Schoellerbank Investment Strategy

Schoellerbank BondRating

Banking that matters.

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Contents

Selecting the best **2**

External rating 3

Internal credit assessment 5

Currency 9

Terms and features 11

Maturity (remaining time to maturity) 14

Relative value 16

Selecting the best

The bond experts of Schoellerbank have developed a stringent selection process to ensure that only the best of the best is selected. Just like the Schoellerbank EquityRating and Schoellerbank FundsRating rating methods, we award stars that indicate our assessment of individual bonds. This gives investors a quick overview of our current assessment of a bond.

Bonds awarded six stars according to our Schoellerbank Bond-Rating method means that the bond meets our strict quality criteria without any qualifications.

Any rating awarded is naturally only a snapshot of the situation at a given moment – and the situation may change at any time. This is why it is necessary to continually monitor the quality criteria – something we do at Schoellerbank on a daily basis for all of our managed products.

The quality criteria of Schoellerbank

Six quality criteria for bonds have proven especially important over the long term:

- External rating
- Internal credit assessment
- Currency
- Terms and features
- Maturity (remaining time to maturity)
- Relative value

The following chapters give a detailed presentation of the aspects we consider for each of the six criteria. For us to even consider a bond as an investment for our portfolios, it has to meet at least four of our assessment criteria. These criteria include an excellent external rating, suitability according to our internal credit assessment, a suitable currency, and attractive terms.

In addition to these hard facts, we also evaluate criteria that change on their own from day to day (for example, remaining time to maturity). When awarding the last star "relative value", we aim to take advantage of often short-lived opportunities.

EXTERNAL RATING: Bonds issued by the world’s best debtors

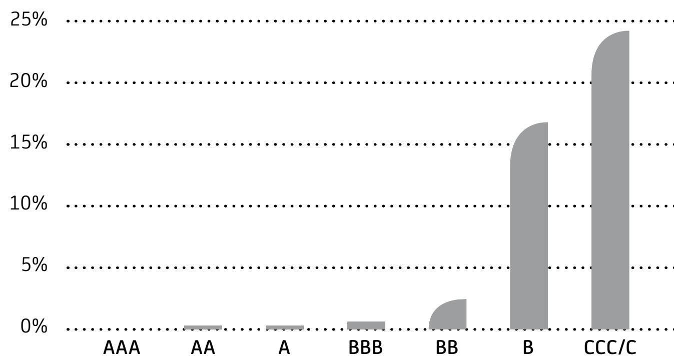
When it comes to bonds, the safety of our investments is our top priority. In our view, the famed “excess returns” cannot be generated by second-rate debtors or achieved with third-rate currencies. For this reason, we are very careful when selecting debtors and have defined criteria based on past performance that have proven resilient in every comparison – and up to now – in every crisis. We invest only in bonds from the investment grade segment. These bonds have credit ratings from “AAA” to “BBB” (equals “Aaa” to “Baa3” in the Moody’s rating scheme).

Decisive for our assessment is the rating assigned by the two rating agencies Standard & Poor’s (S&P) and Moody’s at the time of inclusion of a security. When a bond has two different credit ratings from the two agencies, we use the poorer credit rating. When bonds have additional safety features such as external guarantees in addition to the redemption and interest rate promises of the issuer, we use the rating of such external guarantees in our assessment.

The figure shows the probability of default for debtors with different credit ratings as assessed by the rating agency Standard & Poor’s (S&P): The data in the graph does not represent an extrapolation, but comprises the actual defaults in the period from 1981 to 2018. The probability of default rises exponentially the lower the credit rating; by comparison, the default probability of AAA-rated bonds (first bar) is minimal.

We have a low opinion of highly speculative bonds with low credit ratings that are do not match the interest paid. After all, we do know that the interest rate on bonds with poor credit ratings is often not really attractive, because the risk may even entail a total loss. We want to avoid such unpleasant surprises.

Annual default rates pursuant to S&P (1981 to 2018)



Source: Standard & Poor’s

About external ratings

The credit rating of the debtor is at the core of our considerations when investing in bonds. This criterion is critical for the success of an investment and our objective is to keep assets safe and earn stable returns. Therefore, we are very cautious about ratings and quality.

Today, there are only few countries in the top segment (AAA). Countries with the highest credit ratings such as Austria, France or the US are meanwhile no longer awarded top quality ratings by all rating agencies. Even so, an AA credit rating attests excellent quality.

Bonds guaranteed by states or local governments (often through economic development banks) usually have the same ratings as their guarantors. In many cases, the ratings of the respective states also apply to the local governments and provinces. But it can also happen that the rating of a local government is higher than the rating of the superordinate sovereign state.

On account of their ownerships structure and cross-border activities, most supranational issuers such as the World Bank and the European Investment Bank (EIB) have very good and even top credit ratings.

In many cases, the ratings of corporate bonds are at best the credit ratings of their home countries. There have always been exceptions to this rule in the past, but since the financial crisis a lot has changed in this segment as well. Today, there are many corporate bonds – not least in the segment of covered bonds – which have better credit ratings than their home countries.

