Hello and welcome to our third episode of Conversations for 2024. This year's podcast will take us 'back to basics', a deep dive into each of our strategies.

Today we welcome Payden & Rygel's Nigel Jenkins, a managing director who is also a member of the firm's Investment Policy Committee and oversees the global fixed income strategy team. Together, Nigel and our CEO Damien McIntyre will discuss all things bonds – after all, in our first podcast you heard the pronouncement – bonds are back!

Before I hand over, I need to read this important notice:

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Damo and Nigel, over to you.

Damien McIntyre

Thank you, Tracey. And good afternoon, everyone. And welcome, Nigel Jenkins. Nigel is an 18-year veteran with Payden & Rygel based in London, and he's out with a couple of the team members in Australia this week speaking with institutional and retail clients. And it's always great to make you welcome in Australia, Nigel.

Nigel Jenkins

It's good to be here, Damien. Enjoyed being here a couple of years ago and good to be back.

Damien McIntyre

I'm not sure too many of the listeners have met you so I wonder if you could just quickly give us a few minutes on your background and your role within Payden & Rygel.

Nigel Jenkins

Sure thing. I've been at Payden & Rygel for 18 years. That's just less than half of my career in managing fixed income assets globally. I started all the way back in 1989 at Rothschild Asset Management in London, worked in the fixed income team there for almost a decade and a half, had a short spell of European asset manager head in the fixed income team there, and have been at Payden for the last 18 years. My academic background was in economics, so I'm pleased to say I've been able to use that quite effectively in my career.

Damien McIntyre

Oh. Well, absolutely you would've. What do you do? What's your role at Payden?

Nigel Jenkins

My role at Payden is quite multifaceted. I sit on our investment policy committee which is the group that oversees the management of all strategies at Payden, sets the themes that should be reflected in all portfolios at Payden. I sit in our London office and work very closely with our global fixed income team that are managing against multi-currency benchmarks like the Global Ag and the FTSE WGBI. And I also sit on our absolute return fixed income team, which is the principal reason why we're down here in Australia. We have a number of relationships that have unconstrained mandates with us and their multi-sector go anywhere sorts of strategies, and I'm involved in the management of that strategy too.

Damien McIntyre

You've certainly got a range of different responsibilities, and dare I say it, they're all big ones. Why don't we kick off with our conversation? And I'd like to start with a statement and finish it with question. It's said that bonds are back. Are they and why?

Nigel Jenkins

I think bonds, I would say bonds probably are back because for a long, long period of time, being anchored by zero or negative short-term interest rates, they just weren't throwing off much yield. There wasn't much desire to be in or less desire to be in cash and cash plus strategies and bond strategies when even 10-year government bond yields around the world at times were less than 2%. That's just not a very attractive proposition, either in nominal terms or even in real terms against inflation rates that were also about 2%. So a zero prospective return prospect. But here we are now, yes, inflation we've seen has been higher, but it's come back down towards the 2% mark but not all the way down. But we have positive real interest rates again for the first time in a long time. And that probably does mean that over the medium to long term, bonds are back as potentially a more meaningful part of portfolio.

Damien McIntyre

Yeah. With nominal and real interest rates being so low for so long, you're right. They didn't represent a great opportunity, particularly when compared to equities.

Nigel Jenkins

No, that's right. Money flowed out aggressively into equity markets. And for now, some of that money is staying in equity markets but I can foresee a situation going forward with nicely positive real yields where there's just more of a balancing up, more of a recognition that bonds can play an important role in a properly diversified balanced portfolio.

Damien McIntyre

Which was always I won't say the intention, but it's how we grew up constructing portfolios.

Nigel Jenkins

Yeah, back to the old days in some ways.

Damien McIntyre

Yeah, the good old days. Now, I want to ask a question. Are all bonds created equal?

Nigel Jenkins

No is the answer to that, for sure. I think for us, one of the attractions of bond markets is it's not simply a decision between being bonds or being equities, but the diversity of the types of bonds you can buy is itself very impressive. So you've got international diversification. You can choose different currencies of bonds you want to buy. You can currency hedge those back to the investor's base currency so you can get rid of the currency risk completely. That's one type of diversification and one sense in which bonds certainly aren't created equal.

