No Easy Answers

In this issue of Ivy Global Bond Perspectives, we discuss several issues with which investors are grappling. We begin with a review of the Ivy Global Bond Fund, its philosophy, and strategy.

Here are the important points that current and potential investors in the Ivy Global Bond Fund should know.

Fund Philosophy

We believe there are two keys to successful long-term performance: income generation, and preservation of capital. We call this reward-to-risk management. We implement this philosophy through thorough credit research, conservative duration management, and diversification. The Fund’s flexibility is key to this approach.

Fund Flexibility

The Ivy Global Bond Fund’s older sibling (the Waddell & Reed Advisors Global Bond Fund) was introduced in 2000 and was intentionally structured with a lot of flexibility. The Ivy Global Bond Fund was created in 2008 and has the same objectives as the Advisors Global Bond fund. Since the beginning of the millennium, there have been many changes in bond and equity markets, in investable opportunities, in the type and number of investors, in the type and availability of investment funds, and in the economic and market environments. Given the uncertainty of the investment world, having flexibility is critical to providing investors with an appropriate risk-adjusted reward in terms of current income and reduced net asset value (NAV) volatility. Without flexibility, it is extremely difficult for portfolio managers to prepare for market tumult or to take advantage of market opportunities.

The key elements of the flexibility of the Ivy Global Bond Fund are as follows:

- No geographic constraint — Global means the Fund may invest in both U.S. and non-U.S. securities. Investments internationally may be in developed or emerging markets.
- No sector constraint — The Fund may invest in corporate bonds, government bonds, mortgage-backed securities, convertible bonds, and common and preferred equities.
- The Fund’s primary focus is on corporate bonds globally. We believe this focus strengthens the Fund’s ability to generate decent income while managing risk.
- No quality constraint — The Fund may invest in any quality, from AAA to below investment grade (high yield) bonds.
- Currency exposure — The Fund may alter its currency exposure from 0% to 100% U.S. dollar.

The Fund’s duration, and what happens when interest rates begin to rise

The short duration of the Fund (2.64 years at 12/31/12) relative to its peers and its benchmark (Barclays Capital Multiverse Index) is a reflection of the philosophy of the Fund. A short duration helps to preserve capital. Shorter average maturities on bonds mean better visibility on corporate balance sheet strength and cash flows because we are not having to make projections about performance beyond the next few years. Importantly, we are near the bottom of a secular decline in interest rates. Although we’re not forecasting an immediate rise in rates — and barring a backslide into recession and deflation — we do expect rates to gradually rise once the economy gains some traction over the next few years. If interest rates rise, maintaining a short duration for the foreseeable future seems to be a prudent course of action. Furthermore, due to the tremendous uncertainty that exists today, we are keeping an ample amount of liquidity in the Fund in the form of U.S. Treasuries and cash. Therefore, if and when interest rates begin to rise, the short duration and ample liquidity of the Fund will not only mitigate the NAV impact, but will allow us to more quickly re-invest funds at higher rates.

Emerging Market Exposure

As of 12/31/12, the Fund had 62% of its assets in emerging market bonds. The biggest exposures are in Latin America (29%), Asia (15%), and Eastern Europe (10%). Our three largest emerging market holdings are Bladex (2.3%), VTB Bank (2.1%), and Globo Comunicacao (1.6%).

Bladex is a multinational lender in Latin America. Its primary business is to provide short-term U.S. dollar loans to banks which then on-lend to Latin American corporations and quasi-governmental entities in order to support trade finance. Bladex is rated BBB by Standard & Poor’s.

VTB Bank is a commercial bank in Russia, primarily owned by the government. VTB offers all types of loans, takes deposits, and offers investment banking services. The debt is rated Ba1 by Moody’s.

Globo is the dominant media company in Brazil. The company’s services include broadcasting, cable and internet services, music, and magazine publishing. The debt is rated Baa2 by Moody’s and BBB by Standard & Poor’s.

We’ll discuss in greater detail the rationale for our emerging market exposure later in this report.
Our Worldview for 2013

In summary, our outlook remains the same: global growth will remain at a low level for an extended period of time. We continue to feel the effects of the deleveraging caused by the global financial crisis. Furthermore, governments around the world have shifted or are shifting to greater fiscal austerity rather than fiscal expansion. This will likely further hinder growth. Although central banks continue to push giant sums of money into the global economy, these actions have tended to boost asset prices rather than growth. Due to the fact that these highly expansionary monetary policies are without precedent, they are also the cause of great uncertainty and volatility in the markets and in the capital expenditure plans of businesses. We do not see a sustainable, endogenous growth path developing in the U.S., Europe, or China in the near future. Importantly, we believe that potential GDP (gross domestic product) growth in these three areas will be much lower going forward than it was prior to the Global Financial Crisis.