As indicated by the designation “investment grade”, this universe includes companies for which a prudent investor may expect full repayment of all receivables. The segment of debtors with poor credit ratings – referred to as speculative grade – was formed originally by so-called “fallen stars”, i.e., formerly solid companies that fell into dire straits. Today, there are new companies with speculative-grade ratings in many sectors soliciting investment capital from customers. This development has been driven not least by the extremely low interest rate environment. As the interest burden is very low, even very poorly rated debtors can afford the relatively high credit spreads. Nonetheless, a solid investor must ask what would happen to repayments if a company were to fall into difficulties, for example, due to an economic slump or when rising interest rates impair the ability to meet their payments.

According to the criteria of Schoellerbank‘s BondRating, a speculative grade means that the bond is ruled out. Nonetheless, considering the prevailing low interest rates: everything has its price. When the price is “right” in certain market phases, the Investment Committee of Schoellerbank may take advantage of buy opportunities.

Explanations on Standard & Poor's ratings

Investment grade

Rating	Description
AAA	Extremely strong capacity to meet its financial commitments, extraordinarily good creditworthiness, highest rating assigned by Standard & Poor's
AA	Very strong capacity to meet its financial commitments, very good creditworthiness – only slightly below the highest rating grade
A	Strong capacity to meet its financial commitments, high creditworthiness. Somewhat more susceptible to changes in circumstances than issuers with AAA or AA ratings
BBB	Adequate capacity to meet financial commitments. Changed circumstances and adverse economic conditions are likely to weaken capacity to meet financial commitments

Schoellerbank's universe

Speculative grade

Rating	Description
BB	All securities in this category and below are assessed as "speculative". Capacity to meet commitments is subject to ongoing uncertainty, especially when overall conditions change for the worse – vulnerable.
B	Even more vulnerable than BB-rated securities; capacity to meet financial commitments barely sufficient
CCC	Has difficulties in meeting principal and interest payments; vulnerable to non-payment of interest and principal
CC	Bonds in this category are "highly speculative"
C	Extremely low likelihood of debt repayment
D	Non-performing

Source: Standard & Poor's

INTERNAL CREDIT ASSESSMENT: Taking a closer look

Apart from assessments based on (external) ratings, we believe that our core task as an asset manager includes making our own assessments of the creditworthiness of the bond in our asset management mandates. In our opinion, the key criteria in this context include an issuer's strength, but also the home market and the type of collateral (additional) backing a bond. The classification of an issuer is also relevant. While bonds issued by financial institutions may be regarded as basically solid investments during most cycles, in times of banking crisis, factors such as lack of transparency regarding assets on the balance sheet or heavy leveraging may turn into a problem. While bonds issued by traditional industrial companies of robust quality can be attractively valued in some market phases, the same securities may suddenly become totally overpriced for a variety of reasons (e.g. flight to quality). Generally, corporate bonds play a minor role in Schoellerbank's allocation policy. Historically, they carry higher risks than sovereign bonds or bonds from the highly regulated financial sector – as shown by historic default statistics. Governments have shown themselves to be very willing to provide support, particularly to the financial sector as seen during the financial crisis. Still, an admix of corporate bonds of good quality is a reasonable move, especially in a low-interest environment.

While we view bonds from the AAA to A-segment as solid based in an macroeconomic context the macroeconomic context, we examine individual securities rated BBB+ to BBB– more precisely. The fundamental indicators from the balance sheet and the income statement are analyzed and documented by the asset managers. Traditional key performance indicators also play a decisive role, of course. These reviews are checked by two asset managers and are documented in writing.

Even within one rating segment, there may be substantial differences in risk spreads. For example, despite the best ratings at the time (Aaa/AAA), yields on bonds issued by the Republic of Austria were 2011 almost two percentage points higher in some phases of the financial crisis than those of German government bonds. When such divergent valuations occur, the asset manager must investigate the cause more closely. They ask the question of whether the risk of securities with higher yields is actually that much higher, or – as in the case of the Republic of Austria – is it just market sentiment, which may be qualified as exaggerated, and therefore a buy opportunity.

Still, there are many examples from the past of investments with the highest ratings which turned out to be completely worthless in the end. A prominent example are asset-backed securities (ABS).

About our internal credit assessment

The financial crisis demonstrated once again that investors who rely solely on the advice of others are, in fact, quite often and literally ill-advised. No asset manager can afford to ignore forming an independent opinion. First, it is necessary to assess the macroeconomic context (economic growth, inflation, central bank actions), and subsequently the ‚micro' level. Based on the industry of an issuer, we examine performance using a variety of criteria, with the business model, potential for growth, and level of indebtedness playing key roles. Industrial companies are subject to guidelines that differ from those of the financial sector or for public entities. Tactical decisions are strongly influenced by measurable market sentiment, money flows between the different asset classes, and the positions held by the various groups of professional market players.

Political factors of influence have become very important, especially since the years of the financial crisis. Companies, banks and even states were bailed out, and in some cases funded by enormous volumes of debt and therefore by future generations of taxpayers. The concept of "systemic relevance" was established as a criterion and today it plays a key role in the assessment of issuers and is likely to continue to do so in the future.