You've got all sorts of manner of significant spread of credit quality across all manner of bonds as well. That applies to governments around the world. So there are developed governments, emerging market, emerging economy governments that may have lower credit ratings and offer higher yields. That's another sense in which bonds aren't created equal. You've got bonds that are issued by international agencies and semi-government organisations by corporations, again, right across the rating spectrum.

And then in addition to that, and this is an area where my company, the company I work for, Payden & Rygel, has a particular area of specialisation and focus is in securitisation. So securitised bond asset classes, residential mortgage-backed securities, commercial mortgage-backed securities, asset-backed securities, CLOs, collateralised loan obligations, this type of thing. Again, there's a lot of diversification in that area. If you put them all together in a thoughtful way to create a more diversified, more stable income stream, then you could create by just putting one or two different categories of bonds together.

Damien McIntyre

And tell me, in the current environment, what types of bonds do you think will fare well?

Nigel Jenkins

We have some preference towards shorter-dated bonds right now, shorter maturity bonds for a couple of reasons. One is they're throwing off quite a lot of income and you don't have to take so much price volatility risk in order to harvest that income. So that's an attraction of short-dated bonds. We'd also see short-dated bonds benefiting from the potential for an interest rate cut in cycle around the world. It's not that we're centrally expecting a very aggressive across the board rate cut in cycle, but if it does happen and if growth surprises to the downside, there probably will be a good decline in short-dated government bond yields. And that decline gives you a nice capital gain.

Other parts of the market we'd currently be interested in, we'd probably have a bit of a preference for government securities and higher quality bonds for now than ordinarily we would because we do think we're entering into an environment that might be one of somewhat slower economic growth, somewhat more challenging conditions for risky assets. That would include equities, but it would include lower-rated bonds like high yield bonds, for example. Credit spreads there are quite tight. The amount of yield you get relative to a same maturity. Government bond is not all that much. We're quite conservatively allocated, I would say, at the moment with a preference for shorter-dated bonds and higher quality bonds.

Damien McIntyre

Payden & Rygel, since its origin really have been specialists at the short end of the curve, and many of your products have been borne out of that experience and that expertise. Why should investors feel comfortable invested at the short end over the long end?

Nigel Jenkins

I think it's in particular based on the risk adjusted profile that shorter maturity bonds offer. So you get a lot of the yield, a lot of the income that you can earn from owning much longer-dated bonds, but you take a fraction of the price volatility. In technical terms, the interest rate and spread duration of those securities is much lower than longer-dated securities where you do get a slightly higher income, but you pay for it with an awful lot more volatility. So the risk adjusted return prospects, we think, are generally attractive over whole economic cycles and whole market cycles, especially in five-year maturities and shorter. So that's the majority of Payden's business. That's where we in fact started as an investment management firm 40 years ago. And we think there's a lot of attraction in that part of the market going forward.

Damien McIntyre

And this short end specialisation and philosophical confidence, if you like, is largely because at the short end of the market, let's say you buy a three-year bond, with every day that passes brings it a day closer to maturity. And is that why the volatility is so much less?

Nigel Jenkins

Yes, it is. They're shortening up aggressively a year into a three-year bond, a third of your whole time to maturity is gone compared to a tenth of your time to maturity and a 10-year bond. So they're shortening up aggressively. And if you've made your credit picks carefully, you know are going to get your par value back at the maturity date and you're getting progressively closer to that at a rapid rate. If you can buy that type of security, do the credit work, understand the credit risks or lack of credit risks and be confident about the return of your par value, then it's a pretty attractive proposition.

Damien McIntyre

Yeah. Painful as recent history was for a short period of time, we saw that in 2020, didn't we? When the worst of COVID presented itself, there were drawdowns right across the spectrum of the bond market, but the short end very quickly marched back.

