

Fixed Income

Portfolio manager Q&A

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Q Now that markets look more normal again, where do you think are the best opportunities in global bonds, including the "plus" markets?

A I am enthusiastic about non-dollar securities. I do worry that the dollar might rebound temporarily if there is another period of fear and risk aversion, but I also think most of the heavier fundamental forces are pushing down on the dollar. That's actually helpful to the U.S. economy, but as an investment strategy, it leads me to look outside the U.S. I also tend to be drawn toward certain emerging market currencies, particularly the Asian currencies, which I think are undervalued. And we're beginning to see some signs that policymakers

may choose to allow currencies to move a little more freely as opposed to just stockpiling reserves.

Q How would you characterize the difference between what happened in emerging markets debt during this crisis versus what happened in the late 1990s?

A In this crisis, emerging markets were not the primary causal factor. They didn't start the mess, as they did in the late 1990s, but were pulled into the crisis by developments in the real economy, especially global trade. But this time they had better balance sheets and many countries had been running external surpluses for nearly a decade. In addition, they did not have maturity and currency mismatches in their external borrowing. The exceptions were a few countries in Eastern Europe, but even these were much less problematic compared to the past. In general, most countries had very substantial reserves to work with — and that put them in a better position to weather the storm. Despite these better fundamentals, there still lingered a mismatch between perception and reality, and emerging markets bond prices collapsed as broad market liquidity declined in the worst of the global credit crisis. This misperception persists to some

extent, which we view as a good investment opportunity. Emerging markets assets are a growing share of global bond and global bond-plus portfolios for me.

Q Do you find correlations among markets rising globally?

A Yes, there has been a substantial rise in correlations. Correlations tend to spike in periods of market stress, and then decline as markets stabilize. This has already happened to some extent with local bond markets, and to a lesser extent with currencies. Local bond markets are fundamentally still home-country investment universes. The most active investors are local investors. They're saving for their retirement or they're providing some sort of a long duration hedge against liabilities. And what they care about are domestic factors: the value of the currency, the level of domestic inflation, and the borrowing patterns of the local government or the corporate sector. They tend not to think about a universe of global opportunities, but rather local opportunities. Hence, over longer periods of time, bond markets are more independent, and, you could argue, they provide good diversification geographically.

Q Most investment managers are looking at the same bond markets. How do we at Capital do things differently?

A It is not that we as an investment manager have a superior ability to see the future or to always come to the right conclusion when everyone else is going to miss it. That would be hubris. The road to successful investment decision making is pretty much just hard work and commitment of resources. We feel that it is critically important to be self-sufficient in our research coverage. We want to have an informed opinion about all the securities and opportunities in which we would invest. We do consult with external experts, but to as large an extent as possible we don't want to rely on outside providers to give us the information that we need to develop those opinions and judgments. As a result, we have a lot of internal resources dedicated to proprietary research across a wide variety of sectors, including all parts of credit, government and securitized debt markets. We also do a lot of dedicated currency research, and there is a healthy amount of analysis that goes into broader geopolitical issues. But it is very much a process of working with the analysts and trying to understand the ideas they are generating. All of our analysts manage money, which offers a very important way for portfolio managers to understand what the analysts believe in, as we can see what they're doing in their own investment responsibilities.

Personally, I still do research. That's what I've done for more than 20 years and I enjoy the research process a great deal. I like to get my hands dirty in many of the investments in my own portfolio. I enjoy working with our analysts to develop investment ideas and to gain a better understanding of the risks and opportunities available in the market.

Q How do you work with other portfolio managers?

A The main advantage of our working together is that our investment styles are quite diverse and complementary. Some of us are gradualists, some of us move more abruptly. Some of us are more comfortable with a highly concentrated portfolio, some of us like to be more diversified. We complement one another, because over time we each find a way to do something good for the portfolio, but it is critical that we do not all do it the same way. And we know each other well: we often know where we're going and what our biases are. Over time, we have been able to achieve good outcomes independently through different means and different channels that, when you roll it up into one portfolio, most often results in a good outcome for the client. That is basically what the multiple manager system is designed to do.

Q What is the biggest risk or opportunity you see in the portfolio?

A Well, over the long run, the biggest risk for a bond investor is always going to be inflation. But the inflation risk, as I see it, is not an immediate threat. I am less worried about the kind of "printing money" phenomenon that leads to immediate inflation. I think that is highly unlikely until global economic activity improves dramatically. Even then, there would have to be a sequence of policy mistakes for inflation to become deeply entrenched.

