considerations encouraged us to propose lengthening of average maturities for the first time in May, then again in June and in July.

Question 6: how are the stock exchanges behaving?

We forecast the bursting of the bubble a few months too soon compared with the actual event. The current bear market began in earnest at the beginning of 2000 and may be expected to run for a very long time, not least because share prices are still greatly overvalued.

Question 7: how are currencies behaving?

The dollar has been overvalued because of the attraction of its securities and of the assets of American industrial companies. However, the high value of the dollar is fundamentally unstable because of the enormous current-account deficit, which needs continual offsetting by capital flows towards the USA. That flow dropped drastically in early 2002, about two years after the unattractiveness of US stocks became first apparent. It had gradually fallen on investors that over a billion dollars daily net investment in the USA was not sustainable. Thus the dollar has already gone through a large correction. It is not yet over, and we believe it has further to go against European currencies, although the uncertainties over Iraq and the weakness of the European economy are delaying this second step downwards.

Question 8: what are the risks associated with corporate bonds?

With regard to corporate bonds, we must admit to a certain "house" reticence, even with regards to investment grade bonds, never mind "high-yield bonds (formerly known as "junk bonds"). Corporate bonds may offer attractive yields, very often even, hide unpleasant surprises. Our view is that only investors with serious credit research capacity should deploy some of their assets towards corporate bonds. This view is more justified than ever in this period of rebalancing after excess.

Question 9: And emerging markets?

Bonds issued in convertible currencies by governments of emerging countries are generally a less dangerous means of seeking extra yield. It is not that they never fail, but that bad news comes less frequently, and, when it does, it happens more slowly than in case of corporate bonds. Thus the investor has many chances of exiting before the damage is too great. This year, contagion from Argentina has spread throughout Latin America and beyond. As we write, the prices of emerging-market sovereign bonds are a little on the high side, but opportunities are present in Asia and in former Soviet countries.

Question 10: what external phenomena might affect the yield curve in what might be called an "unnatural way"?

As the recent example we would mention the following:

- The decision of the Clinton Administration to discontinue issuing T-Bonds at 30 years, but rather to buy them back, a policy soon abandoned by the spendthrift Bush Administration,
- The insistence in the UK that the maturities of bonds held by pension funds and life insurers match the timing of their liabilities, thus increasing the demand for long-term Gilts. (This example remains current.)
- In the USA, a current example is to be found in the existence of a credit bubble destined to become a credit squeeze generated by securitisation of debt transferred to the private or semi-private sector, implying that the State is losing control over the money supply and interfering *de facto* with its implied credit quality.

The answers to all these questions led us in summer of 2002 to recommend ten years average maturities for bond portfolios, with the focus on top-quality bonds, and for yield seekers, a component of Korean or Russian bonds. For investors based in Swiss Francs or euros, we have stressed the risk of the dollar declining.

More recently (as of mid-September 2002), our conviction that the recovery will at best be slow and that deflation is a serious possibility has pushed us to recommend long-dated zero-coupon bonds and strips. With both instruments, capital gains when yields decline are substantial. For those who prefer to hedge their risks against inflation anyway, the index-linked market offers an attractive complement.

Conclusion

Since mobility in the sense of being able to trade bonds quickly is a key element of the bond-based asset management for institutional investors, the answers to the ten questions change with time and vary from one investor to the other. What is important for each investor is to draw conclusions matching his profile.

For monitoring a bond portfolio, three elements are offered by the Keox© system of bridport Investor Services :

- A series of exhibits (tabular and graphical data) which bring out for the portfolio the state of the five fixed-income risks;
- A comparison of a given portfolio's yield with that of a model portfolio built from similar bonds offering high quality and liquidity. These model portfolios are built into the system as « source lists ») ;
- The means to simulate quickly the impact the sale or purchase of a given bond, or its replacement (« arbitrage »).

(A description of the five risks and of the "swap curve" is available in specific papers prepared for the participants in our seminar.)

Dynamic Asset Investment Analysis of Japanese Life Insurance Companies Under Regulations

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Abstract. The purpose of this paper is to give the estimation framework for considering whether or not regulatory constraints imposed on the Japanese life insurance industry can explain the behavior of Japanese life insurance companies with respect to their asset investment and dividend policies.

Key words: life insurance industry, dividend policy, investment decisions, asset investment policy.

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1. Introduction

The Japanese life insurance industry is characterized by a small number of companies (in 1994 it was represented by 16 Japanese mutual insurance companies, 11 Japanese stock insurance companies, and 3 foreign stock insurance companies). On the other hand, the size of the Japanese life insurance market is huge. Life premiums approximately amounted to $208 billion (JPY28 trillion) in 199; this represents the second largest market in the world. The value of assets held by the Japanese insurance companies exceeded $1.5 trillion (JPY150 trillion) in 1994. Although the Japanese life insurance companies occupy such an important economic position, several researchers have expressed strong concern that the industry may not be efficient.[1] If the Japanese life insurance companies seem to make an "irrational" decision, we give two possible interpretations of this "irrational" behavior. One is to suppose that the Japanese life insurance companies may be badly managed. The other is to consider the possibility that this inefficiency is caused by regula-

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