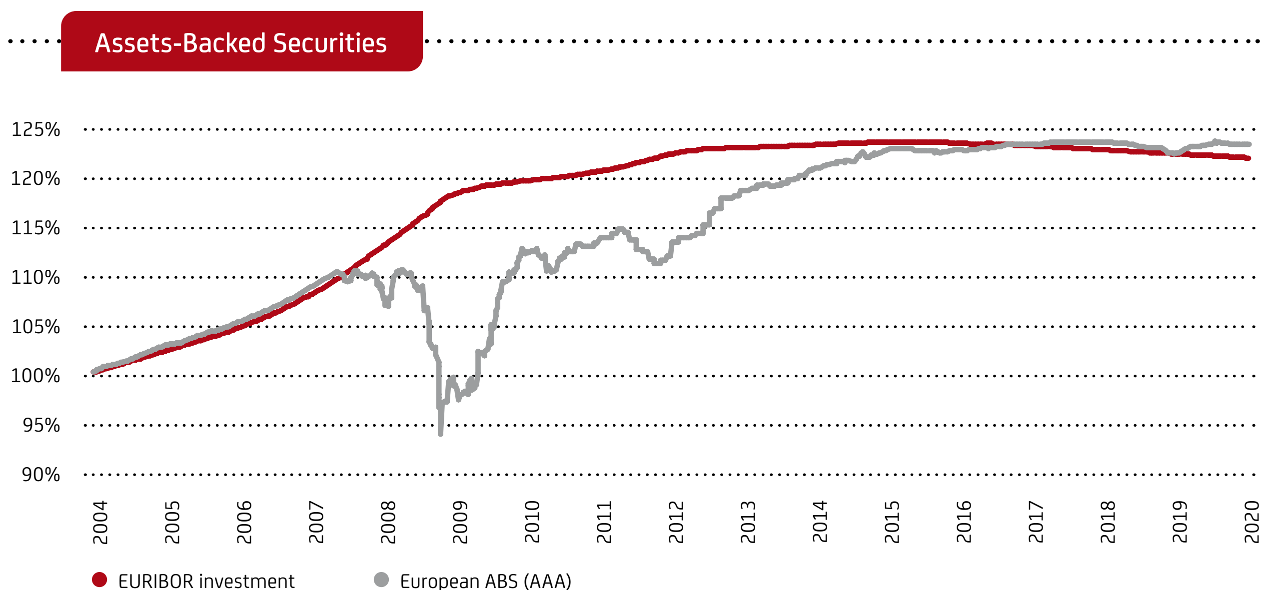
Financial industry

A core issue for financial securities – now more than ever – is the strict regulation of the sector especially when compared to others. Both the legal requirements (e.g. capital adequacy) and close supervision by the authorities have contributed to a higher degree of safety. In the past years, a legislative framework has been created to protect taxpayers. The law now requires the participation of owners (e.g. shareholders) and of creditors (e.g. bondholders) of banks in the losses according to strict priority ranking. In Austria, a federal law was passed on the recovery and resolution of credit institutions (Bundesgesetz über die Sanierung und Abwicklung von Banken, BaSAG) to implement the relevant EU Directive. Further details are available in our customer information sheet "Information on the recovery and resolution of credit institutions under the Austrian Federal Act on the Recovery and Resolution of Banks".

The securities in the investment universe of Schoellerbank do not include any bonds that have equity-like or subordinate bond features. What is always important is to look more closely at the business model of a financial issuer: is it an investment bank, commercial lending bank, or a universal bank with a broad customer base – no two banks are the same and every business model carries different risks and opportunities. Issuers that focus on special topics also have to be assessed differently in different cycles.

Sovereign bonds

In the case of states, the key factors are "systemic relevance", absolute level of indebtedness and budget development as well as soft facts such as the assessment of the political actors. In cases of self-inflicted crises, prominent examples (Argentina, Ukraine) show that the "willingness" to help of the international community weakens when instable partners fall into payment difficulties. Every state has to attempt to reduce its deficit on its own. Countries that do not follow a disciplined budgetary policy are encouraged to solve their own problems. There have been past instances of states having to refinance, which means that they had to prolong the remaining time to maturity of bonds falling due and accept painful interest rate reductions.



Source: Bloomberg; past price trends are not a reliable indicator of future developments.

The chart shows European asset-backed securities (ABS, mortgage claims "repackaged" into securities) with exclusively top ratings of AAA compared to a pure EURIBOR savings investment. Before the crisis, the Bloomberg Barclays index followed an almost linear price trend, with performance slightly better than the interest on savings. In 2008, the index started to fall apart and plunged dramatically with the collapse of the Lehman Brothers.

A special situation in this context are the difficulties encountered by countries or states that are part of larger political constellations. Therefore, an assessment of the potential insolvency of highly indebted US federal states or the difficulties experienced by European Union member states must differ from how we assess the economic problems of independent states. In many respects, the first group cannot act completely autonomously (they do not have their own currency and they cannot freely define its external value; they cannot define monetary policy to steer growth and inflation, etc.). Therefore, these entities are limited in the measures they can take on their own to counteract economic difficulties. In such cases, the international community is much more willing to help than in the case of independent economies.

Corporate bonds

Over the past years, investor attention has shifted more and more to traditional corporate bonds especially during the phase of bank bailouts and high demand for covered bonds and core zone sovereign bonds. Bonds issued by solid industrial companies sometimes even offered higher yields than bonds with the highest credit ratings. However, these yields have been subject to strong cyclical fluctuations in the past. Higher interest rates are not a gift from bond issuers, but compensation for risk that markets perceive as much higher. The higher the interest, the higher the likelihood of default (late payments or non-performance) – and the risk is not only hypothetical. In fact, corporate bonds issued by companies originally considered "unsinkable ships" have defaulted regularly in the past. Problems in the economy may also cause large price losses on low-grade bonds, because the risk of default by problematic debtors is naturally higher in recessionary phases. Such developments can happen very fast and it is not always possible to plan in time to sell the bonds.

