



Orthogonal Investments Bond fund commentary for the quarter ended 30 September 2010

The All Bond Index returned a handy 8.04% for the quarter. The Orthogonal Investments GIPS composite fared slightly better. Since inception of bond management at Orthogonal on 31st August 2007, our composite has beaten the All Bond Index by an annualised 1.91%.

In August, we achieved our maiden three year bond track record and were rather pleased to learn that we were first in South Africa. We never had any particularly strong months: in bond management, the tortoise beats the hare. We'd like to take this opportunity to thank all clients for your support.

Some bond trivia:

The ALBI's 8.04% return for the quarter and 14.11% in the nine months year to date seem like great returns, but they hardly scratch at the surface of the record books. We discard all bond data prior to late 1989 (due to prescribed assets and monetary policy that was anything but independent). Since then, this period's rolling three month return ranks only 39th out of 247 and the rolling nine months rank only 99th out of 241. Adjusted for inflation, these rankings improve to 33rd and 70th respectively.

- The best 3 month return was 21.60%, to November 1998 (soon after the worst 3 month return).
- The best 9 month return was 36.89%, to May 1999.
- The best ever single month return of 11.38% was in September 1998, the very month after the worst ever single month return of -14.43%, occasioned by contagion from the Asian crisis.

Valuation

Let's start with a fairly chilling graph: two year US Treasury bond yields:





It was easier to understand the period of a few hours in December 2008 when 3 month Treasury bills traded at *minus* 0.03%. At the time, there was mayhem in financial markets and strange rules compelled various institutions to hold certain qualifying assets at any price, or risk the wrath of the regulator. But fear of the regulators has subsided, so what induces anyone to buy a 2 year bond yielding 0.41%? The easy answer is expectations of deflation, but the jury is very much out on that. In addition, notwithstanding low 10 year yields of 2.50%, the US yield curve is actually very steep by historical standards. (As an aside, if incorrectly plotted as a ratio rather than a difference, the yield curve steepness is off the chart). So, there is an inconsistency of expectations within the bond market (never mind the more talked about apparent inconsistency between equity and bond market expectations).

A brief period of virtually zero percent short rates coupled with a “steep” yield curve up to about 2% is not a world first – it happened in Japan 8 years ago. It has been unwise ever since to bet against that being a prolonged event!

So, it does not seem to us very wise to currently bet against a sudden reversal in Treasury bonds. It is a very liquid and supposedly highly efficient market, after all. Accordingly, it does not seem too wise to bet heavily against South African bonds either. The persistent strength of the rand, leading to low CPI inflation, plus a fairly stable sovereign risk premium does not add up to a sudden bear market in bonds. Also, convexity increases with lower yields! And yet, we are the first to acknowledge the propensity of the rand to surprise violently on the downside.

Strategy

Our strategy for now is to maintain a modestly short duration position (over the past 21 months, we have steadily decreased the extent of the short duration position, and it is now just 0.25 lower than the ALBI). This probably means less outperformance in the short term, until we identify another fundamental opportunity to take a significant active duration position.

Meanwhile, our bond fund’s weighted average yield to maturity remains comfortably above that of the ALBI. There is clear evidence that South African corporate spreads have begun to narrow (somewhat later than their European and American counterparts and later than the recovery in domestic equities). The good news is that we anticipate further gentle narrowing of spreads, and the absolute level should still be enough to provide moderate outperformance.

Rowan Williams-Short

CIO - Orthogonal Investments