

## GLOBAL FIXED INCOME PROCESS

An investment process for global fixed income portfolios managed by David Roberts, Phil Milburn and Donald Phillips



### 1. Philosophy

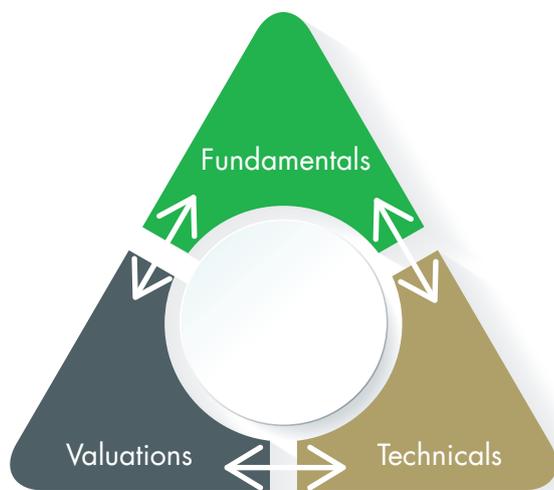
We believe fixed income markets are inefficient and there are myriad ways of adding value to investors' portfolios. The inefficiencies are caused by many market protagonists who are not price sensitive, ranging from the macroeconomic distortions caused by central banks to the idiosyncratic scenarios when companies need to raise debt finance and price accordingly.

The Liontrust Global Fixed Income investment process is designed to take advantage of these inefficiencies through a thorough understanding of the economic environment and detailed bottom up stock analysis. This approach recognises the circularity (or inconsistencies) in data, the nature of correlations between asset classes and the variation in inefficiencies through the cycle.

We seek good investments rather than buying expensive debt in good companies. This means market analysis must always be coupled with an examination of value. The timing of any investment should be finessed to optimise returns. For example, the occurrence of forced selling in the market is often a harbinger, or technical indicator, of a time to initiate buying a bond. We refer to optimising returns as we always consider attendant risks in any investment.

### 2. Process

Three key inputs: fundamentals, valuations and technicals.



We use the same framework to garner a thorough understanding of the economic environment and for bottom up stock analysis: fundamentals, valuations and technicals (FVT). These three factors are examined regardless of whether we are considering a duration position or an investment in a speculative grade rated company. Consistency of decision making is impossible without using the same inputs.

We examine a large range of global macroeconomic variables comprising both hard (official economic data) and soft data (forward looking activity surveys/indicators). This combination is used to challenge our macroeconomic view and ensure our central assumptions about growth, inflation and the economic cycle are still valid. Any topical issues, ranging from sovereign crises to commodity price fluctuations, can be reviewed within this context and their potential to have a meaningful impact suitably gauged.

The FVT framework is then applied to the main markets in which we invest. Fundamentals are crucial but cannot be viewed in isolation. Absolute and relative valuations are considered: is a bond or market cheap in its own right, and does it offer value against history or any other fixed income asset? Are you being compensated for default risk and is there a sufficient illiquidity premium in credit spreads?

Technicals comprise the third factor, and analysis here helps determine the timing of entry into and exiting of positions. We review and analyse sentiment and volatility indicators along with surveys showing investor positioning. Structural distortions, such as central bank quantitative easing, are also considered.

We then conduct a line-by-line review of each of our funds' investments. This ensures that each holding is still applicable given the prevailing macroeconomic backdrop and provides a valuable feedback loop to challenge our top down view. Additionally, this helps the cross-fertilisation of ideas across our funds both at the stock level and through the interpretation and extrapolation of any of our highest conviction investment ideas. For example, a strong view on interest rates can have meaningful ramifications for banks based in the respective jurisdiction.

If a riskier holding is no longer offering a meaningful upside, we will look to rotate the position into a new opportunity. Should significant new information arise, we will react quickly to either protect portfolios or take advantage of market dislocations.

**Three key sources of portfolio alpha: rates, allocation and selection.**

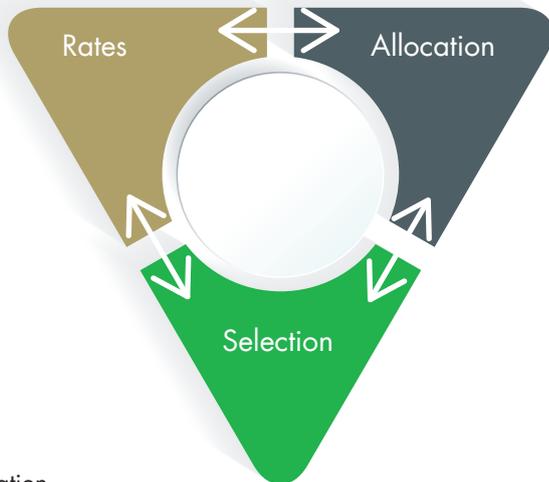
The three main drivers for fixed income portfolios are rates, allocation and selection. The three categories have numerous alpha sources underlying them, and we optimise portfolio positioning by adjusting these sources of risk and return. They can be used to target alpha, beta or risk management depending on a fund's mandate, as shown in the table on the reverse page.