The only thing that helps this context is a deeper fundamental knowledge of the bond issuer. In this case, analysts and asset managers carefully scrutinize the soundness of a company – especially issuers of corporate bonds from the "BBB segment" – with respect to their absolute figures and compared to peers. The criteria that differentiates a good debtor from a bad one includes sound financials, good liquidity ratios, earnings capacity, and competitiveness. The main goal is to add only debtors of excellent quality to the portfolio and not to rely on yields (promised) as sole criterion.

Double the security

Covered bonds such as Pfandbriefe feature a special form of collateral: these bonds have a dual security mechanism. Just like other bonds, issuers of Pfandbriefe guarantee interest payments and principal repayment with their assets. Additionally, every Pfandbrief has a so-called cover pool, which is a pool of collateral assets allocated to the specific covered bond and subject to special protection. When a debtor defaults, this additional collateral is not available to the general creditors for covering their claims but has "priority" and is used to repay the covered bonds.

While the investment instrument of Pfandbriefe was originally well-known mostly in Germany and Austria, Pfandbriefe have meanwhile also become established in other European countries under relevant law. The market for Pfandbriefe ranks second to the market for European sovereign bonds especially through the creation of a "jumbo" segment for high-volume bond issues, thus making Pfandbriefe an excellent option for investing in reliable bonds from the euro area. The yield spreads in this liquid segment reflect the different legal frameworks, the differences in the quality of the cover assets, and also the degree of current risk appetite. The Pfandbrief segment is also in high demand in many market phases on account of its excellent quality and is therefore accordingly expensive.

“Schoellerbank’s experts regularly review and define the criteria for awarding stars as well as the attributes that absolutely rule this out.”

A new world

The situation on the European bond market has changed enormously over the past years, not least because of the financial crisis. The creation of a new regulatory framework and more stringent safeguarding mechanisms – both nationally and at the European Union level – have in some cases even improved market opinion of bonds issued by systemically important financial institutions and of debt securities issued by EU member states. Still, lessons have been learned from the financial crisis and special attention must be paid to creditworthiness especially in times of market turbulence. Investors should not rely exclusively on rating agencies. But in spite of all the criticism, we still believe that the European financial sector is sufficiently regulated and well-stabilized. Therefore, in our view selected issuers including some from below the top segments may be investments with stable returns, especially if the risk spreads are accordingly high versus the AAA– or AA segment – not only with respect to individual securities but also to the market average. Outside the financial sector, we are also increasingly finding bonds issued by sound industrial companies that add excess returns to the portfolio at a well-calculated risk – not least regarding diversification.

Moving with the times

The rules according to which we award our internal credit rating stars are not set in stone. An assessment always takes the current situation and prospects into account. This means that Schoellerbank’s experts regularly review and define the criteria for awarding stars as well as the attributes that absolutely rule this out.

Communication with customers is a top priority in Schoellerbank’s advisory process. We explain the reasons for certain transactions and the decisions of our asset managers in regular bulletins sent to investors (e.g. “Investment Committee Minutes”). Complex investment decisions are explained in greater detail in advisory talks with customers.

Our investment universe includes:

- Sovereign bonds
- State-guaranteed bonds
- Bonds issued by local governments and municipalities
- Bonds backed by local governments and municipalities
- Bonds issued by supranational entities (e.g. European Commission, World Bank)
- Covered debt securities (e.g. Pfandbriefe, Pfandbriefe issued by public agencies)
- Selected financial securities (bank bonds, insurance bonds)
- Selected corporate bonds

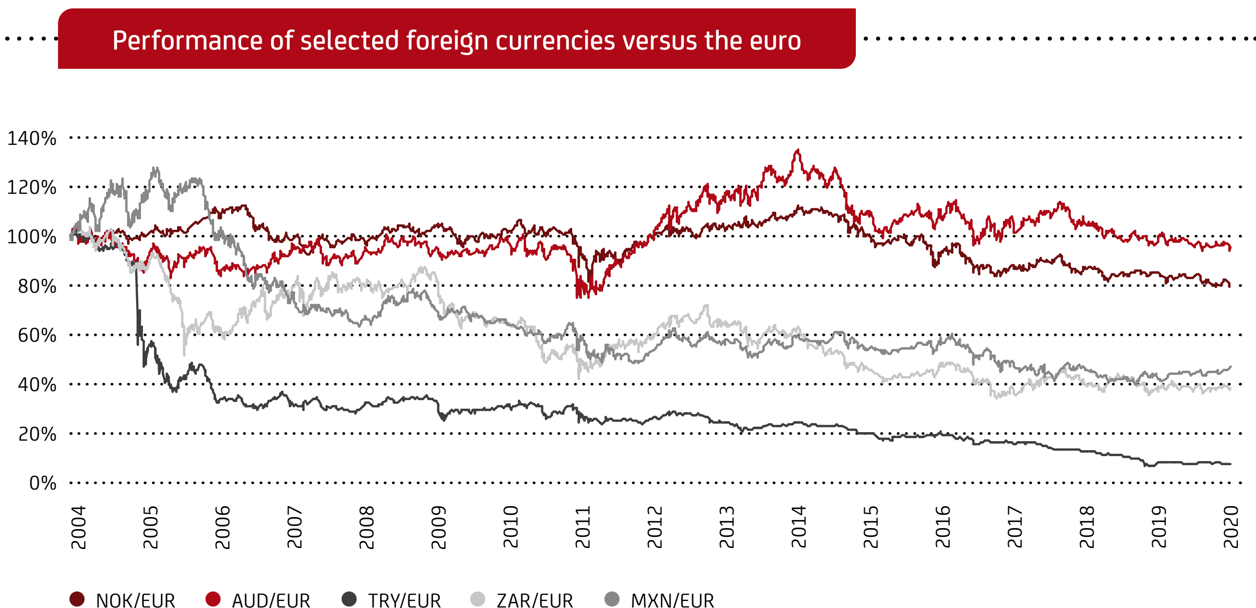
CURRENCY: Bonds in the world's top currencies

Currencies are the most widely traded assets in the world, and this makes them one of the most liquid asset classes.

