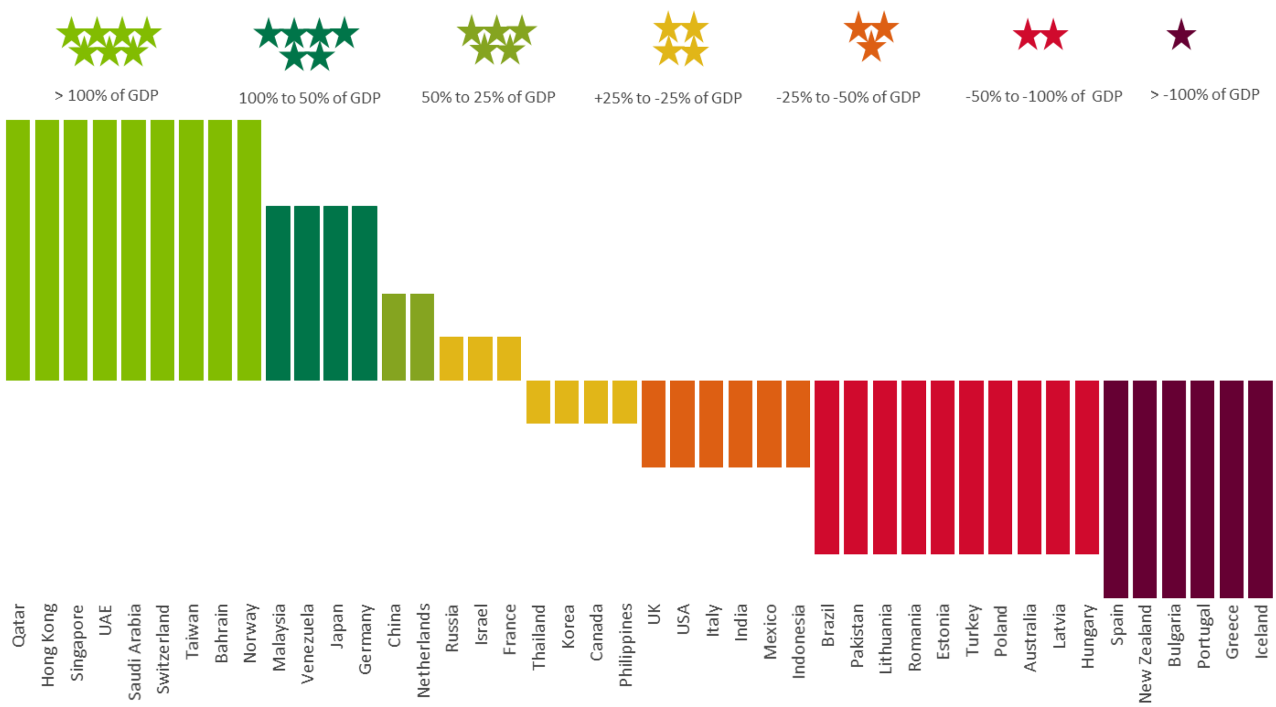
Stratton Street's Net Foreign Asset (NFA) Analysis

For more than 30 years, a combination of receding inflation and increasing leverage has created an extraordinary bull market for bonds that now is coming to a close. Traditional fixed income investors can no longer expect a rising tide of new issuance, low inflation and strong economic growth to keep debtors afloat. A new era of fixed income investment is unfolding that will require more active management to find value in an environment of low yields. Central bank intervention raises the dual spectres of illiquid markets and overvalued asset prices as carry trades and central bank purchases distort prices. New metrics are needed not only for identifying value but also for sorting out vulnerable borrowers from those with a high probability of weathering the new environment of low growth and low inflation.

Stratton Street invests in bonds based on fundamental credit assessment. Countries are screened by their ability to repay debt, using Stratton Street's net foreign assets (NFA) model, and then credits are evaluated based on value for money and fundamentals of the credit. We see this as a return to fundamentals of credit analysis for fixed income, rather than the indexed approach used by the majority of other investment houses.

