

SHINING A LIGHT ON..... SLI STRATEGIC BOND FUND

At a glance

For many investors moving out of cash to purely equity based investments provides too much perceived risk.

There are two ways that investors can reduce the perceived risk, firstly to take one step up on the risk ladder to bonds, or secondly to blend bonds with equities.

Bonds are an attractive asset class for several reasons, firstly they are seen as low risk, and secondly they have delivered strong returns over the past ten years.

The difficulty is that much of the assessment is based on the past and it is very difficult to predict the future. This is important for several reasons.

Firstly we assume that because bonds have been less volatile and therefore less risky this will continue, and secondly we assume that because in the past performance has been strong it will continue. However, what is becoming increasingly clear is that the bull market for bonds is coming to an end. This means that returns will be lower and potentially volatility will increase.

We are already starting to see this where one of the weakest sectors last year was gilts and this year it has reversed that trend against all expectations. An additional factor is that different asset classes will perform differently within the bond market, so for example does an investor select investment grade, high yield, gilts etc.

Investors are becoming more aware of these challenges, as are investment houses that are bringing to market a raft of different investment solutions. This makes it incredibly hard for investors to choose the direction they should go.

One option for investors still wanting bond exposure but unsure where to go is a strategic bond fund – effectively this is a managed bond fund where the manager selects where to invest to gain the best returns. The most well-known fund in this area is the M&G Optimal Income Fund.

This fund can invest up to 20% in equities with the balance in bonds. Last year the holding in equities was around 12%, this has reduced down to below 5% this year. Some investors may be uncomfortable with the equity exposure because effectively they want a pure bond fund.

We recently met the manager of the SLI Strategic Bond Fund. We will touch briefly on the key differences and at the end we will compare performance. The SLI Fund was launched in 2009 and has returned 63.81% since launch, in comparison the M&G Fund has returned 94.80%.

On a pure basis the M&G Optimal Income Fund seems a better option. However, over three years the performance of the two funds is almost identical with the volatility on the SLI Fund being 4.22% compared to 5.19% on the M&G Fund.

So effectively the M&G Fund appears to have captured a lot more when the markets corrected in 2009 but during the more volatile period it actually hasn't added significant outperformance.

LWM Consultants Ltd

Additionally there remains a debate on whether the size of the M&G Fund will cause problems going forward. M&G and the fund manager argue that it will not cause problems but if there is a liquidity squeeze with bonds then there is the potential that this could dampen performance.

In summary the M&G and SLI Funds are different, however for investors looking for a pure actively managed bond fund with low volatility then the SLI Fund may be the right option. For those prepared to accept slightly more volatility and exposure to equities then the M&G Fund may appeal. Although performance appears stronger with M&G it is worth considering the more recent performance.

Who are the team behind the fund?

The fund was established in 2009 and Daniel McKernan took on responsibility for the fund at the end of 2013. He is well respected with a good long-term track record. Previously he had worked for SWIP, BlackRock, Aegon and Norwich Union.

Normally, we would be concerned that the manager has less than a year experience with the fund, however the team approach is to some extent more important than the person.

He is supported by Mark Munro who previously worked at SWIP, Sebastian Mackay who has been at Standard Life for 3 years and David Ennett who has been at Standard Life for 4 years.

Fund highlights?

In the discussion with the manager he explained that the fund is an actively managed bond fund. The essence is to keep risk under control and volatility low. By its very nature Daniel went onto explain that the fund will not be top of the tree but that is why people will buy into it because the returns will be steady and not lumpy.

He also believes that a bond fund should be a bond fund and should not be mixed with equities because investors may already have exposure to equities or simply don't want that exposure.

If investors buy into the concept of a pure bond fund then the next side is how Daniel approaches the investment. This is threefold:

1. Implement best ideas from across the bond markets
2. Construct a portfolio with good risk / reward balance
3. Generate consistent, attractive performance

Touching on some of these points, one of my concerns with the M&G Optimal Fund is that it always appears to be a one-man show. With SLI, the input across the different teams is immense. From a macro view point they have the feed from the SLI Global Absolute Return Strategy Team, they also have input from the equity team, government team, inflation team, EM debt team and credit teams.

Although final decisions are made by Daniel he works with three others across the bond spectrum to ensure all ideas are considered.

The collective approach reduces significantly one man risk and provides a more collective approach to the investment.

LWM Consultants Ltd

We discussed current positioning for the fund, and this gives a good idea of the active nature of the fund. Daniel has reduced exposure to high yield bonds as he feels these are overpriced.

Where he is currently finding value is in financials, emerging markets and some government bonds. Covering each of these briefly, in financials he is finding value with the likes of Lloyds and RBS.

Emerging markets was interesting as he feels that value exists but care has to be taken and it is on a stock by stock basis. Currently the fund has a 5% weighting to emerging markets using dollar and euro currency.

The final area of interest is in government bonds where the focus is on economies where interest rate increases are unlikely or are already priced in by the market (this includes the likes of Germany, Canada, Australia and Norway).

Effectively the fund is a blend of the best ideas filtered from across the business. It is actively managed with a global remit. There are similar funds which may have performed better but the volatility of the fund is important and this may appeal to some investors.

As with any bond fund there is uncertainty what will happen when QE comes to an end and rates start to rise. The fund is positioned to respond to that but they admit that liquidity could be a problem if there is a sudden exit from the fixed interest sector. The fund is much smaller than a lot of funds operating in this space and they should be better able to respond to this.

In summary this is a well-managed and well-supported global bond fund. It will not be top of the tree in terms of performance but volatility will be kept under control and this may appeal to investors who don't like to see large movements in the value of their assets. The risk, as is the same for any bond fund, is what will happen as the markets normalise and that is a consideration that potential investors have to take a view on.

Fund performance

Performance since launch is shown below vs the M&G Optimal Income Fund.

	2010	2011	2012	2013	2014	Since Launch
SLI Strategic Bond Fund	6.75%	4.85%	16.21%	6.24%	3.90%	63.81%
M&G Optimal Income Fund	9.29%	6.59%	13.75%	7.79%	4.92%	94.80%

You should note that past performance is not a reliable indicator of future returns and the value of your investments can fall as well as rise. The total return reflects performance without sales charges or the effects of taxation, but is adjusted to reflect all on-going fund expenses and assumes reinvestment of dividends and capital gains. If adjusted for sales charges and the effects of taxation, the performance quoted would be reduced. Returns are based on the US share class.

Conclusion

This is an actively managed bond fund with a good long-term track record. It does not aim to be the top fund and therefore will appeal to investors looking for low volatility with exposure to the bond market.

The source of information in this note has been provided by SLI and is correct as at October 2014. These are notes from meeting the fund manager or representative and should not be seen as a recommendation to purchase any fund mentioned. Any reference to shares is not a recommendation to buy or sell. Should you wish to make a decision based on these notes we cannot take responsibility for this and you should carry out your own research before making a decision. You should note that past performance is not a reliable indicator of future returns and the value of your investments can fall as well rise.