

Fixed income

Unjustly unloved

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Bonds may be unpopular with Australian investors but they are irreplaceable in a diversified investment portfolio. Advisers should consider helping their clients to boost their exposure to the asset class.

Australians have traditionally shunned investments in fixed income but thanks to volatility in equity markets, shifting industry trends and an ageing population, attention to the asset class has never been greater.

With a large well diversified sharemarket and high rates of share ownership, Australia undeniably has a vibrant equity investment culture. But the same can't be said for bonds.

Whether it's due to their perception as boring, low risk, low returning investments, a lack of coverage in the media or the absence of a true domestic bond exchange, something about fixed income just doesn't resonate with the average Australian.

"You know when a sharemarket is hot when you are getting phone calls and people are asking for particular stocks or particular segments of the market," says Mark Draper adviser at GEM Capital (licensed by Fortnum Financial Advisers) citing the tech boom in the 1990s, or interest in mining stocks as examples. "Now I personally have never had anything like that with the bond market."

There's no doubt bonds are unpopular in Australia in comparison to other countries. OECD data shows that not only do Australian super funds have the highest exposure to equities among developed nations, they also have the lowest exposure to bonds.

Research conducted by investment consultants Towers Watson found that Australian super funds had an average allocation to bonds of just 14 per cent, compared to 27 per cent for US pension funds, 35 per cent for UK pension funds, 36 per cent for Canadian pension funds, and a global average of 33 per cent. In the booming do-it-yourself super fund sector, bonds are even more unloved, with an average allocation to debt securities of just 0.51 per cent, according to the Australian Tax Office.

It's a situation that has left many observers perplexed, but Australians' comparatively low allocation to fixed income has a number of root causes.

Colonial First State Asset Management's head of fixed interest, Warren Bird cites the "1994 effect" as one of the factors that turned Australians away from bonds.

In the preceding two years, bond yields had fallen sharply, meaning prices had rallied, after the government made huge inroads in reducing inflation. Investors flocked to bond funds, which were offering returns in the high double digits. "It was one of those once in 20- to 30-year phenomena," he says.

Then in 1994, the inflation genie crept out of the bottle again and central banks across the globe were forced to raise interest rates sharply: Australia's Reserve Bank by some 275 basis points. Bond fund managers, awash with inflows, rushed to extend the duration of their portfolios. This only added to the weight of selling, which ultimately smashed returns from the asset class.

"Bond investors were spooked by that experience. And a lot of the investors came out of it feeling like that the bond market was quite a nasty place to be," Bird says.

Making matters worse, carnage in the bond market coincided with a period in which a number of household names including AMP, Commonwealth Bank of Australia and Qantas were successfully floated. The perception that equities was the place to be was firmly established in the eyes of the average Australian.

Peter Dorrian, PIMCO's head of global wealth management, says that a number of factors are behind this anomaly. The first is the fact that Australia has consistently had a higher base interest rate than most other developed countries, which means many investors are happy to park money in term deposits rather than in bonds.

"What a lot of Australian investors don't understand is that if you walk down a street in New York you don't see a poster on Citibank's window saying 7.5 per cent for three years; its 3.5 per cent if you're lucky," he says.



Mark Draper, GEM Capital: Bonds have never excited the same interest as equities. **Photo: David Mariuz**

The second factor is the dividend imputation system, almost unique to Australia, which makes after-tax returns on offer in equities more attractive relative to bonds.

A comparatively small domestic corporate bond market doesn't help, either. For years policymakers have been trying to establish a viable domestic bond market, but growth has been stifled by regulations which make it much easier for companies to issue equity than debt. (Privately, fixed income observers say the big banks have impeded the growth of a local bond market because, by giving corporations a new way to raise capital, it could threaten their corporate lending businesses.)

The cash trap

A common error that planners make is to lump term deposits in with bonds under a broad definition of fixed income, ING Investment Management's head of fixed income, Greg Michel, says. Many investors that do so think they are diversifying exposure to equities through a term deposit, which Michel says is a big mistake.