A basic currency requirement for any potential Schoellerbank investment is unrestricted tradability and sufficient liquidity. Our core universe of currencies includes not only the euro, but also the so-called G10 currencies, i.e., the ten major global currencies. To round off an investment, we may also consider other, smaller currencies of countries with strong growth and low debt. These smaller currencies differ from the currencies we do not recommend by the following features: all currencies are from developed, industrialized, modern Western-type economies. The countries have sufficient foreign currency reserves to ward off speculative attacks on their currencies. In all countries, political leadership is largely predictable, and it may be assumed that no unexpected currency interventions will occur that are damaging to investors.

Bonds issued in peripheral currencies often attract investors by offering high yields and the prospects of exchange rate gains. However, sudden devaluations, as they tend to occur in Latin America, Asia or even in Europe can destroy the best performance within just a few hours. Therefore, it is not possible to earn reliable returns where there is unpredictability and political instability. This only results in wider fluctuations of returns, and therefore, in higher unnecessary risks. The chart shows the development of two first-rate currencies versus the euro since the turn of the millennium: the Australian dollar (AUD) and the Norwegian krone (NOK). Their relatively stable performance contrasts starkly to currencies such as Turkish lira (TRY), the Mexican peso (MXN) or the South African rand (ZAR).

We rule out second-rate currencies: reliable earnings can only be generated by first-rate currencies.



Source: Bloomberg; Past price trends are not a reliable indicator of future developments.

About our currency decisions

At Schoellerbank, we pursue a strategy of investing only in the best currencies of the world for all our bond funds and in all our asset management variants.

Bonds, investment funds ...

Selecting the right currency plays a key role in the foreign currency portfolios of Schoellerbank. In other funds such as conventional euro bond funds, this decision is defined by the fund rules, which stipulate investments exclusively in euro. Ultimately, the decision in favor of only one currency plays a key role also in these clearly defined funds. This is the only way we can guarantee that Schoellerbank's bond funds are a solid component of our asset management based on investment funds. Here as well, we select only from among the best currencies in the world.

... and individual asset management portfolios

All of the considerations mentioned above apply to our asset management portfolios and to Schoellerbank's money market funds and money market-linked funds. The key selection criteria for currencies: freely tradable, stable, and internationally accepted. We do not engage in speculation in currencies that are at risk of disappearing from international trade due to foreign exchange restrictions. The long-term stability of a currency plays a key role for us in addition to the size of the currency. Consequently, we also take currencies into account with lower interest rates than the euro if we believe there is upside potential on the respective currency market. An example is lessening risk tolerance on world markets entailing a reduction in carry trades (purchases financed in low-interest currencies), which regularly triggers the steep appreciation of currencies, above all, of the Japanese yen and the Swiss franc.

On the reliability of forecasts

We become highly skeptical when all analysts are excessively convinced of a certain trend. We advise caution not only because of the recent experience of investors with overly optimistic forecasts. The more a specific trend is pushed, the more it pays off to swim against the tide. Over the medium to long term, our anti-cyclical approach has proven highly successful, not least in currency decisions. In this context, we pay special attention to measurable investment sentiment as well as to the positioning of the different investor groups.

TERMS AND FEATURES: No unpleasant surprises

Some bonds offer remarkable terms at first sight. Usually these include higher interest than on (seemingly) comparable bonds. Unfortunately, such “treasures” often hide unpleasant surprises when one takes a closer look. These surprises can take on very different forms. The main questions are whether interest payments will be paid regardless of the circumstances and whether repayment of principal is guaranteed on the date specified.

Caution with bonds with an equity component

Bonds usually represent debt capital for companies. To borrow funds, the issuing companies must pay interest either in the form of fixed interest or variable interest. Upon maturity, the principal is repaid. Financial institutions often issue these types of bonds with terms that make the payments contingent on the net profit of the issuing bank. This contingency may refer to the interest payments or to the principal repayment. Usually, such profit-linked financial instruments pay higher interest rates than conventional bonds, the downside being that their nature as fixed-income instruments is diluted.

Well known from the financial crisis is so-called participation capital. These instruments often attract investors with higher “interest” (in fact, dividends), sometimes even in the double-digit range. What investors tend to forget though is that no interest is paid if the issuer posts a net loss instead of a profit. And should the issuer become insolvent, participation capital ranks at the bottom of the hierarchy of financial instruments when claims are settled, slightly ahead of ordinary shares – a high price to pay for the potential of high interest. Furthermore, a specific repayment date is usually not part of the terms of participation capital. The price trends of some participation capital instruments are more like those of shares than of bonds.

