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FIXED INTEREST

Fixed interest:  
**Balance *shifts* back**



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## Fixed interest has long been regarded as the ugly step-sister for Australian investors. The lessons of the GFC may now see this asset class having its Cinderella moment, but financial planners still need to contend with disagreement over definition. JANINE MACE reports.

**W**ithout the glamour and sex appeal of equities, fixed interest has always been the afterthought added into a portfolio after all the 'interesting stuff' has been selected. But not any more. In the wake of the financial crisis, fixed interest is revealing its many attractions for cautious retail investors.

Vanguard Australia CIO, Joe Brennan, believes investors should be taking a fresh look at the asset class.

"Fixed interest is absolutely a meaningful part of one's asset allocation and should not be overlooked. We have had a wake-up call with the GFC and hopefully now financial planners will respond to this asset class," he said.

The environment is inviting as well, with the local market currently a top performer in terms of real yields.

"We are sitting in a market where yields in fixed interest are very decent on a relative basis, so I would hope there is no hesitation to make these allocations," Brennan said.

FIIG Securities director, planner services, Stephen Hart, agrees current trends make an "allocation to caution" a wise move, in terms of long-term planning and reducing risk.

### But what to choose?

When it comes to fixed interest, investors are not short on choice.

As Peter Dorrian, Pimco's Australian head of global wealth management notes, the global fixed interest market is worth US\$93 trillion, which is several times the size of equity markets. Even in Australia the market cap is around A\$500 billion, with 25 per cent of this provided by government debt.

"There are a lot of opportunities to get good diversification, even with just a domestic bond market allocation," he explained.

Although investment experts believe fixed interest is a key component of a well-constructed investment portfolio, there is debate over which assets should be included in the allocation.

According to Brennan, fixed interest is broadly defined as anything producing yield as the main component of its return. "With fixed interest the key characteristic is the income, its defensive qualities and the lower volatility and low correlation with shares."

In Dorrian's view, fixed interest is "an asset that has a degree of liquidity and an ability to exit it without penalty" as well as an opportunity for upside growth.

However according to Wilson HTM asset allocation strategist, Damien Klassen, these assets should be split even further.

"We break fixed interest into a minimum of two subsets. The first is government bonds and low-risk AAA securities. This is the defensive category where those assets are expected to rise

when things go wrong," he explained.

"Corporate bonds are in a different bucket. We benchmark them to other riskier assets and accept you are not really getting the safety aspect. We do not treat them as defensive."

For Hart, the asset class stretches from at-call accounts through to term deposits and bonds, but does not include hybrid offerings.

"Hybrids are more like an equity with some fixed interest features, but it is not fixed interest as the price moves up and down with equity markets," he said.

Klassen is also reluctant to categorise most hybrids as real fixed interest assets. "Hybrids are not an optimal fixed interest investment, as the return does not justify the risk you are taking."

### Where do term deposits fit?

This debate about what is and isn't fixed interest is highlighted in a recent survey by Pimco, which found 50 per cent of Australian planners thought of term deposits as being fixed interest and 50 per cent classing them as cash. On average, advisers allocate 29 per cent of their client's fixed income portfolio to term deposits.

Dorrian is surprised by the finding. "We are not saying term deposits are bad, but planners need to understand they are not fixed interest," he said.

"Fixed interest is anything issued as a bond with a coupon attached and has a rating for the quality of the issuer. These are not characteristics of term deposits."

In addition, they are not really defensive assets.

"Although term deposits provide capital stability, they are technically not defensive assets. A defensive asset will perform better when riskier assets perform poorly, while term deposits will not change due to their illiquid nature," Dorrian said.

"An issue people do not appear to understand about term deposits is that while you have a known rate of return, you cannot capture the upside as in the bond markets."

He points out that over the past two years the return from the bond market has been 10-12 per cent, while term deposits have



Joe Brennan



only provided 5-6 per cent – a significant loss in return potential for a small increase in risk.

Hart agrees term deposits are not truly defensive.

“While they are not correlated with equities, they do not have interest rate risk. Bonds and those types of assets which are moving with interest rate risk offer the opportunity to benefit from their see-saw effect with equities.”

Brennan understands the appeal of term deposits, but cautions there is “no free lunch in any investment”.

“The main attraction is the advertised yield over a given term, but with term deposits you have concentrated your risk in one issuer and there is a penalty for getting out,” he said.

Dorrian also highlights this factor. “Bond funds are liquid and can be exited easily, but with term deposits there is a break fee. People often do not understand the liquidity risk or opportunity cost of term deposits,” he said.

With the Pimco survey showing 47 per cent of advisers’ clients had little or no idea about the illiquid nature of term deposits, Brennan believes many clients fail to fully appreciate their characteristics. “If investors thought about all aspects of term deposits, they might not be so keen, as they are giving up liquidity and diversity.”

Although Klassen has some concerns about the use of term deposits as fixed interest, it depends on how they are being utilised.

“If it is the stability of income that you are seeking, then that is a great use for term deposits. However, if you are looking for diversification, then they are not appropriate,” he said.

“The real benefit of fixed interest is if it is used for diversification in the portfolio. It allows you to gain on fixed interest to offset losses incurred on equities.”

