Markets Monthly February 2019 - Fixed Income Biases

TIME: 7:21

INVESTMENT PRODUCTS ARE NOT FDIC INSURED, NOT A BANK GUARANTEE, AND MAY LOSE VALUE. Please read other important information, which can be found on the link at the end of the podcast episode.

[Transcript]

[techno music]

Mr. Manoukian: Hi, my name is Jake Manoukian. Welcome to the February edition of Markets Monthly. This month, I'm lucky enough to be joined by Irena Alagic, she's a Fixed Income Specialist on our team. Irena, thanks so much for joining us.

Ms. Alagic: My pleasure.

Mr. Manoukian: So last time Irena was with us was over the summer in 2018, and since then, we've seen a pretty substantial period of market volatility, and when we think about that market volatility, what it really means in layman's terms is that equities are going down, and when equities go down, investors usually find themselves caught between this tug of war between fundamental investing based on your goals and having a disciplined approach, and then the kind of emotional side of investing. Those biases are really important to examine as investors, and I just feel that a lot of the time we frame those conversations in the context of equity investing, but I have a feeling they exist in fixed income investing as well.

Ms. Alagic: Yeah. Look, we're humans first and investors second, and what that means is that in a lot of instances, we don't make the most optimal decisions. We are prone to biases, and those biases can be costly, and I know we often talk about them in the context of equity investing, but it's just as pervasive in fixed income, and so what we really want to make sure we do is isolate some of the most common biases we come across within fixed income investing, so that we can give fixed income the opportunity to do what we essentially hired it to do in a portfolio, whether it be income generation, capital preservation, diversification, you name it.

Mr. Manoukian: Yeah, so I love this idea of, of thinking about what you hire fixed income to do in your portfolio. One of the most important things that many investors hire fixed income to do is provide a cushion against the volatility that equities have.

Ms. Alagic: Right.

Mr. Manoukian: Now, there's this kind of theory that's starting to bubble up in the market narrative that because interest rates are so low, fixed income won't have the same amount of that diversification protection that it has provided historically against equity risk in the past. What is your take on this theory?

Ms. Alagic: Look, I think the main thing you need to do really is just to look at 2018 as a reasonable case study, right, especially the fourth quarter, and especially December, right? In December, the S&P was down about nine percent, and the Barclays AG Broad Fixed Income Index that we use was up two, so I think especially as we get later in the economic cycle, it's important to own the appropriate amount of core fixed income so that you can get that benefit if we have more volatility, which by the way, we think we're definitely going to have.

Mr. Manoukian: So the fourth quarter of 2018 suggested to us that fixed income could still provide that diversification benefit against equities.

Ms. Alagic: Oh, for sure, for sure.

Mr. Manoukian: So another kind of recency bias that definitely shows up in equity markets is performance chasing- the desire to buy assets that have appreciated a lot, and the desire to sell assets that have depreciated a lot. What is that like, and how does that manifest itself in fixed income?

Ms. Alagic: Yeah, recency bias really refers to this idea that you take what has happened recently, and you extrapolate it into the future, and we absolutely see that behavior in fixed income investing as well, whether it's chasing positive performance, or selling on the back of a couple of months of negative returns, and look, it's not that we're saying don't sell ever. You have to take a step back and consider whether your original investment thesis has changed, but what we end up experiencing in reality in most cases is that people don't actually have the discipline to go back and think through why they own this in the first place, and whether something fundamentally has changed about the thesis, so we have this experience where people tend to sell first and ask questions later.

Mr. Manoukian: Yeah. Again, it goes back to that concept of what might be more important than the short-term price fluctuations-

Ms. Alagic: Right.

Mr. Manoukian: -is really thinking about what the reason that you have the asset in the portfolio is.

Ms. Alagic: Right.

Mr. Manoukian: So going back to this idea of why hire fixed income at all- one of the main reasons is for actual income generation, so how do you think about income generation as a fixed income investor?

Ms. Alagic: Well, it's related to what we just spoke about, this concept of recency bias, and, you know, selling first and asking questions later, and we absolutely do see people forgetting that the income portion of fixed income is supposed to work for them, right? So for most fixed income instruments, your return is comprised of price return and your coupon, and if you react and you sell a bond without thinking about, have the circumstances materially changed, or is this just a temporary price dislocation, you end up crystallizing the loss, and then you haven't given yourself the opportunity to earn out the coupon, and the coupon is ultimately what's going to help cushion your total return experience over your holding period for that security. And again, if circumstances have changed, then it's absolutely worth reevaluating, right? But in a lot of cases, again, it's very reactionary behavior. You just react to what has happened recently, as opposed to look ahead.

Mr. Manoukian: I might be oversimplifying, but one of the refreshing things about fixed income investing to me is that as long as that you believe that the issuer, or the entity that you're lending money to, will pay you back, you have a pretty good idea of what your return experience will be like.

