Yield chaser

Income investments can fund your lifestyle or supplement your returns

A hedge in time

Anyone with memories of the 1970s will see the wisdom in seeking ways to make fixed income investments inflation proof, **Philip Baker** writes.

Inflation looks as if it is under control right now. But investors should take a closer look at inflation-linked bonds (ILBs), which are proving popular in other major economies.

Investors have been put on short rations when it comes to inflation protection. But last year the government started to issue bonds for the first time in about six years, to help pay for the $67 billion stimulus package.

Inflation can be a really nasty word for bond investors, as it erodes the purchasing power of future coupon payments. Suppose one buys a five-year bond with a principal value of $100. If the rate of inflation is 3 per cent a year, the value of the principal adjusted for inflation will drop to about $83 over the five-year term of the bond.

The real interest rate on an asset is the nominal rate minus the rate of inflation. Because it takes inflation into account, the real interest rate is more indicative of the growth in the investor's purchasing power. If a bond has a nominal interest rate of 6 per cent and inflation is 3 per cent, then the real interest rate is only 3 per cent.

Inflation can adversely affect fixed income investments in another way. When inflation rises, interest rates also tend to creep up, either due to market expectations of higher inflation or because the Reserve Bank of Australia has raised interest rates in a bid to fight it.

When interest rates rise, bond prices fall. So inflation may lead to a fall in bond prices, and reduce total returns on bonds.

Inflation-linked bonds are a direct hedge against inflation, and help investors achieve what all decent investments deliver: a return that is above the consumer price index. Investors should always try to work out what their returns are after allowing for inflation. Fixed income brokerage firm FIIG Securities says these bonds could easily make up at least 10 per cent of a portfolio.

The bond expert says that investors with little fixed income exposure should use index-linked bonds to provide some meaningful interest rate exposure to their portfolios, as well as to provide a hedge against inflation.

But younger investors can handle a higher level of risk than their older peers. So maybe the average allocation to ILBs might be about 7 per cent. A younger investor might allocate only 5 per cent, while an older investor could set aside, say, 20 per cent of a portfolio to these instruments.

The way these bonds work is that income increases as inflation rises. The principal also rises as inflation increases. Inflation-linked bonds generally have their principal sum indexed to an inflation measure such as the consumer price index. As inflation rises so does the amount of the principal, and the interest rate (calculated on the higher, indexed amount) also increases in line with inflation. At maturity, for a capital amount of $100, investors receive $100 plus inflation and, as long as their inflation rate coincides with the CPI measure used, their invested capital is protected against inflation.

As FIIG Securities explains, the indexing of these bonds occurs quarterly on the capital, or principal amount of the bond, which is repaid at maturity. The indexation factor is usually based on consumer price inflation as measured by the ABS consumer price index. Interest is payable, generally quarterly, on the then current indexed capital amount at a fixed coupon rate; usually 4 per cent a year. As the inflation indexation usually increases the principal value of the security over time, the amount due at maturity usually becomes greater.

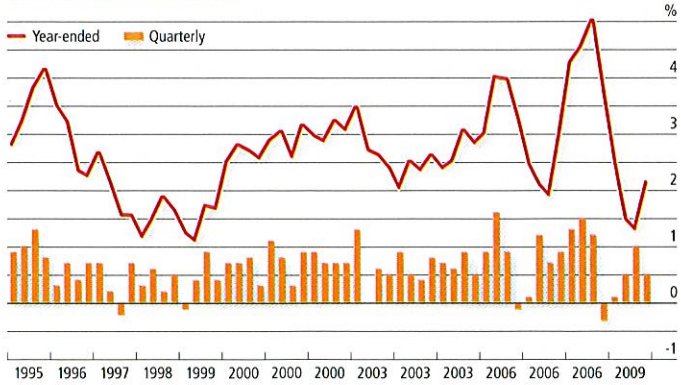
For example, if the capital amount in year one is $100 and inflation is 10 per cent in year one, then the base payment would rise to $110 in year two and the security would pay 4 per cent of the base payment, which is now set at $110. Thus in the first year the capital amount would be $100 and the coupon 4 per cent. Income is calculated by multiplying the $100 base payment by the 4 per cent coupon rate, which equals $4. In the second year, the capital amount rises to $110 if inflation stays at 10 per cent. So the income is $4.40 (the $110 capital amount multiplied by the 4 per cent coupon).

Investors who need to ask why they should look for protection against the ravages of inflation probably weren't around in the 1970s, when double-digit price rises wreaked havoc on fixed interest investors worldwide. And now that sharemarket investors have been rattled, there seems to be a push towards more income-producing investments. **Si**

Philip Baker is a former bond trader who heads the Market Wrap section of The AFR.

Lessons in history

Consumer price inflation*



**Excluding interest charges before the September quarter 1998 and adjusted for the tax changes of 1999-2000.*

Source: ABS, RBA