Investing in fixed income based on index weights simply means having to buy more of a country or company's debt as it becomes more indebted. Stratton Street first screens out the countries that are dangerously indebted, so have never invested in Greece, Spain, Portugal or Ireland for example. Instead we invest in the wealthy countries that in net terms are creditors internationally, not debtors. These countries include Germany, China, Norway, the Netherlands, United Arab Emirates and South Korea. Based on the NFA model and then using the bond fundamentals and value for money, some examples of positions held in 2015 were PEMEX 5.5% 2044, of Mexico, and Codelco 4.5% 2023, in Chile. On a relative value basis we believe Brazil is currently expensive, and Tesco 6% 2029, in the UK, although meeting the country NFA criteria, is expensive so this is not currently held.



Source: Stratton Street Capital LLP calculations (2015) and extended version of the External Wealth of Nations Mark II database developed by Lane and Milesi-Ferretti

Emerging countries which are funded for long periods of time largely with short term debt are particularly vulnerable. Examples are countries like Turkey which has run a large current account deficit for many years, accumulating large external debts. These debts need to be funded and rolled over at maturity; exposing the country to large risks should investors lose confidence. This contrast's to many Asian countries, such as China and Malaysia that have run surpluses, and in net terms are creditors, so do not have to worry about finding short term funding. They are free to use the assets accumulated to invest strategically abroad. No country has ever defaulted on its debt while it was a net creditor, while those that have defaulted were indebted countries.

Added to this is the fact bond indices are constructed using the amount of securities outstanding and therefore gives a disproportionately high weight to the most indebted companies and countries. As countries and companies become more indebted, their weight in these indices tends to rise. Left unchecked, this would result in significant defaults in portfolios of bond investors who track indices closely. However, this effect ought to be mitigated if rating agencies were to downgrade countries well in advance of default, giving investors time to adjust their portfolios accordingly. However, the example of Greece illustrates that rating agencies have been slow to adjust ratings as economic fundamentals deteriorate. In early 2009, Greece was rated A1 by Moody's and A- by Standard & Poor's. Based on a long series of historical data, such a rating implies a probability of default of considerably less than one percent within three years.

However, by early 2009, Greece had amassed debts to foreigners of well in excess of 100% of GDP, a level that would suggest a far higher probability of default than that implied by the assets. Valuation effects will alter the magnitude of the assets or liabilities but they rarely cause a country to move from a net creditor to a net debtor.

The chart on page one shows the net foreign asset positions for a number of countries expressed as a proportion of GDP. The creditors are on the left and the debtors are on the right. From this chart we can see that Qatar is one of the wealthiest countries in the world (with net foreign assets of 263% of GDP) and Greece is one of the poorest (with net foreign liabilities estimated to be at 147% of GDP) in the year immediately prior to Greece's default. Note too, that the estimates for Portugal and Spain show net foreign liabilities of in excess of 100% of GDP.

By definition, a country that runs a current account deficit has to finance this by borrowing from abroad. This is due to the fact that the capital account and current account must always sum to zero. Conversely, countries that run current account surpluses are forced to invest abroad in order to maintain this accounting identity.

The above results have potentially alarming implications for bond investors who closely follow bond indices. With the indices constructed to give the biggest weighting to the most indebted countries, such an approach will expose an investor to a disproportionately high number of defaults and downgrades during a deleveraging cycle. Unfortunately, sovereign credit ratings have also been of little use to investors in screening out potential default candidates.
For life cycle investors this is equally alarming. Life cycle investors try to reduce the risk of a portfolio as retirement approaches typically reducing equity exposure in favour of bonds. However any investor approaching retirement who switched into bonds that subsequently defaulted would suffer a significant loss of capital with limited time to recover those losses.

In a world of low yields and deleveraging of financial institutions, it is likely to be especially important to avoid losers. The first priority is to avoid credit events, but we are also likely to see credit quality deteriorate as long as central banks continue to run negative real policy rates because conditions encourage a mentality of 'deny and refi'' rather than one that focuses on a more judicious use of leverage. Implicit or explicit use of bond indices as an investment metric assures that investors will own an increasing amount of bonds issued by 'debt deniers' as opposed to those of cautious borrowers who afford to repay. A closer analysis of country's net foreign assets has proven to be a good way of sorting the winners and losers and should continue to do so in an era of low yields.

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