

The new bond portfolio: why YFYS is a game changer

The comprehensive Your Future, Your Super (YFYS) superannuation reforms recently introduced are reshaping the way superannuation funds invest.

At its centre is the YFYS annual performance test. It imposes stringent penalties on underperforming MySuper products, meaning funds will be closely monitoring a range of new underlying benchmarks.

It will also have significant implications for bond portfolios, according to [industry-wide research](#) conducted by NMG Consulting on behalf of J.P. Morgan Asset Management (JPMAM).

Allocations to fixed income sub-asset classes will now be marked against two much broader indices:

Description	Assumed index
Australian fixed interest	Bloomberg Ausbond Composite 0+ Yr Index (ticker: BACMO)
International fixed interest	Bloomberg Global Aggregate Index (ticker: LEGATRAH)

These broad-based benchmarks are not always a representative measure of fixed income sub-asset classes and can introduce meaningful tracking error risk. We see two primary consequences:

- 1) Super funds are likely to move their fixed income portfolios towards core fixed income strategies managed against the Bloomberg Global Aggregate Index rather than directly allocate to fixed income sub-sectors.
- 2) Investors will likely favour actively managed (rather than passive) core solutions, which have the flexibility to go overweight/underweight fixed income sub-sectors to take advantage of the most attractive opportunities.

We believe a core fixed income solution that is actively managed against the Bloomberg Global Aggregate is well placed to pass the stringent YFYS performance hurdle.

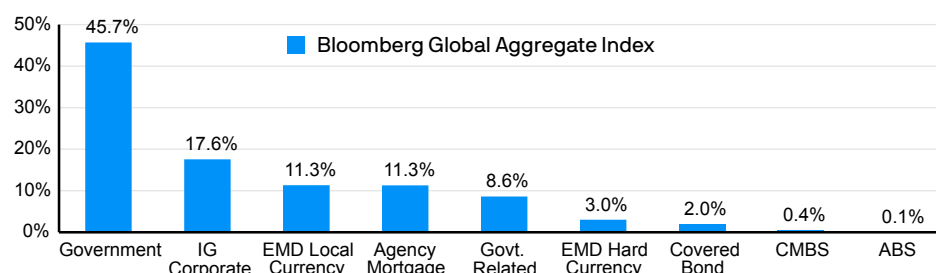
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The benefits of diversification¹

The Bloomberg Global Aggregate Index offers a wide opportunity set spanning government, corporate, government-related, emerging markets debt and securitised bond markets.

This diversity also stretches across regions, with exposure to more than 30 local currency markets. This diversification is important for managing volatility and identifying attractive return opportunities.

Global Aggregate benchmark offers diversified exposure to global fixed income (% market value)



For instance, the Bloomberg Global Aggregate Index has an approximate 8% exposure to China local bonds (as of March 2022), which provide a low correlation to developed market government bonds, opportunities for attractive yields and exhibit a counter-cyclicality to the direction of monetary policy in the rest of the world.

An active approach to take advantage of opportunities

We believe an active approach is needed to exploit these opportunities.

It allows an investment manager to generate returns through a variety of sources, including both bottom-up security selection and top-down sector allocation, while taking advantage of relative value opportunities by rotating between sectors.

As a result, investors can diversify their risk exposure across the broad investment universe while giving investment managers the flexibility to rotate risk within the sub-sectors they deem most attractive.

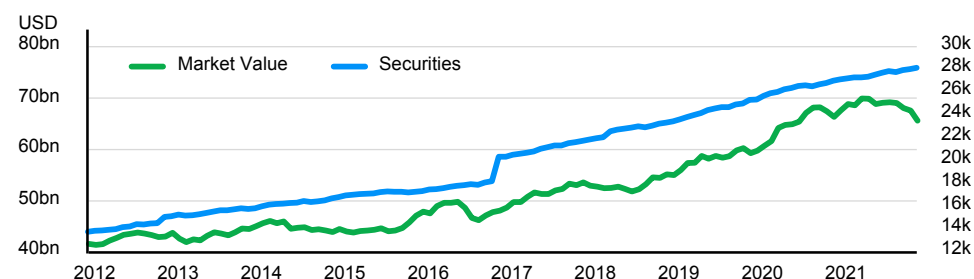
An active approach also allows managers to incorporate environmental, social and governance (ESG) factors into their investment decisions. This is an important element to manage volatility and takes into account investor preferences, which is likely absent from passive global aggregate strategies.