The right mix is crucial

Achieving the right asset structure with a balanced mix of equity and debt capital is up to you, your advisor, or the asset managers of Schoellerbank – but most certainly not the bond issuer.

We are not influenced by first impressions, but look closely at the fundamental value of a bond – and save you and us from unpleasant surprises.

Hierarchy of a bank’s capital structure

	Name/type
Debt capital	Covered bond (e.g. Pfandbrief)
	Debt capital (bearer bond)/senior bond
Mixed forms	Hybrid capital (tier 2)
	Tier 1 capital/participation capital/preference shares
Equity capital	Shares

A coupon payment cannot be suspended if a lower-ranking security receives a payout (e.g. when shares pay a dividend).

About bond terms and features

We advise special caution when investing in bonds where interest payments depend on the profits of the respective bond issuer. This is the case, for example, in the case of hybrid bonds. Interest is only paid if interest payments are covered by the net profit. Therefore, bond buyers bear the “shareholder” risk to a certain degree, because dividends are only paid out in years that the company reports a net profit.

Hybrid bonds are a special type of subordinate bond, which in the event of liquidation of a company are settled only after all other (senior) debts. Therefore, payments on such bonds are contingent on the issuer’s creditworthiness and performance.

Even within the segment of senior bonds, an assessment is now more complex due to the new “bail-in” system.

Structured interest products

In the past years, the significance of structured interest products has been increasing steadily. This development has led to improvements in some products, but also to greater complexity in others. In fact, solutions are meanwhile available for almost any kind of interest rate expectation. For this reason, Schoellerbank has developed its own rating system for structured capital market products that pays attention to the special features of each product. What remains absolutely crucial is to know exactly who the debtor is – also for structured interest products.

Decisive in this context is to be able to assess the future direction the market will take and to recognize market anomalies such as when certain parameters deviate significantly from the long-term averages. Just as important, however, is an investor’s planning horizon. Products with very long maturities, for example, are prone to sometimes steep losses throughout their life when markets develop adversely. For this reason, Schoellerbank always recommends a manageable investment horizon, also for structured products.

These products must always be compared with conventional bonds, specifically with those that do not include any options and offer precisely calculated payments defined in advance. The same holds true for the process we use to select structured interest products for asset management portfolios. These are exclusively products with guaranteed principal repayment that aim to exploit the various anomalies on bond markets.

Caution must be exercised in the case of special investment products for which many different loans are packaged into one new product. This makes it more or less impossible to really assess the debtor’s risk. It therefore comes as no surprise that it was precisely this category of instruments that caused the financial crisis of 2008. Schoellerbank has always steered clear of such products.

In this context it is important to differentiate between structured interest products and so-called “structured credit products”. While structured interest products make it possible to benefit from anomalies in terms of interest rate expectations, inflation expectations, steepness of the yield curve, spreads between different markets, etc., structured credit products are ultimately always a bet on complex combinations of the default probabilities of a bundle of more or less bad debtors. Schoellerbank gives wide berth to these variants, which are often referred to by acronyms (examples ABS, asset-backed securities; CDOs, collateralized debt obligations). The underlying bundles of receivables are impossible to grasp clearly and that is why Schoellerbank has never considered them potential investments.

“We recommend only bonds with easily understandable terms and features.”

Catchy names and innovations

A common feature of new products and innovations in the area of structured products is that they always have catchy names. Often, they have appealing acronyms (e.g. GOALs, PERLs, etc.) or complex names (CoCos, ABS, RMBS, CDO). As a rule, these names should be red flags to investors.

Frequently, such instruments are launched on the market when the relevant sector has seen a rally – sometimes very short-lived – and quite often in a generally low interest rate environment. However, an abundance of offers is often a warning sign: in the past, prices have dropped steeply right after the market was swamped with a new type of “promising” bond. These lessons learned from the past should be remembered when “novel” products are being promoted.

Caution is also advised with new products commended by regulators such as “Tier-2 hybrid bonds” or “CoCo bonds” (contingent convertible bonds). The main purpose of these instruments is to boost a banks‘ regulatory capital. But for investors, they are riskier than conventional bonds.

We do not like surprises. This is why we recommend only bonds with easily understandable terms and features.

MATURITY (REMAINING TIME TO MATURITY): The big picture

Our investments focus on bonds with maturities from one to ten years, not least because these segments contain the largest number of potential bonds to invest in. However, we still feel free to also consider maturities longer than ten years when an opportunity arises. At Schoellerbank, short-term bonds refer to maturities of up to three years; medium-term bonds are those with maturities from three to seven years; and long-term bonds have remaining times to maturity of more than seven years.

Normally, different maturities yield different returns. The level of current interest on the different maturities depends on different factors, but longer maturities do not necessarily translate into higher returns.

Selecting the right maturity segment is a key success factor for bond investments. Our strategy focuses on long-term returns with a balanced risk.

About maturity selection

The world’s two largest central banks, the US Federal Reserve System (Fed) and the European Central Bank (ECB), play a crucial role for the development of the economy. On the one hand, central banks ensure that inflation does not surge when the economy is expanding. A controlled price development works to keep an economy from overheating. In times of economic contraction, the central banks’ task is to refrain from slowing economic activity by raising interest too high, and to supply sufficient liquidity. Both measures are an important contribution to maintaining stable economic conditions and monetary stability. The objective of central banks is to identify trends early and to use the instruments at their disposal to smooth imbalances in the economic cycles. Lowering liquidity in boom phases by raising interest rates, and increasing the supply of liquidity in times of crisis through lower interest rates are the principal tools used by central banks to implement their policies. The “unconventional” measures taken by central banks do not change this either; these are simply complementary measures.

