Investment update

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Stewart Cowley, Head of Fixed Income and manager of the Old Mutual Global Strategic Bond Fund

Stewart joined OMAM in June 2009 from Newton Investment Management where he held a similar role and managed the Newton International Bond Fund and BNY Mellon Global Bond Funds, both rated AAA by Standard & Poor's. He has more than 20 years' experience of global fixed income markets, having begun his career in 1987 as a broker before subsequently switching to fund management.

Low duration policy, not owning the euro, increasing inflation protection

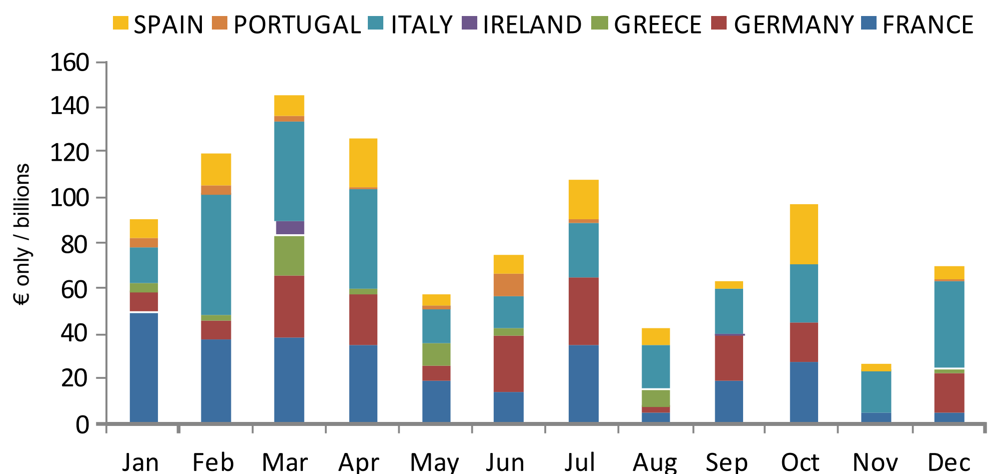
How to fail - repeat the past

The more we repeat our failures, the more we perfect them. Success in bond markets in 2012 will depend on breaking habits of failure and facing fundamental evidence

We owe to business commentator Sydney Finkelstein the identification of the Seven Habits of Spectacularly Unsuccessful People*. The seventh of these is: 'Stubbornly relying on what worked in the past'. Finkelstein explains that the warning sign is dogmatically repeating losing behaviours despite evidence for the need for change.

We've all been guilty to a certain degree of living in the past instead of learning from it, but we can adapt Finkelstein's observation to what we learnt – or failed to learn – in 2011. First of all the politicisation of financial markets has made them inherently unpredictable. This is a big change from the past. We simply don't know what is coming out of left field in Europe from one day to the next. To pretend anything else is foolish. There was a day when you could look at a bunch of economic statistics and charts and work out, with reasonable accuracy, what a country's interest rates, bonds and currency were going to do over time. Those days have gone. It's the reason we don't own the euro in our global bond funds – we just don't know what will happen to it. Greek officials are openly discussing the possibility that Greece will leave the euro in 2012.

Figure 1: Selected Eurozone redemption profiles 2012



Source: Bloomberg.

From a bond perspective the funding pattern in Europe (and globally) is extraordinarily heavy this year and a slip at one of the auctions could send the dominoes falling. March in particular in Europe is a potential trigger point (see Figure 1). Will this be good or bad for the

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euro? We don't know. But we do know the gains from guessing a positive result correctly will be much less than the cost of getting it wrong. Metaphorically, duration management has become like running into the middle of the motorway to pick up pennies.

It seems fruitless to keep harping on about how bad growth prospects are. In the face of 'The Incredible Shrinking Financial System', where banks are reducing lending and consumers and governments are reducing borrowing, we know there is little prospect of a swift return to the past. We should get over it – there are no quick fixes. In that sense government bond yields have already gotten the message. They are low and negative in real terms. Their only meaningful value lies in offering a place to hide your money at moments of stress. The good times for government bonds have gone. Instead of being 'fundamentally long' we prefer to play the markets with a low duration (with the facility to create a negative duration), and the possibility of occasional tactical longs. Again, the costs of getting it wrong outweigh the benefits of being correct.

Finally, there appears a deep and abiding desire, despite all the evidence, to expect that inflation will fall back to some ultra-low level. Our own Bank of England for instance has once more predicted that inflation will fall from 5% down to 2% this year, mainly because of tax increases dropping out of the equation and the lack of increases in real wages. However, with energy and commodity indices on the rise again (why has there not been more written about the 35% rise in the oil price since September?) and the inflationary consequences of the 2012 Olympics (more on this another time) it is more than likely that inflation targets will be exceeded. Expecting that negative output gaps or historical Phillips Curves will deliver low inflation is an attempt to replicate the experiences of the past. It ignores the new dynamic of a global war for resources that is being fought out through the medium of those with ample cash (such as the Chinese) buying what they want at any price. Inflation assumptions built into the index-linked markets of around 2% are well below the probable level of inflation of between 3% and 5% going forwards, and for those reasons we have increased the inflation protection in the Old Mutual Global Strategic Bond Fund to nearly 15%.

This year is going to be hard. Spending too much time thinking about the future leads people to ignore the evidence of the present. Given what we have learned from 2011 and what we now know, it would be to feed the seventh habit of spectacularly failing fund managers not to heed those messages.

**Why Smart Executives Fail, Sydney Finkelstein, Portfolio Hardcover, 2003*

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