EUREKA report

Five costly bond myths

By Elizabeth Moran
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PORTFOLIO POINT: Fixed interest investments are a vital part of any portfolio. Investors who listen to commonly held myths are costly themselves money.

Investors almost always have a natural bias towards particular asset classes. Whether that is shares or direct property, harbouring a bias like this almost always comes at the expense of portfolio returns.

Modern portfolio theory demands exposure to a broad range of asset classes, including fixed income, but some investors remain reluctant to engage them because of a group of commonly held myths. This week I thought I'd address some of them those myths in the context of our current recommendations.

Myth 1: You will be short changed if you buy fixed income in an environment of rising interest rates or inflationary environment

Some investors are just as concerned about locking into an uncompetitive rate of return as they are that the capital value of their investment will fall. What they don't consider is how quickly markets reflect the likelihood of further rate rises that are, in turn, reflected in the prices of fixed income asset class by the time investors acknowledge the RBA tightening stance (ie, when the cash rate goes up).

Most issuers issue a range of fixed rate bonds and floating rate notes. Investors concerned about rising cash rates can opt to invest in **floating rate notes (FRNs)**. Unlike fixed rate bonds, where the coupon is determined at the time of issue for the life of the bond, these bonds are linked to an underling benchmark.

The benchmark for Australian dollar issues is usually the **bank bill swap rate (BBSW)** and the coupon for FRNs is reset every three months according to changes in the benchmark. These bonds are actually a better investment than a term deposit in these circumstances. Any large upswing in rates will be captured by the changing coupon, whereas term deposits with longer than three-month maturities will be left behind.

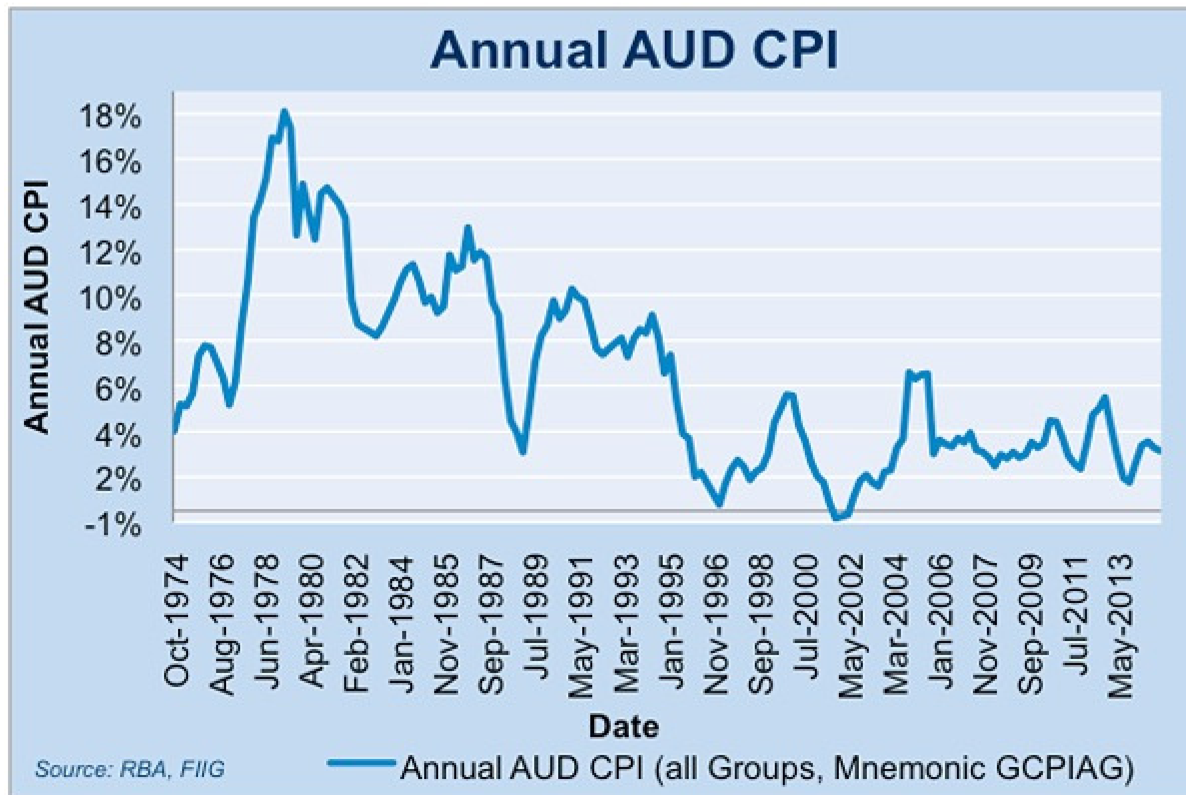
Remembering the inverse relationship between bond prices and yields described in my **previous** article, demand by the market for higher yield to match the higher interest rates will mean that fixed rate bond prices should fall. Lower bond prices provide an opportunity for astute investors. Bonds trading at a discount (that is, less than the $100 face or par value) provide potential for capital gain. Buying when bond prices are low and selling when they rise is a robust and accepted investment strategy.