Central banks, bond issues and sentiment indicators

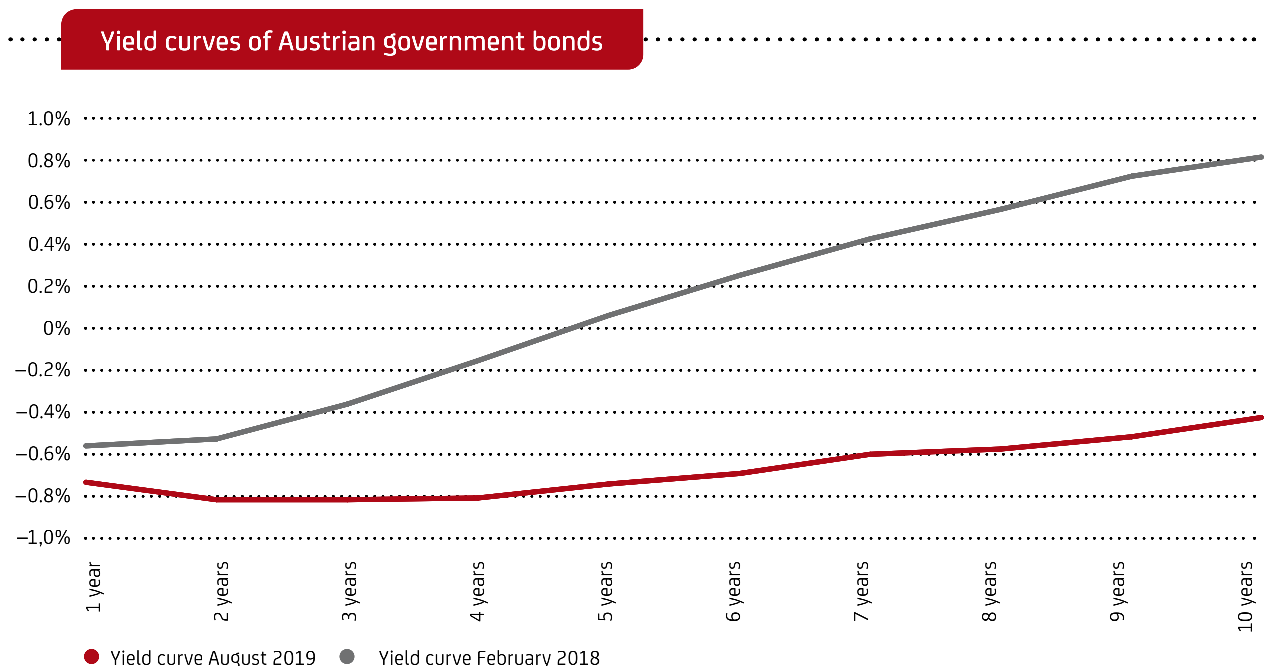
We monitor the signals of central banks closely regarding interest rates. At the same time, we closely follow the issuing activity of leading countries and track demand in the different maturity segments of bond markets. We base our investment decisions on this information.

The situation of an issuer is a mirror image of the situation of an investor. When interest rates are high, investors want to fix them for as long as possible, while debtors will strive to avoid having to pay high interest for any longer period. Hoping for lower interest rates in the future, debtors tend to prefer shorter maturities and thus issue bonds with shorter maturities.

Our behavior is anti-cyclical. We buy longer maturities when most bond issues have short maturities, and we buy bonds with shorter maturities when issuers show a tendency of issuing bonds with longer maturities. In addition, we monitor buyer (investor) sentiment based on so-called sentiment indicators. Here as well, our approach is anticyclical. When sentiment starts pointing clearly in one direction, we like to go in the opposite direction.

Yield curve management

Schoellerbank's bond fund management refines maturity selection by combining different maturity segments. Depending on the market situation and assessment, we achieve, for example, a five-year average maturity in a fund by investing primarily in bonds with a five-year time-to-maturity or by combining two-year and eight-year bonds. Such fine-tuning contributes significantly to the higher returns on bond investments, which is the aim of the Schoellerbank BondRating method. This is also closely related to the topic of "relative value".



A yield curve is a graphic representation of interest rates, at a set point in time, across the different maturities of the bonds. Usually, investments with longer maturities carry higher interest (such as in February 2018). For different reasons, yield curves can also be flat (like in August 2019), or short-term interest rates may even be higher than on long maturities. Past price trends are not a reliable indicator of future developments.

RELATIVE VALUE: Liquidity and excess returns before and after tax

An investment first needs to obtain five stars before it can be awarded the sixth one: earning excess returns. Recognizing opportunities in the bond segment is one of our basic tasks when selecting securities.