Klassen also believes planners need to carefully assess the characteristics of each asset.

“They need to pull the asset class apart and understand not all fixed interest assets are the same. The GFC has been a wake-up call for the approach of just buying different types of fixed interest and thinking that you have covered the asset class,” he said.

### Rolling out new products

One thing the experts do agree on is that to date, most Australian investors have not had sufficient exposure to fixed interest in their portfolios.

“Fixed interest has been under-represented in the portfolio of many investors due to many years of strong equity returns and this has led some to forget about the risks involved,” Brennan explained.

The underexposure has been compounded by the difficulty of directly accessing fixed interest assets.

“The fixed interest market in Australia is underdeveloped,” Brennan said. “Greater investor interest would be a factor in developing a more robust market here, which would be a win-win for everyone.”

According to Hart, many planners have had very little exposure to these assets due to their unavailability in small parcels. This is now changing, with FIIG Securities, for example, offering smaller bond parcels and a complimentary custody service.

“FIIG now offers \$50,000 face value parcels rather than the investor needing to take \$500,000 and this is resulting in good interest from financial planners, especially for SMSF clients,” Hart said.

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There are also moves by Australian ETF providers to roll out funds based on fixed interest assets, according to Klassen. "This will provide a fillip for planners looking to use fixed interest in a portfolio. If it is hard to buy an asset class, then it tends to get ignored by investors."

### Putting it in the portfolio

With access increasing, fixed interest may start to play a bigger part in investor portfolios.

"Fixed interest has a role in most portfolios and probably a quite significant role in some portfolios. In the past it has been overlooked somewhat," Brennan said.

Dorrian agrees: "The defensive allocation should be the core or anchor of the portfolio." He points out in many overseas markets retail investors are advised to "own your age in bonds" and they have much lower allocations to equities than in Australia.

In fact, OECD figures show Australia pension fund allocations are heavily skewed towards equities compared with similar markets such as Canada, the US and Germany.

Although this worked well until the GFC, Dorrian believes there are now compelling reasons for planners to reassess their use of fixed interest.

"Over the past 10 years, equity returns have been exaggerated by the use of leverage and you can see that in listed property trusts.

The absence of leverage now will lead to returns being lower than before," he said.

"Also, if we have muted economic growth over the next decade in the big equity markets and economic growth drives equity returns, then it will be sensible to have less weighting to equities than in the past and a greater weighting to fixed interest."

Dorrian believes there is an "increasing appetite" for fixed interest information and education among planners and investors. "Since the GFC, people have become aware of how much of their portfolio was in equities, or assets that performed like equities."

High equity allocations also overlook an important issue for income investors, Hart said. "With equities, the dividend policy is in the hands of the directors, but interest is a legal requirement and must be paid before the dividends are paid."

There are also benefits when it comes to long-term financial planning, as coupon payments from bonds can be matched to planned future expenses or the commencement of an allocated pension.

"They offer known sums and coupons, so you can plan better," Hart said.

"With bonds you can match cashflows with greater certainty of payment, especially if you are well up the capital structure. In choppy times like now, this is very important." ❖

## MANAGED OR DIRECT?

Another interesting question highlighted in the Pimco survey is the best way to approach fixed interest allocations.

The survey found planners currently favour active management, with 80 per cent believing it will provide higher returns. Forty per cent also feel it will help avoid high risk debt.

Although Pimco offers both actively and passively managed bond funds, Peter Dorrian believes the current environment is suited to active management, given the rising level of government paper on offer.

"The problem with purely passively managed funds in the current environment is that with a market weighted index, the more a particular sector dominates the market, the more it influences returns," he said.

"If current debt market trends continue over the next few years, the index will be dominated by government issuances, so this means investors will be holding an increasing amount of government debt."

Unsurprisingly, Vanguard's Joe Brennan is a champion of the passive approach.

"The biggest argument for the benefits of indexing rests in the cost category," he said.

"The cost advantage on the lower fixed interest return base magnifies the results of indexing even more than in the equities space, given the lower long-term returns. The cost advantage of indexing compounds every year, so over the long-term it is a very powerful benefit."

Rather than deciding between active or passive bond funds, FTIG Securities' Stephen Hart believes planners should consider taking the direct approach – just as they are doing with equities.

"In managed bond funds you may not be able to sell when you want as the fund is frozen. You do not get the same liquidity as in the bond market," he said.

"The main benefits of the active approach are transparency (as you know what you own) and control, as you can sell when you want. There is also liquidity, as you are not

affected if everyone decides to sell.

"With a bond fund, you sell out at a future price, but with bonds you know precisely what you will get. They offer more certainty," Hart said.

While acknowledging managed funds provide diversification, he argues this is only necessary with riskier assets. "The further you go down the capital structure, the more diversification you need to protect yourself," he added.

"Diversification is very important and it can be delivered with three to four bonds used in the same way as can be done through a managed bond fund."

However, Brennan favours the diversification managed funds provide.

"Advisers may feel confident buying individual shares, but if you apply the same approach to bonds, there is a whole list of things to understand such as credit risk or bond pricing. Bonds are not complicated, but they require a different skill set and approach to shares," he said.