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Rising Interest Rates: A JPMorgan Bond Pro Gets Ready

By Reshma Kapadia

William Eigen III, manager of the $21 billion JPMorgan Strategic Income Opportunities fund, often spends his weekends at one of the three auto-repair shops he partly owns in the Boston area. Tinkering with cars has been a passion ever since Eigen bought his first muscle car at the age of 15. Besides, he says, the shops offer a front-row seat on the U.S. economy. Right now, he’s seeing bullish signs: People are bringing their vehicles in on schedule for maintenance, rather than deferring it, and they’re paying up for quality parts.

That’s one reason why Eigen thinks bond investors could be in for some real pain as the Federal Reserve gets closer to raising short-term interest rates, ending a 33-year bond bull market. A strengthening economy gives the Fed more room for hikes, and rising rates mean trouble for bond values.

With 25 years of experience in credit markets, including running a multisector bond fund at Fidelity, Eigen now holds hefty amounts of cash and is carrying out some careful hedging strategies.

The Strategic Income Opportunities fund (ticker: JSOAX) has returned an average 3% annually over the past five years, putting it in the middle of Morningstar’s nontraditional bond category. But Eigen takes issue with that category, a hodgepodge of funds. He sees Strategic Opportunities as an “absolute return” fund that makes money, regardless of how broad bond markets fare. He targets a return one to eight percentage points better than cash, now meaning better than zero, over any 12- to 18-month period, and with less daily volatility than the broader bond market. We talked with Eigen via telephone from his Boston office.

Barron’s: Let’s start with the economy. What’s the view from the grease pits?

Eigen: We are seeing both commercial and retail customers coming in for on-time maintenance and repairs, and even doing upgrades -- for example, paying extra for better brake pads and rotors and doing extra work that doesn’t necessarily need to be done right away. We’re seeing
increasing requests for mechanical restorations on vintage cars, and that is definitely a sign of increased spending, disposable income, and overall economic health.

*Sounds like you have your own real-time economic indicator.*

One of the repair shops I have an interest in is in the middle of an industrial park. The minute the economy turns, the shop feels it. For instance, what does it tell me when I suddenly see maintenance getting deferred indefinitely for a fleet of commercial delivery trucks, or a local landscaping company that’s suddenly sporting a brand new line of trucks?

Based on the activity we are seeing now, the economy is doing pretty darn well. All the other data -- inflation, retail sales, and even the jobs number -- have been way above expectations and support economic growth at a 3% handle.

*Does that mean that the Federal Reserve will raise rates before the year is over?*

I hope so. They should. Every self-imposed hurdle the Fed has set to raise rates has been surpassed, but they keep moving the goal post. That isn’t healthy. It gets people addicted. Investors realize the Fed has had the keg flowing for years and just ran out of beer, so everyone’s running to the bar that’s open until after 1 a.m. -- the European Central Bank. They will get drunk there until those kegs run out, and that’s not going to end well. If the Fed lifts off in September, as we think it should, that could spell problems for the bond market.

*Has the market priced in a rate hike with the recent bond volatility?*

No. When a rate hike finally occurs, investors’ reactions will not be favorable to fixed income as a whole. With coupon rates so low, the losses can multiply quickly. People may also start to price in too many future rate hikes, creating more volatility.

*So, what is a bond investor to do?*

Get diversified. I can own bonds, short securities, or focus on relative-value trades [buying one currency and selling another or buying one security and shorting another.] We manage risk by testing our portfolio against scenarios that may be plausible over the next six to 24 months, to be sure we can generate positive returns in any of those.

*Are you seeing many opportunities?*

On a scale of 1 to 10, I would describe the opportunity set as about 4.5. Right now, many of the opportunities are in areas not many play in or that are less liquid and require specialized knowledge, like direct lending in the commercial real estate market, which is about 3% of the fund’s assets. Within insurance-linked or catastrophe bonds, we have found some niche areas. High-yield bonds are still reasonable, but you have to be careful.

*You sometimes hold a lot of cash -- as much as 80% in 2008. Why?*
I wait until the opportunity set is good enough. I am not going to roll a die and put investors’ money in essentially a coin-flip trade on the direction of interest rates and then hope the market reacts rationally, which it didn’t last year.