Ms. Alagic: Right, right.

Mr. Manoukian: Now, the one that we want to end on is this idea of reach for yield behavior, that is really, in large part, caused by this air of quantitative easing, where central banks took a really active and large position in asset markets and fixed income markets. How are you seeing that play out, now that the era of quantitative easing is coming to an end?

Ms. Alagic: Yeah. Look, we see a lot of that behavior still happening, and I think it's just now starting to get unwound. As we sort of switch from quantitative easing to quantitative tightening, we had a hundred basis points of Fed hikes in 2018, the balance sheet has been reduced, and it's going to continue, and what's happened as a result of that is that a lot of people, a lot of investors have gone down, for example, in credit quality, without getting the proper compensation for it, or taken on more liquid investments, again, without getting adequately compensated for it, so at some point, we are going to have a downturn in credit, and at that point, it's really going to pay to know what you own. You can't really just rely on ratings, and there are parts of the fixed income market that are not going to provide you the same protection as they have in the past, so you really want to take a very close look at where have underwriting standards deteriorated.

Mr. Manoukian: So it's really important to ask the question about am I getting compensated for the amount of risk I'm taking?

Ms. Alagic: For sure.

Mr. Manoukian: So we've covered a lot over those four biases, but I think in times of market volatility, it's more important than ever to really reflect on those biases with the help of your advisor, and really to make sure that fixed income is doing the job that we hire it to do in your portfolios. So Irena, thank you so much for spending the time.

Ms. Alagic: My pleasure.

Mr. Manoukian: Hopefully, we'll have you back in a couple of months.

Ms. Alagic: I hope so.

Mr. Manoukian: And hopefully, we'll see you next month for the March edition of Markets Monthly. Thank you.

Legal Entities and Regulatory Information: In the United States, Bank deposit accounts, such as checking, savings and bank lending, may be subject to approval. Deposit products and related services are offered by JPMorgan Chase Bank, N.A. Member FDIC.

JPMorgan Chase Bank, N.A. and its affiliates (collectively "JPMCB") offer investment products, which may include bank managed accounts and custody, as part of its trust and fiduciary services. Other investment products and services, such as brokerage and advisory accounts, are offered through J.P. Morgan Securities LLC ("JPMS"), a member of FINRA and SIPC. Annuities are made available through Chase Insurance Agency, Inc. (CIA), a licensed insurance agency, doing business as Chase Insurance Agency Services, Inc. in Florida. JPMCB, JPMS and CIA are affiliated companies under the common control of JPMorgan Chase & Co. Products not available in all states.

In the United Kingdom, this material is issued by J.P. Morgan International Bank Limited (JPMIB) with the registered office located at 25 Bank Street, Canary Wharf, London E14 5JP, registered in England No. 03838766. JPMIB is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. In addition, this material may be distributed by JPMorgan Chase Bank, N.A. ("JPMCB"), Paris branch, which is regulated by the French banking authorities Autorité de Contrôle Prudentiel et de Résolution and Autorité des Marchés Financiers or by J.P. Morgan (Suisse) SA, which is regulated in Switzerland by the Swiss Financial Market Supervisory Authority (FINMA).

In Hong Kong, this material is distributed by JPMCB, Hong Kong branch. JPMCB, Hong Kong branch is regulated by the Hong Kong Monetary Authority and the Securities and Futures Commission of Hong Kong. In Hong Kong, we will cease to use your personal data for our marketing purposes without charge if you so request. In Singapore, this material is distributed by JPMCB, Singapore branch. JPMCB, Singapore branch is regulated by the Monetary Authority of Singapore. Dealing and advisory services and discretionary investment management services are provided to you by JPMCB, Hong Kong/Singapore branch (as notified to you). Banking and custody services are provided to you by JPMIB and/or JPMCB Singapore Branch. The contents of this document have not been reviewed by any regulatory authority in Hong Kong, Singapore or any other jurisdictions. You are advised to exercise caution in relation to this document. If you are in any doubt about any of the contents of this document, you should obtain independent professional advice.

With respect to countries in Latin America, the distribution of this material may be restricted in certain jurisdictions. Receipt of this material does not constitute an offer or solicitation to any person in any jurisdiction in which such offer or solicitation is not authorized or to any person to whom it would be unlawful to make such offer or solicitation. To the extent this content makes reference to a fund, the Fund may not be publicly offered in any Latin American country, without previous registration of such fund´s securities in compliance with the laws of the corresponding jurisdiction. Public Offering of any security, including the shares of the Fund, without previous registration at Brazilian Securities and Exchange Commission – CVM is completely prohibited. Some products or services contained in the materials might not be currently provided by the Brazilian and Mexican platforms.This material should not be duplicated or redistributed without our permission.