The importance of manager skill and resources

The Bloomberg Global Aggregate Index has grown by 57% in market value over the last 10 years (as of 31 March 2022). With over 28,000 securities in the index – an increase of more than 14,000 securities in the last decade – complexities in the fixed income market have increased.

Managers must have the capacity to comprehend the macroeconomic environment as well as assess the creditworthiness of each individual issuer in the portfolio in order to deliver alpha.

Breadth and complexity of bond market has increased over the past decade



Source: Bloomberg Global Aggregate index; J.P. Morgan Asset Management. As of 31 March 2022. Past performance is not indicative of current or future results.

Source: J.P. Morgan Asset Management. As on 31 March 2022. EMD: Emerging market debt; IG: Investment Grade; CMBS: Commercial Mortgage Backed Securities; ABS: Asset Backed Securities. Index composition is subject to change from time to time.

1. Diversification does not guarantee positive returns or eliminates risks of loss. Provided to illustrate Industry trends, not to be construed as offer, research or investment advice. Investments involve risks and are not similar or comparable to deposits. Not all investments are suitable for all investors. Risk management does not imply elimination of risks.

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The enduring benefits of core fixed income

An allocation to a core active fixed income strategy can provide the potential for both managing downside risks and positive returns in a variety of market environments.

Core fixed income returns have a low correlation to equities, and therefore act as a risk hedge in the context of an overall portfolio.

How a global aggregate solution can work

Within a core fixed income allocation, J.P. Morgan Asset Management's Global Aggregate Bond strategy can offer a combination of income, diversification and managed volatility.

J.P. Morgan Asset Management's Global Aggregate Bond strategy seeks to outperform the Bloomberg Global Aggregate Index by 0.75%-1.25% per annum², with a similar level of volatility.

Our dedicated and diverse Global Aggregate investment team spans three locations around the globe (London, Hong Kong, New York). The team is led by Myles Bradshaw, who has over 25 years of experience managing interest rate, credit, securitised, volatility and currency risks in global bond portfolios.³

In addition to the dedicated Global Aggregate team, the strategy leverages J.P. Morgan Asset Management's well-resourced fixed income investment platform. With 295 investors covering all sectors of the bond market, including 70 dedicated research analysts, we have the scale and in-house expertise to research every bond we invest in.

Our investment process combines our Global Aggregate Bond strategy portfolio managers' top-down macro views with sector specialists' bottom-up security selection, resulting in dynamic management of sector allocation, security selection, duration/yield curve, currency and hedging.

These multiple performance levers allow us to seek consistent long-term returns while limiting drawdowns as portfolio managers can rotate risk between sectors, taking advantage of relative value opportunities. Some examples of these levers include:

Diversification does not guarantee positive returns or eliminates risks of loss.

2. Targets and returns are indicative, may or may not come to pass. The manager seeks to achieve its objectives, there is no guarantee they will be met.

3. As of 04/2022 for investment team's details. There can be no assurance that professionals currently employees by JPMAM will continue to be employed by JPMAM or that past performance or success of such professionals serves as an indicator of their future performance or success.

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Investment grade corporate credit

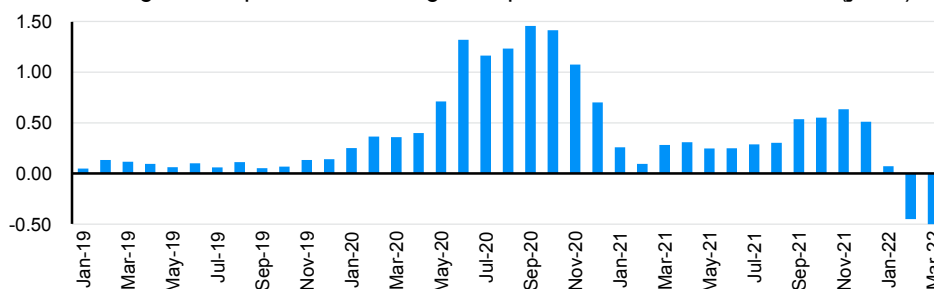
The March 2020 global pandemic rocked investment markets. The unprecedented fiscal and monetary policy easing in response also created opportunities for high quality bond managers.

The J.P. Morgan Global Aggregate Bond strategy portfolio managers established an overweight position to investment grade (IG) corporate credit in April, leveraging cheap valuations during the volatility to build high quality spread exposure.