Nigel Jenkins

It did. So March 2020 was a very challenging month for all asset classes for obvious reasons right in the teeth of the realisation of how serious the short-term implications of COVID could be. But 3, 4, 5 months later, the rebound in short-dated bonds had had more than fully recovered the losses in March. So it didn't take long as long as you were an investor that could see through the here and now. If you could see through the 1, 2, 3, 4, 5 months, your full value was recovered. The worst thing to have done at that time would've been to lighten up and sell.

Damien McIntyre

So…absolute return bond funds, how are they different from the traditional bond product?

Nigel Jenkins

One of the critiques of traditional bond products that we heard from clients and potential clients was that when a manager is given a bond benchmark, which would be a typical way to manage fixed income portfolios, investors were finding that 95% of the returns of those products were driven by the performance of the benchmark, the asset allocation rather than by the investment decisions of the managers.

In addition to that, significant asset allocators were not themselves in a position to reallocate their portfolio across different sectors and respond to market developments very quickly. It's a very slow moving process to move a significant asset allocation around unconstrained fixed income, absolute return fixed income. Managers can do that much, much more quickly. So it sort of endogenises the asset allocation within fixed income in a way that isn't really possible and can't be done anywhere near as flexibly by asset allocation committees of investors. So we think it's part of a diversified fixed income. Asset allocation really should include almost a tactical asset allocation piece that's able to respond very quickly to change in market circumstances. And that's one of the things that absolutely term fixed income can do very well.

Damien McIntyre

So from where we sit today, we're in this period of time where inflation spiked, interest rates spiked response to that. And now we're seeing inflation fall albeit quickly in some jurisdictions, slower in others. And we have this expectation that interest rates will be cut to compensate for fall in inflation. How do you think absolute return bond funds will cope in an environment where people are expecting rates to fall?

Nigel Jenkins

One of the things we think is going on is the markets are overestimating the extent to which rates are in fact likely to fall.

Damien McIntyre

And is this because inflation is proving to be more stubborn?

Nigel Jenkins

We think that's the way it's panning out. It may not turn out that way, so we have to be flexible of mind, but we think the idea that inflation is heading inexorably back to 2% in a pretty smooth manner and we're going to resume this low inflation and zero inflation volatility that we had prior to COVID, we think that's quite a leap to be honest. And we think the big gains, the easier gains against 7, 8, 9% inflation have already been made. But from here, inflation may well prove to be stickier. Employment markets are quite tight around the world, so wage gains are quite firm. Maybe in the US for example, a percent to a percent and a half stronger than they were prior to COVID. That's one factor.

Reshoring, French shoring, less cheap labour supply from abroad being used to lower labour costs, that's another one. Fiscal policies around the world have been very expansionary. That's another potential for higher inflation going forward. And maybe looking back, monetary policy was just too loose for too long. We are now seeing the effects of pent-up demand from that overstimulation of the world economy. So all of those things to us suggest that there's some reasonable chance that inflation around the world might level off or even head back up a little bit around the 3% mark rather than getting all the way down to 2%. And in that sort of environment, it's hard to see central banks come interest rates as aggressively as is now priced in.

I think longer term, there's likely to be a reversion to positively sloped yield curves around the world. And in that environment, fixed income, the starting yield should be outperforming cash. And if you can be actively sector rotating and issue selecting within that, then fixed income will offer really quite attractive above cash sort of returns in the environment where forward-looking returns from global equity markets might be much more mixed than they have been for the last lots of years.

Damien McIntyre

I just want to change tact to one second, just have a chat about passive funds. And this is also in the context that index funds play an important role and they're also competitively priced, so they have their positive virtues. Again, coming back to where we are now, how do you see passive bond funds performing from here?

Nigel Jenkins

Well, passive funds are certainly part of the landscape that are not going to disappear. They're here to stay. And I think there's positive things to be said about the bearing down on cost and the efficiency of investing passively. I think when you are talking about though the efficient allocation of capital to the best risk-adjusted return opportunities, in a philosophical sense, I'd rather have a set of asset allocators and portfolio managers determining where they want to spend the marginal dollar in actively managed funds than I would simply buy in a company or buy in a set of bonds because they represent a large part of a bond universe or an equity universe.