What do you say to those who don’t want to pay managers to hold cash?

You know what I say: “Why did you pay your bond manager 0.90% to lose you 3%?” The cash is a substitute for things I don’t want to invest in because I’m afraid they are going to lose money.

Your cash levels have fallen to 37% from 65% last year. What have you been buying?

The cue to put money to work is when we get lots of volatility and things get mispriced. About this time last year, I was actively cutting our high-yield exposure to about 18% from 40% and increasing cash because spreads got extremely tight, with high-yield debt trading at just 3.5 percentage points over Treasuries -- a level where I do not want to own them.

But in the big selloff late last year, especially among energy-related securities, we brought high-yield back up to about a third of assets, buying some energy-related bonds and Venezuelan credit default swaps, which were trading at 33 cents on the dollar. If you make anything cheap enough, I will buy it.

What are you shorting?

We have a couple of short positions in the belly of the curve, or two- to five-year bonds -- positions that would do well if rates rose. But our key shorts are protective, and they hedge against our high-yield positions, which we like, but are nervous could be hit by volatility. We are hedging about a third of our high-yield exposure with short positions in dollar-denominated emerging-market debt.
Why emerging-market debt?

It tends to go down when equities fall. It’s also very vulnerable and seems to weaken every time the Fed decides to put a rate rise on the table.

The bond market’s volatility has been striking. Are there some technical factors behind it?

Since 2008-09, dealers have pulled back from market-making activities. As a result, dealer inventories of corporate bonds are at an all-time low right now, as big banks face regulatory pressures on what they can do. This creates a liquidity “conflict” as exchange-traded fund inflows and outflows are highly correlated to how an asset class is performing.

So, the banks and other market makers just aren’t the stabilizers they used to be.

Yes. The top five corporate-bond ETFs have much more in assets under management than the inventory available at all sell-side firms for bonds. This pattern, which is something the markets haven’t had to contend with before, exacerbates volatility episodes. It also creates opportunities for those with cash, who can put that money to work when the markets are craving it.

Should something be done about the ETFs?

The only axe I have to grind with ETFs are with those that target the least liquid areas of the market, like emerging-market debt, high-yield, and bank loans, and that offer second-by-second liquidity. For example, tens of billions of dollars have poured into high-yield exchange-traded funds granting investors the option to trade the ETF by the second, but the underlying securities sometimes trade by appointment only, or take 10 to 30 days to settle. That creates a mismatch.
As a result, ETFs are going to suck liquidity out of the systems during volatile times, instead of being a source of it.

*How does that end?*

You have all this debate about flash crashes and questions about why high-yield bonds fell 3% in a week in December. ETFs are contributing to this. The minute that people lose money in high-yield, they will start selling, and the sell-side is not there to help on the other side of the trade. As a result, sellers need to talk to people like me to see if I want to use my cash to buy these securities. My answer likely will be that it’s going to have to go a lot lower, which can exacerbate the volatility. People think we are done with flash crashes. It’s going to get worse.

*Where does this leave the individual investor?*

Fixed income is 40% of investors’ portfolios, and they spend 1% of their time looking at it. Over the next decade, that’s going to change. People are going to wish they had paid more attention. It’s kind of like the maintenance on your car. As you are going down I-95 and the engine blows up, you wish you had given it those oil changes and replaced the belt along the way.

*What maintenance should investors be doing?*

It’s not that you should run and get out of bonds. Just get more diversified. Most folks own “traditional” bond funds that target benchmarks with a high degree of interest-rate sensitivity or are otherwise fully invested on the long side.

*That sounds like a pitch the industry has been making with the launch of nontraditional bond funds, like yours.*

But they aren’t all the same; many can only go long. If a fund isn’t getting returns from a combination of being long, relative-value trades, and hedges deployed at all times, then they are not addressing the problem. Shorting is uncomfortable. It is often a money-losing proposition because you are paying for the opportunity to do it and you are wrong two out of three times. But you have to do it. It’s like owning a huge house with homeowners insurance. The same goes for holding cash, because I doubt any manager would say this is the best investing climate for bonds they have ever seen.

*What is your boldest call right now?*

Taking no interest-rate exposure. And holding cash, which puts you in the driver’s seat when everyone is freaking out.

*Thanks, Bill.*

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