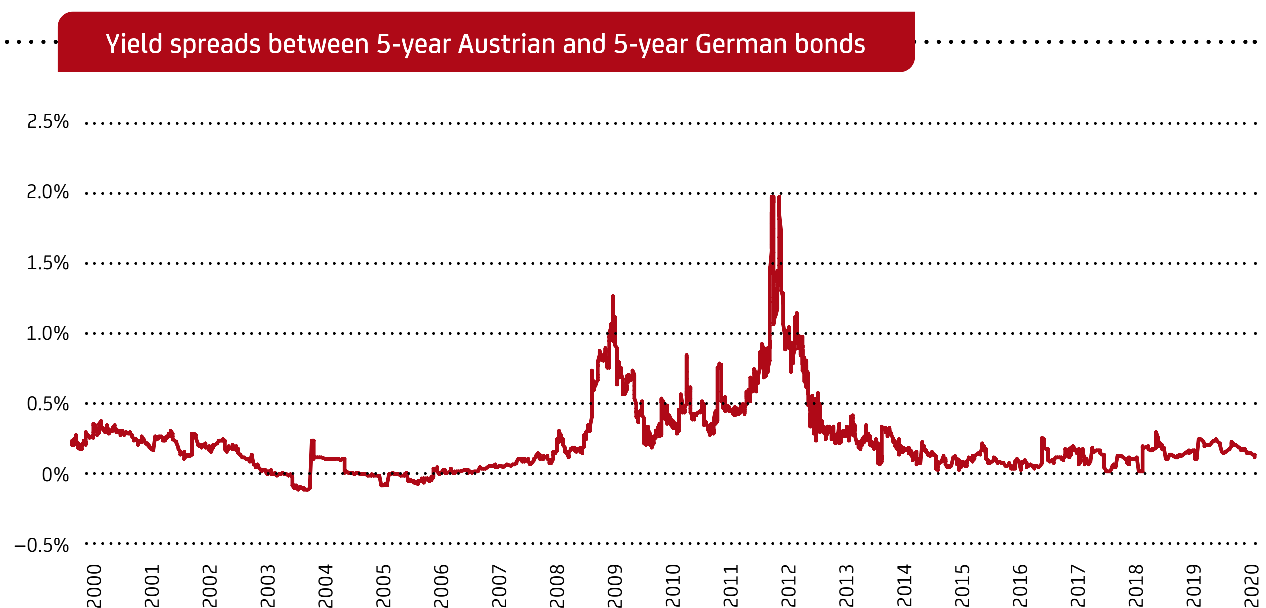
Special market opportunities may arise in all rating classes. There are opportunities for earning excess returns in both AAA and AA bonds as well as among speculative debtors. The fact must be taken into consideration that excess returns are not constant and that non-sovereign bonds and bonds issued by smaller states are less liquid than those of larger issuers (Germany, France).

The chart below shows the excess returns earned with lower-liquidity Austrian government bonds compared to German bonds. Since 2000, the bandwidths for excess returns on AAA bonds with five-year maturities have ranged from practically zero to more than 200 basis points.

The latter equals two full percentage points in excess returns per year. Values above the long-term average of around 25 basis points (1/4 percentage point) are considered attractive buy opportunities for Austrian bonds.

Our task is to achieve excess returns for our clients using the Schoellerbank BondRating approach. The excess returns have to be reasonable in relation to the liquidity of a bond.

Tax considerations are important for clients. As a bank, we cannot act as a tax advisor. However, when there are economically equivalent alternatives, we take our customers' tax situation into account. This may mean, for example, that in the case of equivalent alternatives we buy bonds that carry lower interest to minimize withholding taxes.



Source: Bloomberg; past price trends are not a reliable indicator of future developments.

More about the relationship between liquidity and excess returns before and after tax

Liquidity and excess returns correlate directly. The higher the liquidity of a bond, the more expensive it usually is. If a bond can be easily traded, it will be possible to convert the bond into money relatively quickly and at a good price. Less liquid bonds tend to be less expensive, but are harder to sell – the bid-ask spread is wider.

This is how market imbalances may occur also in high-quality segments. Bonds for which trading is not as lively may become true bargains in turbulent times that should be taken advantage of. We often buy such securities following a buy-and-hold strategy. This means we keep the bonds to maturity to earn the excess returns.

Our investment style is balanced: We profit from excess returns on strategic positions in less liquid bonds that are therefore relatively inexpensive, and aim to keep part of the assets in funds and asset management portfolios liquid enough to be able act on the markets at any time and adapt our strategy as needed.

Our goal is to earn excess returns

The magic word when reconciling excess returns and liquidity is "relative value". Relative (excess) value can be achieved both within a segment (e.g. sovereign bonds) or between different segments (e.g. sovereign bonds and Pfandbriefe). The influence of relevant research is growing with respect to large-volume managed assets – and thus also investment funds – because the excess returns aimed for can often only be achieved with correspondingly large volumes.

Tax considerations may also help generate excess returns. However, the professional advice of a tax advisor cannot be replaced by the services of a bank.

Our declared goal is to keep all investments as simple as possible, striving for the lowest possible taxation and full tax truthfulness. We are well aware that any information provided on tax matters is subject to change at any time. At the same time, we assure clients that we always strive to act in line with these goals in all products we manage (investment funds, asset management).

The information presented in this brochure applies to the managed products of Schoellerbank (investment funds, asset management). We hope you find the information useful for optimizing your investment strategy for bonds.

Important risk disclosure for investors

Any investment of capital involves risk. The value of an investment and of returns can increase or decrease suddenly and steeply and cannot be guaranteed. Currency fluctuations can also influence the performance of an investment. Investors may fail to recover the full amount of the capital invested if, for example, the capital is invested only for a short period. Under certain special circumstances, investors may even lose the entire capital invested including the purchase costs. Please note that the figures and information on valuations refer to past trends and these are not a reliable indicator of future performance.

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