#### Rates

Duration, the interest rate sensitivity of a bond or fund, is one of the biggest traditional drivers of fixed income performance. However, there are so many other levers that can be pulled to aid performance. Yield curve positioning is tremendously useful through the monetary cycle; frequently when short rates rise, longer dated bonds outperform their shorter dated cousins (the assumption is the central bank rate rise will reduce longer term growth). We can capture yield curve positions in a duration neutral fashion, thereby prioritising rates' alpha over beta. Cross market duration trades across developed economies' government bonds are a good alpha source.

As well as conventional fixed income securities, we can also invest in floating rate debt, which benefits when rates rise, and inflation linked securities. The difference between the conventional bond and the index linked bond's yield, the breakeven, is another potential performance source.

For core markets, the rates' positioning flows straight from the FVT framework. To examine cross market opportunities and yield curve opportunities, we use a quantitative screen. Fundamental and technical analysis is then married with this to evaluate whether the valuation anomaly can easily be used to capture some alpha.



**Allocation**

Economic conditions rarely hinder all parts of the fixed income universe. For example, areas with higher credit risk react positively to strong growth, whereas this is clearly a headwind for quality sovereign debt. We use quantitative screens, as well as our experience of managing through the cycle, to aid us in identifying opportunities.

**Selection**

In judging whether a company is an attractive long-term investment, we analyse the following factors, which we call our PRISM:

- Protections – operational and contractual, such as structure and covenants
- Risks – credit, business and market
- Interest cover, leverage and other key ratios
- Sustainability, of cash flows and environmental, social and governance (ESG) factors
- Motivations of management and shareholders

The operational analysis of an industry covers the competitive forces that a company faces. Does a company have a sustainable competitive advantage, are margins coming under pressure and will there be technological disruptors affecting the industry? Questions of this nature are ultimately seeking to understand whether the company

For a comprehensive list of common financial words and terms, see our glossary at: <https://www.liontrust.co.uk/benefits-of-investing/guide-financial-words-terms>

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will service its coupons and still be around to refinance its debt at maturity. Further reassurance can be garnered by reviewing the legal documentation surrounding any bond issue, which includes the seniority of the bond within the capital structure and any covenants that grant bondholders additional protections.

Investing in credit is essentially the business of pricing risk and so a large amount of time is dedicated to understanding the main risks facing a company or, indeed, sovereign issuer. The credibility of the investment story has to withstand the examination of historic numbers as we delve into the past financial performance of the issuer. Key ratios are considered, including leverage ratios such as net debt to EBITDA (earnings before interest, taxation, depreciation and amortisation) and interest coverage ratios (EBITDA/interest both before and after capital expenditures).

The sustainability of the business captures how these ratios will look in the future, and the modelling side of this can be thought of as expressing the verbiage around protections in financial projections. ESG drivers are also analysed as these help ascertain the company's attitude and the risks of any off balance sheet liabilities coming home to roost.

Finally, we like to walk in the shoes of the management and owners of the business. We consider the actions we would be most likely to take if we were in charge and ask whether shareholders are using bonds to finance expansion or leverage their equity returns. Grasping the motivations of the managers and owners of the business is a powerful way of checking if their interests are aligned with those of bondholders.

With the fundamental side of the work completed, we consider the valuations and technicals surrounding any bond issue, with the latter helping us in finessing the entry point.

The myriad maturities, currencies of issuance and differing seniorities can present opportunities as well. For example, frequently a corporate bond issuer's debt will offer a more attractive yield premium outside of its domestic bond market due to the reduced investor familiarity with the name.

As well as stock selection, the sub-sector weighting within a portfolio is also an alpha driver. Each cycle witnesses a different sector becoming stressed. Identifying the survivors within stressed sectors can be a massive boon for performance.

	Liontrust Strategic Bond Strategy	Liontrust Absolute Return Bond Strategy	Liontrust High Yield Bond Strategy
<b>Rates</b>	Alpha & Beta	Alpha focus	Risk reduction only
<b>Allocation</b>	Alpha & Beta	Alpha focus	Smaller alpha driver
<b>Selection</b>	Alpha & Beta	Alpha focus	Key alpha driver