And I think there's a growing as well academic literature that there may be some misallocation of capital that's going on through the overuse of index funds, particularly in equity markets. That the money is flowing into the Magnificent 7 for example right now because they're big. Is it only because they've got great products or great prospects? If you are a passive fund, you are investing more and more into Nvidia because Nvidia is big. It's just something that's blurring the edges of what otherwise would be I think a more efficient allocation of capital.

So maybe that's a bit too deep and an academic point, but I think it does suggest to me that generally the use of passive funds could be in the process of topping out. They're not the ideal solution in all circumstances that I think they've come to represent over the last few years.

Damien McIntyre

I hope this term, we've come to live with it and accept it's part of our vernacular in a risk-on environment, whether that's equities or bonds. Passive funds give you beta, but in bond land, you've got nowhere to hide in terms of duration. So whatever it is you buy at that point in time when you enter, you're stuck with that. Whereas an active manager at least can vary the beta exposure in an absolute return bond fund. You can take negative duration if you wanted to. You can use cash. You can use all sorts of tools. Costs aside, you're rolling the dice with the future. You are stuck with the beta you're buying.

Nigel Jenkins

Yeah. And I guess in that context, another feature of passive funds is that you lock in underperformance of an index by the amount of the fees. The fees might be low, but you lock in that underperformance. And for fixed income allocation as opposed to equity allocation, if you are investing in bonds, for example, of corporations based on the amount of debt they have that's outstanding, you are locking into the idea that the more debt a company has, the more of it I want to own. It's a bit different than passive investing in equity where a company is successful. It grows and you invest more as a passive investor because of that growth. In debt land, in fixed income land, you are investing more because a company's got more debt. Is that an interesting proposition? Yeah, probably not.

Damien McIntyre

Yeah. That is the problem with capitalisation-based indexes in bond land. You are rewarding heavy borrowers. And that may be a good thing and may be a bad thing. Coming back to the income opportunities fund and in the context of the risks we were just discussing, how does that fund mitigate those risks?

Nigel Jenkins

So the fund mitigates the risks through, first off, a focus on short duration securities, relatively short maturity securities. So you have this effect we were talking about earlier, bonds pulling towards par. You have the option of if you own a three-year security, waiting until it matures in three years time, then you're getting your par value back, whatever price volatility there's in the meantime. But of course the price volatility is lower in the meantime because of that short maturity. So that short maturity orientation is a particular feature, but the approach of the fund offers diversified exposure across a whole range of sectors that whilst positively correlated with each other are very far from perfectly correlated with each other.

So there's good, really good sectoral diversification across government bonds, across semi-government bonds, emerging market bonds, developed bonds, investment grade corporate bonds, high yield corporate bonds, and various components of the securitised asset market as well. Diversification, ability to move between multiple sectors that aren't perfectly correlated with each other just smooths return over time. It's a good part of the market to have an active manager be in a position to respond quickly to new market developments. And if the last three or four years have shown us anything, it's that things can happen very quickly that cause a rapid change in market perceptions and the value of securities. And so you really need to be in a position to be able to respond promptly to new developments.

Damien McIntyre

I've heard it said from Payden many times that rather than looking at a security from its index construct or weight, you look at a security in the context of does this security exhibit the right attributes for an absolute return fund? Am I going to get my money back? Can you expand on that?

Nigel Jenkins

Yeah. So to us, absolute return bond should really be about generating or attempting to generate a relatively smooth profile of returns in excess of cash without incurring too much volatility as you are doing it. Now, if you have a period of time like March 2020, it's hard to avoid short term downside as we were discussing earlier. But over somewhat longer term periods, 18 months to two years, let's say, that sort of approach of a focus on a diversified set of low duration securities, none of which we have to own. We could choose to own none of them. We could just own cash instead or we could just own government bonds instead.