"A term deposit will deliver income and is capital stable, but they do not exhibit all the characteristics of what would be considered a truly defensive asset," he says, "A true defensive asset should increase in value when growth assets fall. Term deposits do not provide investors with this protection."

Michel points out that term deposits carry liquidity risk because they can leave investors locked into low interest rates for lengthy periods, and without access to their funds unless they are prepared to pay a "hefty" cancellation fee. By contrast, retail bonds can be bought and sold every day on the Australian Securities Exchange and bond managed funds almost universally offer daily liquidity.

Dorrian adds that in an environment where interest rates are expected to increase sharply over the next few years, term deposits can be a very dangerous investment.

"Only having exposure to term deposits for the defensive part of your portfolio is not very sensible because you have just as much interest rate risk but no-one managing it."

Dorrian cites the example of 2008, when the global economy was on the verge of collapsing, equity markets tanked and the Reserve Bank slashed interest rates to 3 per cent to try and stimulate growth.

"There was such nervousness around," he says. "People had big hits to their equity portfolios, and any sort of positive return looked like a good thing. But if you locked away your money in a term deposit back then, when interest rates started rising again, your opportunity cost was massive."

This lack of understanding of bonds, and confusion about how they differ from cash investments like term deposits means many investors aren't fully aware of what exposure to fixed income can actually provide.

While most investors understand that bonds are a defensive asset class that can insulate portfolios against shocks in higher risk markets like equities, what is often overlooked is the returns available.

Rainmaker Information data shows that an actively managed bonds fund returned, on average, 5.92 per cent a year over the past five years, stacking up more than favourably against the performance of the S&P/ASX 200, which returned 4 per cent a year over the same period. The best performing bond fund was Tyndall's Australian Bond Fund, with an annual return of 8.51 per cent. For some investors the question is not why bother with bonds, but why bother with equities.

"The thing that people have lost a little sight of is: what is the additional return that you should expect from equities, relative to bonds in an environment of high volatility?," says Dorrian.

"To put up with the level of volatility the extra return we demand has to be pretty good and we just haven't seen that extra return for many, many years now."

If fixed income can offer a liquid, stable investment with surprisingly decent returns, the next question for investors and advisers is: what is the best way to get exposure?

Managed funds have been the avenue of choice for exposure to bonds for decades now. But investment in direct bonds is generating increased attention. A number of high profile companies, including Commonwealth Bank, Bendigo and Adelaide Bank, Tabcorp, Primary Healthcare and AMP have issued retail bonds listed on the ASX over the past two years.

Retail bonds carry a face value of \$5000 and as such, they are easily accessible to the ordinary investor. They generally pay a floating rate of interest tied to the three-month bank bill rate, providing protection against rising interest rates.

The larger and more common institutional bond issues usually carry a parcel size of \$500,000, and as a result are beyond the reach of most ordinary investors. But FIIG Securities is one broker which allows for investment into over-the-counter bonds issued by household names such as Telstra, Macquarie Bank and Suncorp, as well as

offshore issuers such as Morgan Stanley, BNP Paribas and GE Capital, for as little as \$50,000.

As the financial planning industry transitions to a fee-for-service remuneration model, and as investors seek more control over the moving parts of their super, FIIG's head of planning services Stephen Hart, thinks direct bond investing could continue to increase in popularity.

"Direct investing doesn't pay fees to planners, it's tomorrow's era rather than yesterday's era. With the rise of self-managed super, people are looking at more and more alternatives, and direct bonds is one of them," he says.

The main advantages of directly investing in bonds, Hart says, include transparency, the lack of management and performance fees, and the ability to match a bond's cash flows with the liabilities of an allocated pension.

Planner Paul Banner of self-licensed Provenance Financial is one adviser who recommends direct bond exposure to clients. He runs a pure, fee-for-service practice, and roughly 90 per cent of his clients are self-managed super fund trustees.