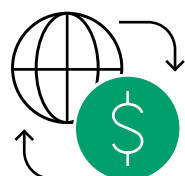
Spreads compressed amid the vaccine-driven recovery later in the year, causing the IG corporate credit exposure to contribute favorably to performance – it was the largest driver of the portfolio's positive returns in 2020.

Our portfolio managers then began trimming exposure towards the end of the year, taking partial profits as spreads compressed significantly.

Investment grade corporate credit weighted spread duration vs. benchmark (years)



Source: J.P. Morgan Asset Management. As on 31 March 2022.



Duration

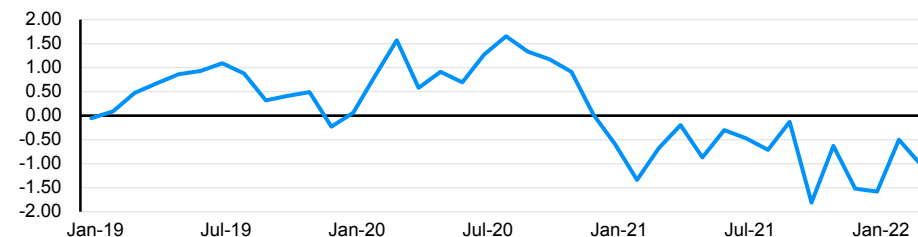
Portfolio managers can also dial up or down interest rate risk depending on the macro environment.

A recent example occurred when the J.P. Morgan Global Aggregate Bond strategy portfolio managers took an underweight duration position at the start of 2021.

As the volatility shifted from the credit market to the interest rate market towards the end of 2020, the portfolio managers began rotating some of the risk from spread sectors into duration. They established an underweight duration due to the strong growth and high inflation environment, which we expected to drive more hawkish central bank rhetoric.

This position boosted performance – duration was the largest driver of excess returns in 2021.

Portfolio duration vs. benchmark



Source: J.P. Morgan Asset Management. As on 31 March 2022.

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ESG

A formal assessment of the ESG profiles of the issuers in which we invest is key to managing portfolio risk and uncovering potential investment opportunities.

This process follows a consistent approach spanning three pillars: proprietary research, engagement and portfolio construction. We then implement a tailored approach by sector given the nuances of each market.

We have developed a number of tools and scoring frameworks, such as a 40-question ESG checklist for corporate bonds, country ESG rankings for both developed and emerging market sovereigns, and a systematic identification of ESG leaders and laggards in the securitised space.

Proven Track Record

An active approach aims to deliver a quantifiable long-term performance boost. The J.P. Morgan Global Aggregate Bond strategy's embedded risk management team plays a central role in our active process, working closely with the portfolio managers to develop individualised scenario analyses to identify positive investment opportunities and guard against downside risk.

The strategy's focus on seeking superior long term outcomes for investors through prudent processes and active risk management is demonstrated by:

- Over the last decade, the J.P. Morgan Global Aggregate Bond strategy has only experienced three quarters in which excess returns were lower than 50 basis points (bps), despite an environment of numerous risk events (such as the Euro debt crisis of 2011-2012, the taper tantrum in 2013, the oil price slump and deflation scare in 2016, and COVID-19 pandemic in 2020)
- Taking into account the YFYS hurdle, on an eight-year rolling basis the J.P. Morgan Global Aggregate Bond strategy (USD hedged) has outperformed the Bloomberg Global Aggregate Index by 95 bps (gross of fees)⁴. The strategy has been able to achieve more than double its alpha target of 100 bps over the past three years with stable tracking error.
- The J.P. Morgan Global Aggregate Bond strategy has produced information ratios greater than one over one year, three years and 10-year periods. As of 31 March 2022, our portfolio ranks in the 21st percentile over the past 1 year, 6th over past 3 years and 11th over past 5 years, according to the Morningstar Global Bond category.