The other major risk to bond markets is the position of fiscal balances and the borrowing needs of governments that have taken their deficits to extraordinary levels to get some stability in their economies, but as a result have raised their debt to

worrisome amounts as a percentage of GDP. As long as the private sector is not borrowing heavily and credit demand is weak, that's a sustainable situation. But if there is a change in credit demand from the real economy and rising private sector demand starts competing with government borrowing, you could have the classic crowding-out of private borrowers, a tightening of credit in markets, and a very significant rise in yields. I think that scenario is more likely to occur before inflation picks up, and it is the one I worry about more. It would result in rising yields and bond market price weakness. So there are implications for duration positioning, and also for currency adjustments.

Q How does currency exposure work its way into your investment decisions?

A I think of currency exposure as a component of the overall investment decision, but as a discrete investment choice, separate from the decision to own the bond. I look at a currency as an asset, and I try to understand where that asset value is likely to go: is it undervalued or overvalued and should that drive the decision, or are there other factors that I need to look at on the margin, such as politics, capital flows and balance of payments? There could be technical factors at work, but I do consider those in the bigger decision as well. Most often, it leads me to link the bond and the currency decisions. But sometimes I may come to a different conclusion, where the bond market decision takes one approach and the currency decision another. In those cases, we use hedging as a way to manage the currency risk. The emerging markets have also developed deep, functional hedging markets, and that was not true as recently as five years ago.

Q Do you expect capital flows to remain the dominant factor influencing currencies?

A Capital flows would absolutely remain the dominant factor, but capital flows are not exogenous. They are always traceable to trade balance behavior or relative changes in monetary policy, interest rate levels, or other macroeconomic policy choices. Capital flows are very often connected to foreign exchange policies and the decision by authorities to intervene or not intervene. The question is whether foreign exchange policies are ever going to behave in a way that lets capital flows freely exert pressure on currencies, or are they going to be resisted and offset? There is still a huge part of the world where capital flows are signaling that currencies ought to go up a lot, yet they do not because of the policy offsets and reserves that keep piling up. I don't think that will change, and governments will continue to intervene in some way. Instead of intervening 100%, or fully offsetting inflows with purchases, perhaps they will intervene at 90% and allow some movement. However, I doubt they will step back and allow most of the effects to pass through into the nominal currencies. In many countries, forex intervention is a rational policy that advances their self-interests, at least for the foreseeable future. Those factors almost always trump global political sensitivities.

Q How do you build those factors into your investment decision making?

A I have more exposure to the markets that I think will eventually see the

marginal change but haven't yet, and as a result, those currencies have not moved much. China is the best example; Singapore and Malaysia are others. The currencies have not moved a lot but the pressure is such that authorities may be forced to yield — and there is valuation support even if they adjust slowly. For a while these countries were letting their currencies appreciate, but that stopped in late 2007 and early 2008. It is a question of timing: at what point will divergent real economy fundamentals start to impact markets and correlations normally? I think it will be some time within the next six to 12 months.

Q Let's go back to the U.S. dollar. Is the weight of the fundamentals — the balance of payments — so huge that it has to weaken over the longer term?

A The factors working against the dollar are indeed primarily balance sheet issues: the financing of the debt and balance of payments. These problems are generally corrected by currencies moving enough and policies changing enough to trigger real-economy adjustments that eventually turn around the fundamentals. Having said that, there is a very good argument that the dollar has already depreciated a great deal and has reached the point where the foreign exchange fundamentals will start improving. It could be a multiyear process, or it could happen sooner and be quite orderly. That said, my strongest views are not against major developed market currencies. There is more mispricing in the emerging market currencies. But I cannot really argue that the dollar needs to drop a lot more against

the euro as it has already dropped a lot and is certainly no longer overvalued against most of the OECD currencies.

Q Do you manage mutual fund and institutional portfolios any differently?

A There is no difference in terms of the investment views I am trying to reflect. There are some guideline constraints, such as rating limits in institutional portfolios. Also, the cash flows can be lumpier in institutional portfolios. But there is no difference in the investment views I am expressing in both types of portfolios. ■

The Multiple Portfolio Manager System

Capital Guardian uses a multiple portfolio manager system that divides your portfolio into multiple segments. While an investment committee has oversight over the total portfolio, all segments are managed independently. This ensures that the portfolio holds only the strongest investment ideas of our portfolio managers and analysts.

By design, a range of investment styles and approaches are incorporated to make a well-diversified core portfolio. In this system differences of opinion are common, and the opinions expressed by an individual do not necessarily reflect the consensus of the team.

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