We buy securities because we like their risk adjusted return profile and we like the way the securities in the fund complement each other. It's nothing to do with the amount of outstanding issuance or nothing to do necessarily with the directionality of credit spreads or government interest rates. It's everything to do with how those securities interact with each other. And we are in a great place and have a lot of experience in putting those portfolios and funds together in thoughtful ways that generate the smoothest profile of risk adjusted return.

Damien McIntyre

So here we are today in almost the middle of March of 2024, very big year for elections. We've just had Taiwan, we've just had, was it Brazil?

Nigel Jenkins

Indonesia.

Damien McIntyre

Indonesia. And then later on in the year, we have, when does the UK go?

Nigel Jenkins

The UK probably goes around the time of the US election. So in the fall towards the winter.

Damien McIntyre

Right, right. So big year for elections. And we're also in this tug of war between inflation and GDP growth. So a lot to think about for an active manager. How are you viewing the world today and how have you positioned your fund today and what are you expecting as the year rolls on?

Nigel Jenkins

Yeah, I think what's happened in all honesty is that from late 2021 into 2022, we began to see rising interest rates around the world and the whole seam changed for what's a normal level of interest rates and what's a normal level of bond yields. And the market went from the certainty of very, very low and stable interest rates and inflation to an environment where nothing was very certain anymore. So it's like narratives now fluctuate from one quarter to the next. One quarter, it might be disinflation and the potential for interest rate cuts. Another quarter it might be the potential unsustainability of large fiscal deficits around the world. Another quarter, it might be resurgent growth. And then probably towards the end of the year, it will be a focus on political developments and the risks that provides.

So to us with a kind of lack of a centre of gravity for where interest rates and bond yields should be, these fluctuating narratives mean that you really want to be fleet afoot. You want active management in hands that can respond quite quickly. And I'm sure especially the US presidential election and congressional elections in November of this year are going to be very influential over financial markets or potentially very influential over financial markets. But for now, they're out of sight and out of mind. They might only be seven or eight months away, but seven or eight months a lot can happen in that time. Watch for fireworks towards the end of the year, but there'll probably be fireworks between now and then from Fed policy, from ECB policy, from inflation, from other elections around the world. Got to look in lots of directions at once in markets right now.

Damien McIntyre

Does there come a period where all the market thinks about is an election outcome and what are the implications of that? Or is it too simple? Is there just too much going on?

Nigel Jenkins

I think the habit of markets for the last two or three years has been to have a fairly narrow focus for a period of time. I think the US election, for example, I think it's going to be out of sight and out of mind in all likelihood for another few months. But as we get closer towards it, it could well be the dominating factor. I think having said that, one of the things we've learned from opinion polls and election outcomes over the last several years is that you can be quite significantly misled by being too confident about predictions as to what's going to happen.

So I think speculation just in advance of the election will be a big thing, but more important will be the outcome of the election. And probably in the US in particular, whether you get a unified White House and congressional outcome because if you do, the potential for a further expansion of fiscal policy rises, either through tax cutting or spending increases, and that could be in an environment where bond yields get even more attractive going forward.

Damien McIntyre

In that environment, are you saying that bond yields would rise?

Nigel Jenkins

Potentially could rise. And interestingly, we could have a yield curve pivot to use the market jargon where you have shorter maturity yields that are potentially falling because central banks are modestly cutting interest rates, at the same time as you have longer-dated bond yields rising because there's a lot of bond supply coming from large fiscal deficits and new fiscal spending plans and tax cuts. So you could have quite a bifurcated market that's looking quite attractive at the short end but for a period of time might involve rising yields at longer maturities.

What I would say about rising yields in bond markets though is that that can be a painful process whilst it's happening, as we saw in 2022 in the early part of 2023. But once you get those higher yields, you are enjoying the sunny uplands. So if you can extend maturities after yields have risen and enjoy the benefits of higher yields and the potential from capital gains when yields fall, that's quite an attractive proposition. So rising yields can be a double-edged sword. Bad whilst it's happening, but very good once it's happened.