Comparing strategic income funds to global bond funds

There is a great variety of fund styles in global bond funds and strategic income funds. Given the flexibility of these two types of funds, there are many different ways to achieve income or total return objectives. For example, the global bond category contains funds that are similar to the Ivy Global Bond Fund. However, it also contains funds that focus on currency movements for a large part of their return. Other global bond funds focus on long duration government bonds around the world. Some have almost no corporate bond exposure, while some are primarily corporate bond funds. Finally, some global bond funds are merely funds of funds. The situation for strategic income funds is the same. There is a great variety of styles. Some have a high exposure to U.S. high yield bonds, while others focus on mortgage-backed securities. Many have started dabbling in markets outside the U.S. Some funds in both categories are also using leverage in this low interest rate environment to boost returns (we believe this is a very risky strategy). In our opinion, you could probably lump most global bond funds and strategic income funds into a flexible fund category. As an aside, it should be noted that many formerly U.S.-only high yield funds are now branching out beyond the U.S. border.

So, which type of fund is best for the investor? Don’t be fooled by a name — look underneath the hood to see what a fund is doing, whether it has recently changed its capabilities in a meaningful way, and whether the managers have experience in the areas in which they are investing. Finally, make sure that you agree with the fund’s philosophy and strategy.

Emerging Markets

In a section above we discussed the emerging market exposure in the Ivy Global Bond fund. Here are a few questions about our emerging market strategy and emerging market investing in general.

Why are we investing in emerging markets? — Part 1

First, there has been solid improvement in emerging market sovereign credit quality. It is said that a picture is worth a thousand words. Here are three pictures that define the improving nature of emerging markets — on both an absolute and a relative basis.

Chart 1 shows how the credit quality of developed market (DM) sovereign bonds has deteriorated since the global financial crisis. At the same time, the decade-long trend in rising emerging market (EM) sovereign debt quality continues.

Chart 2 breaks down the improvement in EM credit quality by region — Asia, Latin America, and Eastern Europe. As you can see, the improvement is across all regions.
Do EM bonds offer the best reward-to-risk going forward?

No one has a crystal ball. However, the four charts above tell a story of improving credit quality while still providing better yields. The approach we take in the Ivy Global Bond Fund is to use the diversity, and higher yield, and improving credit quality in emerging markets and EM corporate bonds in an effort to provide a better income stream for the investor than a purely U.S. medium-grade investment strategy could supply. We also mitigate the risk of EM investing through our years of experience operating in these areas, and by preferring a shorter duration strategy.

The Bond Market

Will interest rates remain low, or is there a bond bubble able to be punctured?

First, we do believe short-term rates will remain low for an extended period, per the Federal Reserve Board’s communications. Second, we think the term “bond bubble” is too general and misleading. However, certain areas of the bond market are more vulnerable than others, and investors must be astute when investing in bonds in the current environment. Third, we believe that certain bonds, bond funds, and bond markets still provide an attractive investment opportunity. Finally, if a “bond bubble” were to burst, the conditions under which it bursts will determine which asset classes will fare better than others.

The Federal Reserve Board has clearly stated that it will keep its policy rate low until 2015. The Fed has used this communication policy to bolster its arsenal of monetary policy tools. Furthermore, the Fed continues with its unconventional monetary easing, mostly through the purchase of long-term debt instruments. The Fed has control of short-term rates, but the market controls long-term rates. By proactively buying longer-term Treasuries and mortgage-backed securities, the Fed is seeking to lower the whole yield curve in order to spur an economic recovery. The Fed’s chairman, Ben Bernanke, has stated numerous times that the Fed cannot succeed on its own, but requires accommodative fiscal policy over the near-term. Because elected officials in Washington have not supported the Fed, Bernanke has stated that the Fed will continue its unconventional easing policy, as it strongly believes its actions will keep the economy from falling back into recession, or worse, into a deflationary environment.

Why are longer-term interest rates so low? Is it solely because of the Fed? Our view is that weak economic growth due to the ongoing deleveraging of the consumer and financial sectors of the U.S. economy is the primary source of all lower interest rates. However, the Fed is having a modest impact on longer-term yields through its unconventional monetary policies. So is this a bubble? Investors are certainly uneasy investing in bonds with rates at or near all-time lows. However, in our opinion, the risk of recession, disinflation, and even deflation are more acute at the present time than the risk of inflation. That said, if rates (especially on the long end of the yield curve) were to begin rising, then longer duration bonds and bond funds would be most negatively affected.