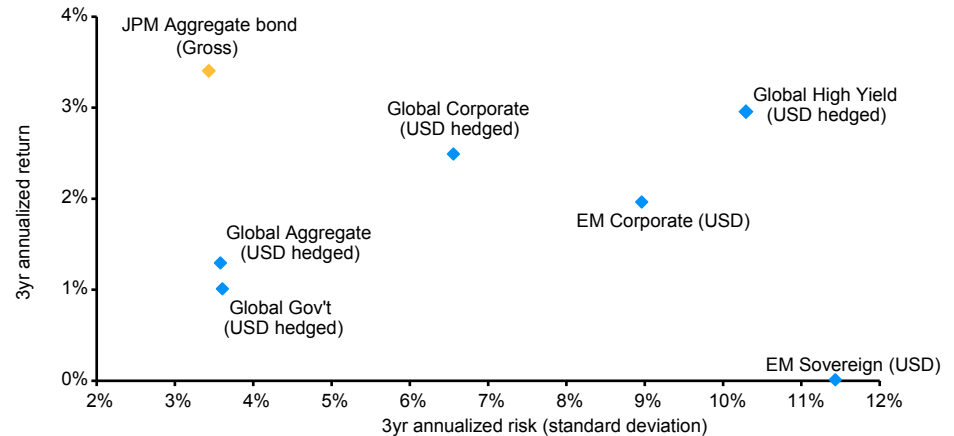
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4. As at 03/2022.

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The chart below shows the risk-return profile relative to the benchmark and the wider fixed income opportunity set.

Strong risk adjusted returns: 3yr risk/ return profile vs. key market indices



Source: J.P. Morgan Asset Management. Data as on 31 March 2022. © 2022 Morningstar, Inc. All rights reserved. Morningstar category: Global Bond – USD Hedged. Data as at 31 March 2022. Risk/return graph shown for past 3 years data; risk is represented by standard deviation. The information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied, adapted or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information, except where such damages or losses cannot be limited or excluded by law in your jurisdiction.

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Complementing An Active Core Solution

An active global aggregate solution as the core foundation of a fixed income allocation can be complemented by various satellite strategies. These extended sectors can help to fulfill some of the key objectives of a fixed income allocation, including income and diversification.

For instance, dedicated allocations to extended sectors such as high yield (HY) and emerging markets debt (EMD) can allow super funds to adjust the overall risk stance and boost the return potential of their overall fixed income allocation.

The combination of higher yields and lower interest rate sensitivity offered by these sectors versus traditional fixed income markets (such as investment grade corporate and developed market government bonds) can be compelling, particularly in a rising rate environment. For example, the global high yield index currently has a yield of 6.2% with a duration of four years, and the emerging market hard currency sovereign index yields 6.4% with a duration of seven years (as of 31 March 2022).

These higher yields reflect increased risk. Higher potential returns are expected to come with increased volatility, as well as higher default risk in the HY space and sovereign or currency risk in EMD.

However, these risks can be managed by a skilled and deeply resourced team of research analysts through prudent security selection and active management.

This approach of combining a core fixed income allocation with exposure to dedicated HY and EMD portfolios allows super funds to express their tactical views, dialing up risk exposure amid a positive outlook on the macroeconomic backdrop or reducing risk and tracking error against the Bloomberg Global Aggregate Index during more uncertain periods.

Diversification does not guarantee positive returns or eliminates risks of loss.

Conclusion

We believe the YFYS performance test will have a meaningful impact on super funds' fixed income portfolios.

The reform mandates that global fixed income allocations will be benchmarked against the Bloomberg Global Aggregate Index and impose strict penalties associated with failing the performance test.

This will drive higher allocations towards core fixed income and will indirectly incentivize investors to allocate to actively managed strategies that are managed against the Bloomberg Global Aggregate Index.

We believe our Global Aggregate strategy is well positioned for this emerging landscape as it aims to deliver diversified fixed income exposure while taking advantage of relative value opportunities identified by our deeply resourced team of investors, with multiple levers for generating performance in a risk-controlled manner.

This can act as a core solution which is complemented by satellite strategies, such as dedicated allocations to high yield and emerging market debt as a way to boost return potential, albeit by taking on higher risk.

Such an approach will allow super funds to express tactical views on those markets, while having their core fixed income allocation appropriately managed.

To learn more about our **Global Aggregate strategy**, or any of our other solutions, please contact your J.P. Morgan Asset Management Client Advisor.

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About J.P. Morgan Asset Management

J.P. Morgan Asset Management, with assets under management of USD\$2.7 trillion (as of December 31, 2021), is a global leader in investment management. J.P. Morgan Asset Management's clients include institutions, retail investors and high net worth individuals in every major market throughout the world. J.P. Morgan Asset Management offers global investment management in equities, fixed income, real estate, hedge funds, private equity and liquidity.

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All data referenced throughout this document, unless otherwise specified, is as at March 2022.