Damien McIntyre

Now, I'm going to ask you a couple of questions. In the context of, and forgive me for my opinion, notwithstanding the necessity of QA and what the US in particular did to bail out the banks post-crisis or during the crisis, it gave birth to a zero interest rate policy. And in my view, that in itself is the most elaborate economic experiment certainly in my lifetime, and it's changed the landscape for interest rates and bonds considerably. Do you think that we've become obsessed with low interest rates? And not take into consideration the lower they are, the less magnitude or the less levers the government has to pull in times of a crisis when it needs to stimulate fast.

Nigel Jenkins

Yeah, I think to some extent markets and voters and everybody in the world did become enamored with a low interest rate environment and the idea that in any crisis, central banks, even if they had low interest rates, would expand monetary policy through unconventional means like quantitative easing, buying government bonds. Some of them buy in even corporate bonds and some central banks even buy in equities as well. So expansion of central bank balance sheets, and that monetary stimulation has created an environment or did create an environment where you felt that in a worst case scenario, there would always be a backstop. But what you didn't have was when interest rates were zero, you didn't have the ability to cut rates further so you had to rely on these other sorts of unconventional policies, and that meant distortions, significantly distorted capital markets. It's not really the way it should work.

The Western capitalist model should be capital goes to where the risk adjusted returns are the strongest, not because a central bank happens to be buying that type of security. So I do think that it probably has contributed to a misallocation of capital over a long period of time and that we may need to pay the consequences of that for some period of time going forward. That could be in the form of weaker growth rates. It might already have been in the form of lower productivity growth around the world because of the misallocation of capital. So it is an approach that has helped the short term at the potential expense of the longer term. And what you could say is that a reversion to more normal interest rates that we've now seen might speak to a lower degree of misallocation of capital going forward.

Damien McIntyre

Forgive my ignorance. I want to ask about the practicalities of investing in government bonds with negative yields. What did you get out of it? Did you have to write a check to the issuer every year for that interest rate or was it purely a duration plan?

Nigel Jenkins

Pretty much it was the case that you were locking in negative returns for a period of time if you bought a bond at a negative yield, not only a negative nominal return but a more significantly negative real return relative to inflation. So I guess investors became used to the idea that even when government bond yields are low or even when they're negative, if they go even more negative, that creates a capital gain in the short term. So there was that short-term reason still to be buying bonds in an absolute sense, but a lot of it was to do with asset allocators had nowhere else to go. Interest rates were negative. Bond yields were also negative but perhaps not quite as negative as short-term interest rates. So I'm going to put some of my money there.

Looking back, it was quite a wacky period that would've been, let's say, if we went back to the start of my career in the late '80s and early '90s. At the time, it did seem inconceivable to be in the environment where you could have a large portion of the world's government bond markets with negative yields and people would still be buying them. That just didn't seem a possibility, but lo and behold, it happened.

Damien McIntyre

Yeah. Look, I must say it was fortunately in financial markets, I chose a career in sales as opposed to managing money. Being reasonably good throughout my career at articulating investment ideas, that is the one notion that I have always struggled to reconcile and understand. I left it to the intellect of your good self to enlighten us because I certainly always found it hard to get my head around that.

Nigel Jenkins

Yeah. I think even as a professional bond investor, getting used to how low interest rates went and how low and negative government bond yields went, that really took some adjusting to. And as negative yields moved further and further out of global yield curves, once we had five-year bonds and even 10-year bonds in European markets at negative yields, who would've thought?

Damien McIntyre

Yeah. Well, fortunately, of course you've always got to be careful what you wish for, but this spike in inflation and this resulting spike in interest rates has at least normalised interest rates, and it's more like what we expect from a bond.

So Nigel, really enjoyed our conversation today. Thank you for coming to Australia. I know you've had a very busy start to the week, and no doubt you're going to be busy for the rest of the week. So I hope you have a great time here. And once again, thank you very much for your thoughts.

Nigel Jenkins

No, very good to be down here, and thanks for the warm welcome and kind words.