"They offer greater control, because you are holding a direct investment," he says.

For Banner, direct investments in bonds offer a number of advantages. For retiree clients, with direct bonds he can easily project cash flows for years ahead, particularly useful for allocated pensions. He prefers to use floating rate securities, because they offer protection against the interest rate cycle, "so if interest rates change, we can go straight to the client and say : this is going to affect your cash flows in this way", he says.

Because the Australian bond market is limited to a handful of issuers, Banner finds it difficult to justify paying fees to a fund manager when you can get the exposure directly. "We are talking about a market that has got very few corporates in it. We are talking about a handful securities. Why not just get them directly?"

In an environment where many investors have been burned the lack of transparency in managed investment schemes, another advantage of direct bond investing for Banner is simplicity. "It's also easy to explain the exposure to the client. You are not trying to explain the way a fund manager works and the way unit prices are struck," he says. "And when you have got clients that have been struggling through difficult markets over the past few years, things that are easy to understand, and where you can demonstrate value, are fantastic."

Unsurprisingly, fund managers argue that investing in managed funds has advantages over direct ownership of bonds. Michel says that by placing money in a managed fund, an investor can gain exposure to bonds issued by a wider range of entities, of varying degrees of quality and at different levels of the capital structure. It also offers clients the flexibility of investing in funds that have access to global bond markets which can then be hedged back into Australian dollars.

"A managed fund delivers far greater risk diversity and greater opportunity of performance by spreading that investment exposure across a broad portfolio of bonds, as compared to a single name exposure that you would get in buying a bond direct," he says.

Bird says investors owning bonds directly could be over-concentrating the credit risk in their portfolios, and just one default could have significant consequences. He says that the real benefit of having exposure to bonds via a managed fund is diversification.

"If you are going to take any credit risk the only way you can manage that properly is to diversify, by owning corporate names in lots of industries around the world, exposed to the whole world's interest rate cycle," he says. "In our view you really need to have 400 to 500 individual bonds to get the proper degree of exposure."

While Banner might disagree when it comes to the local market, he sees things differently when it comes to global fixed income. "Absolutely, fund managers are the way to go," he says. "In that situation you have a much deeper, broader market, and you necessarily need to be employing a fund manager with the expertise to manage the exposure."

If Australians don't have enough fixed income in their portfolios, the question for advisers is: what is the correct allocation?

Experts agree that there is no set rule, and the appropriate allocation to fixed income depends on an investor's stage in the life cycle, risk tolerance and individual needs.

Banner says that a client needs a minimum allocation of \$300,000 to be able to get the diversification needed in a portfolio through investments in direct bonds.

"If a client has less than \$300,000, I start to worry how much diversification we can get," he says.

Banner usually likes to own at least six different bond issues. For retirees, maturities are often staggered to provide certainty, and to underpin pension requirements, with a bias towards shorter dated issues "so I am not talking with a 75-year-old about the next 15 years, but the next five years".

Draper sticks to a few general rules when it comes to fixed income. "For retirees we recommend they have at least three years of income they need in retirement," he says, "but for an asset accumulator unless you have got a view on the markets you would keep just enough to get you through emergencies."

But Draper warns against broad generalisations when it comes to constructing the defensive part of a portfolio. "It depends on the client's needs rather than an arbitrary risk profile," he says.

Michel agrees that there is no silver bullet when it comes to the correct allocation for fixed income in a portfolio, but says that exposure to fixed income should increase with age because the older an investor gets, the less time there is to recover from a shock to system.

"There is an old saying that you do hear amongst investors particularly in Europe, and that is you should invest your age in bonds," he says. "What this is really saying is that ... as you approach retirement or are actually in retirement, your capacity to recover from significant negative return shocks is more limited. Your capital protection strategy and therefore allocation to defensive assets should be front and centre," he says.

Asset

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