Myth 2: You will be short changed if you buy fixed income in an inflationary environment

If the Reserve Bank is in a tightening mode it's increasing the cash rate to limit growth and inflation. The current spike in world oil prices with uncertainty in the Middle East has the resurrected the dreaded "inflation" term. The only investment across all asset classes that truly protects against inflation is an **inflation-linked bond (ILB).**

These bonds pay a set margin over a benchmark, usually the consumer price index (CPI), a direct measure of inflation. There are some very good inflation-linked bonds available in the current market. The Sydney Airport ILBs are paying 5.5% "real", which means they are paying the CPI (assume that is 3%) plus 5.5%, providing a current yield of 8.5%. If inflation were to blow out to over 10%, as it did in the 1970s and 1980s, these bonds would continue to provide a real return of 5.5% but total return would move to 15.5%, likely to be much higher than most equities and cash returns during the period.

If you have a sizeable nest egg, high inflation will be a key threat. For any investors new to fixed income, ILBs remain one of our key recommendations. The CBA and Rabobank, both very low risk issuers, also offer ILBs paying a very attractive return of 4% real.



Myth 3: I don't need a fixed income exposure because my portfolio contains a mixture of equities and cash

Wrong, you actually do need to consider fixed income because it performs in ways to protect your portfolio that equities and cash cannot. Equities and fixed income securities are not correlated, meaning a fixed income portfolio will act to reduce volatility of an overall portfolio. When equities underperform, bonds outperform and vice versa.

Unlike cash, bonds and other fixed income securities have an element of capital gain. Bonds are more liquid than term deposits, while FRNs link to a benchmark, making the most of returns in a rising interest rate environment. Furthermore, fixed income securities offer diversification through investment in entities not available on the ASX such as international banks.

Inflation-linked bonds provide a direct hedge against inflation and are the only asset available that provides that complete protection, although FRNs tend to broadly move in tandem with inflation. If you have plans for your investments like retirement, a wedding, gifts to grandchildren to fund education, you need some certainty in your portfolio. Most bonds have a known maturity date and investments can be made so that maturities coincide with investor's plans.

Myth 4: Fixed Income returns are low and will be a drag on my portfolio's overall returns

Fixed income securities offer a range of securities with different risk profiles to suit all investors. While returns are generally lower than equities, the securities are in almost always lower risk. They sit higher in the capital structure so that in the event of default are repaid before lower ranking creditors.

As fixed income securities are lower risk than equities, investors would expect returns to be less than equities. However, this is not always the case. There are currently some bonds offered by large international companies that offer returns over 10%. Insurers Swiss RE and AXA SA are good examples.

The recent earthquake and tsunami in Japan are expected to have minimal impact on AXA SA. Swiss Re has a greater exposure (although only 2.8% of total premiums are written in Japan) and while affecting profit, it is thought to be manageable at this early stage.

Some higher risk hybrid securities are deeply discounted and so offer very high returns. The Elders and PaperlinX hybrids are good examples. See the article ***Slow but steady***, which provided a range of securities and their returns.

Myth 5: You need a lot of money to be a direct investor in fixed income and managed funds are better

Not so, there are small minimum transaction amounts available on Commonwealth and semi-government bonds and there is no minimum transaction amount on listed retail bonds or hybrids. Other types of bonds are available from $50,000 face value parcels.

Managed funds charge you management fees that can be avoided with direct investment. You have access to your investments and can determine the best time to buy/sell to suit your personal taxation position. Direct investment means your investment cannot be frozen, as has been the case with some funds. Some investors mistakenly classify mortgage or property funds as fixed income investment. They may provide a regular income, but they do not provide the same protective elements as described above.

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