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Threadneedle Dynamic Real Return Fund: a focus on quality

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Markets have been on a rollercoaster journey this year with the onset of the global coronavirus pandemic, delivering significant falls in equity and corporate fixed income markets. Yet the most recent news on the coronavirus has been incrementally positive, with the level of new infections and death rates looking to have peaked globally, in turn prompting risk markets to recover some of their losses through April.

The fiscal and monetary response to the pandemic has been mind-boggling in terms of the magnitude and speed of implementation, with the aim of ensuring fixed income markets continue to function and economies can try to get back to some level of normality when we slowly exit lockdowns, as we are seeing in many countries across Europe and Asia. We are indeed living in very volatile and fluid times.

So what has changed?

Reflective of these very volatile times we have made a number of portfolio changes within the Threadneedle Dynamic Real Return Fund, both to the way we are accessing certain investments and the style of assets we are exposing the portfolio to.

At the end of March 2020, we held 20.2% of NAV in equity futures, compared to 12.8% at the end of February. Not only is this a significant increase over a month but is also the highest allocation to futures that we have held in the Fund since its inception back in June 2013. With some of the largest intra-day moves in asset prices occurring in March, holding futures felt like the prudent thing to do. Firstly, we wanted the ability to build or cut positions quickly and, secondly, holding periods can be considerably shorter and therefore we wanted to avoid being overly exposed to concentrated stock holdings where an individual stock can be the main determiner of returns.

Quality exposure

The second key change we have made is to increase the Fund's exposure to quality, in both equities and fixed income.

Within equities, one demonstrable difference has been the creation of a new global equity sleeve. Once again this is something new for the Fund which, since its inception, has targeted a regional approach rather than a global approach. This sleeve, managed by our global equity colleagues, focuses on investing in companies with high returns on invested capital, recurring cash flows and strong balance sheets. These are typically capital-light businesses, with a strong competitive advantage that allows them to sustain those returns over time and deliver growth, even in this highly uncertain environment.

Since the global financial crisis quality has performed well with compounding businesses leading the charge. The structure of these businesses tends to mean they outperform in bear markets, with asset-light business models being easier to navigate through downturns, allowing successful companies to sustain high returns. This type of strategy should perform well in absolute terms over all types of recovery, but we believe will do better if the economic recovery is drawn out over a longer period – our base case.

We have funded this sleeve primarily through the reduction of some of the aforementioned futures positions – the US, UK and Japan – whose aggregate allocation fell by around 7.9% during the month of April. We also trimmed some of our internal fund allocation as well, in Europe ex-UK and Japan, meaning that the overall reduction to regional equities in April has been in the region of 10%, while adding 7.5% to the global sleeve.

So a net reduction in the overall equity, though as mentioned we have also been increasing our quality exposure within fixed income, and to that end have added to our corporate investment grade exposure.

Investment grade credit exposure

As long-term investors will know we have long favoured shorter-term investment grade as a way to provide protection to the portfolio and bring down overall volatility. However, the recent increase has been through longer-duration credit, with an average duration of around seven years.

In this environment, we were looking to take advantage of potential spread tightening which will deliver more price return at longer durations, amid a background of appealing valuations as global investment grade spreads moved from being slightly expensive to 3 standard deviations cheap. Alongside the aforementioned central bank support, this valuation case led us to build a 4% allocation in the fund over the month.

All of these changes have meant that the overall risk within the portfolio has remained within the second-highest “Favour” quintile, to which we moved in March. But, the changes mean we now have a higher proportion of assets with greater levels of risk premia (combined equities and corporate fixed income assets), and within equities we have a more concentrated stock approach using this global sleeve rather than a higher proportion to a broad market.

However, things remain fluid and positions change as new information emerges.

Source: Columbia Threadneedle Investments, all data as at 29 April 2020, unless otherwise specified.

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