This is one of the reasons why the Ivy Global Bond Fund keeps a shorter duration. When rates are at all-time lows, we want to remain flexible. If rates rise suddenly, the impact on the Ivy Global Bond Fund’s NAV (net asset value) should be less than that on longer-duration bond funds.

So should investors be afraid of all bonds and bond funds? Our answer is no — a short duration fund like the Ivy Global Bond Fund is designed to use its short duration and liquidity to take advantage of rising yields — potentially mitigating NAV movement and adding income for investors.

Different voices are screaming in the media about impending inflation because of the Fed’s easy monetary policies. However, all of the excess money that has been created by the Fed is not working its way into the economy because the banks are not lending it out. The excess money is helping to keep the banking system afloat after the global financial crisis and is allowing banks to deleverage and raise capital in order to be stronger going forward. Although we all know the Fed is not perfect, and even has a very sketchy
forecasting record, we believe it has learned a great deal from the global financial crisis, and will be capable of keeping inflation under control by gradually withdrawing excess money from the system should the economy suddenly perk up.

For argument’s sake, let’s assume there is a bond bubble. What could cause it to collapse? We’ve mentioned in the paragraphs above that it could come from higher inflation and/or a more rapid economic recovery. On the darker side, it could come from a collapse or rapid decline in the dollar, as investors’ concern over the rise in U.S. debt overwhelms their desire to hold the dollar. We place a very low probability on a “dollar collapse” scenario. As previously mentioned, the dollar does well in a “risk-off” situation; we believe the global economy will continue to oscillate between “risk-off” and “risk-on” situations for the foreseeable future due to all of the uncertainty we have discussed to this point. Secondly, although the U.S. debt to GDP is approaching 100%, this is nowhere near a level that would cause a dollar collapse. The debt-to-GDP ratio cannot be viewed in isolation — the safe haven status of the U.S. and the dollar as the world’s reserve currency will go a long way toward keeping the dollar stable. This doesn’t mean the dollar can’t weaken over time; we just don’t see a collapse occurring.

Okay, so where are we? We don’t think short-term rates will rise for quite some time. We are concerned that longer rates may stay low for awhile, with a risk that they could go even lower. We do acknowledge that there is a chance that inflation and/or growth could be better than we are forecasting. In that case, investors would probably be better off not being in longer-duration bond funds — which, again, is one of the reasons we keep a shorter duration.

We are in highly uncertain times. No one knows for sure which direction the economy will go from here; no one knows how each individual market will react. One thing we can be sure of is more volatility and uncertainty in the months ahead.

This is precisely why we have structured the Ivy Global Bond Fund to be prepared for a number of scenarios — our goal is to provide a good income stream while investors wait for more clarity, and mitigate NAV volatility with a sound risk management approach that emphasizes a short duration, financially strong corporate issuers, diversification, and plenty of liquidity in the fund.

Will investors’ concerns about bonds drive them back into the equity market?

For the time being we don’t see it. One big issue is trust. The increased power of hedge funds and private equity firms, dark pools, market snafus, and high frequency trading have all taken a toll on the retail investor’s confidence in the equity markets. We’ve seen some insurance companies and pension funds are allocating away from equities and toward bonds. In the mutual fund world, bond inflows continue strong, and until early in 2013, money continued to flow out of equity funds (see Chart 5 below, which includes ETFs). The ageing of the population, the degree of under-saving for retirement, two stock market crashes in a decade, and the ongoing housing crisis have caused a sea change in investor attitudes. A desire for income and reduced volatility are now paramount, and we expect this to continue.

CHART 5
Accumulated Combined Mutual Fund and ETF Long-Term Flows

The opinions expressed in this commentary are those of the fund managers and are current through March 11, 2013. The managers’ views are subject to change at any time based on market and other conditions, and no forecasts can be guaranteed. Past performance is no guarantee of future results.

Risk factors. As with any mutual fund, the value of the Fund’s shares will change, and you could lose money on your investment. International investing involves additional risks including currency fluctuations, political or economic conditions affecting the foreign country, and differences in accounting standards and foreign regulations. Investing in emerging markets may accentuate these risks. Fixed income securities are subject to interest rate risk and, as such, the net asset value of the Fund may fall as interest rates rise. Not all funds or fund classes may be offered at all broker/dealers. These and other risks are more fully described in the Fund’s prospectus.

Investors should consider the investment objectives, risks, charges and expenses of a fund carefully before investing. For a prospectus, or if available a summary prospectus, containing this and other information for the Ivy Funds, call your financial advisor or visit us online at www.ivyfunds.com. Please read the prospectus or summary prospectus carefully before investing.

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