



Coming in from the cold

As the dust settles on the post-GFC world, **Janine Mace** discovers that the previously mundane world of fixed interest investments is now in vogue.

NOBODY ever brags about their bond investments at a mate's barbeque.

At least that is the traditional view, but it looks set to change with boring old bonds now becoming quite fashionable.

As FIIG Securities director of planner services, Dr Stephen Hart, remarks: "The post-GFC world is much more conservative, and bonds are the new black."

It seems the losses equity investors incurred during the global financial crisis (GFC) have left deep scars.

"Investors now want to be confident they will have return of capital, as much as a return on capital," explains Perpetual Diversified Income Fund portfolio manager Vivek Prabhu.

Concern about capital protection is translating into a higher level of investor interest in the fixed interest universe and the various ways it can be used when constructing a portfolio.

Aberdeen Asset Management Australian head of fixed income Victor Rodriguez agrees that investors are taking a fresh look. "We are definitely seeing increased interest by financial planners and investors in fixed interest products," he says.

Over at Perpetual the story is the same, according to fixed interest portfo-

lio specialist Adam Curtis. "We are seeing increasing interest and an increasing appetite for this type of investment," he says.

By way of example, Curtis cites the inflows into Perpetual's Diversified Income Fund, which increased from \$100 million in 2008 to \$410 million in 2011.

The interest means Perpetual is spending more time educating advisers and paraplanners about the asset class. "There has been a huge increase in demand for fixed interest education after the GFC," Curtis says.

Pimco Australia has also seen its inflows rise, according to head of global wealth management Peter Dorrian. "Inflows for this financial year are up by a factor of two-and-a-half times on last year, which was up two times on the previous year. It is very interesting, given the broader industry inflow data is flat," he says.

"There has been a lot of interest by financial planners, particularly given the excellent performance of bond funds."

Attention is coming from right across the client spectrum. "A sign of the uptick in adviser interest is it is even being used by private banks and high-net-worth [HNW] clients, who are tradition-

ally not so interested," Dorrian notes.

Shifting investor attitudes

When it comes to the reason for the surge in interest, Dorrian believes the performance figures speak for themselves.

"We are coming up to the third financial year in a row where the performance of fixed interest and bonds has gone against investor expectations. Most of our bond portfolios are heading for 9-10 per cent, while the ASX200 looks like ending up with 8 per cent. Over time this has got to shape how an investor views these assets," he says.

The last few years have shaken both advisers and investors, leaving many

Key points

- After the trauma of the global financial crisis, investors are looking to the stability of fixed interest.
- Compared to Australia, US portfolios have a significantly smaller allocation to shares.
- Australian financial planners are starting to appreciate the benefits of fixed interest.
- The launch of fixed interest exchange-traded funds will help boost retail investment.



asking fundamental questions about portfolio construction, according to Dorrian.

"Advisers have traditionally looked for a growth and an income component in their portfolio, and the income components usually came from AREITs [Australian Real Estate Investment Trusts]. But after the AREITs crashed, they needed to replace them with something else for income and this has led them to reconsider fixed income. This has had a significant impact on portfolio construction at the retail level," Dorrian says.

"The freezing up of mortgage funds has also had an impact. Those two things have helped advisers to get clients to look at fixed interest."

There is also renewed interest in developing portfolios that achieve a specific investment goal, rather than focusing purely on achieving high returns.

"Post-GFC there is a greater focus on what assets to hold and how you match

them to your liabilities," Hart explains.

Following the GFC, many experts believe local investors are slowly recognising a large allocation to equities may not be the right approach for the new investment environment.

"Australian portfolio construction is unusual with its very heavy weighting to shares. In the US, the core of a portfolio is 40-45 per cent in fixed interest, and then advisers use shares almost as a tactical investment around that," Dorrian explains.

Hart agrees most Australian investors are very overweight equities compared to international investors. "Often they hold 70 per cent equities, when the common rule of thumb is to own your age in bonds."

Ongoing equity market volatility has also made investors wary.

"Some advisers are getting tired of sharemarket volatility and the continuing influence of bad news. This is leading them to consider having a fixed exposure to fixed interest at the core of

the portfolio," Dorrian says.

Bonds can also be a valuable counterweight to sharemarket fluctuations. "Investors need to get long duration bonds as they are the best offset for equity volatility," Nash says.

The basic building blocks of a properly constructed portfolio are equity and fixed income. "Properly diversified portfolios should be across all asset classes – not just shares, some property and cash," he says.

"The new fiduciary responsibilities mean financial planners can't ignore fixed interest. It is in the interests of the client for financial planners to be fully across fixed interest assets," Nash says.

The role of fixed interest

Dorrian believes planners are starting to appreciate the various tasks fixed interest can fulfil in a portfolio. "Allocations to fixed interest provide stronger returns and strong diversification benefits," he says.





Hart agrees bonds have an important role to play, because they provide more certainty of return and future value.

Rodriguez believes high quality investment bonds can be used to provide both protection and a buffer when equity returns fall. He urges advisers to think carefully about what they hope to achieve

with a fixed interest allocation.

"Planners need to fully understand what they want from a fixed interest portfolio. Is it above cash returns when shares fall – a diversification benefit – or do they want inflation protection? Or is it purely capital preservation on that section of your portfolio? Is it yield enhancement?" Rodriguez asks.

Prabhu agrees advisers need to be discerning. "There are lots of opportunities within the fixed interest universe, but advisers need to make distinctions about what attributes they are looking for in their fixed interest allocations."

This can be vital, as chasing higher yield – even within a fixed income allocation – can have important consequences.

"Investors have learnt they cannot focus only on yield, as more yield leads to changes in the nature of the fixed interest portfolio," Rodriguez explains.

Prabhu agrees: "If you are going to chase yield, then you can lose the attributes of a defensive investment. The more you move away from defensive attributes, the more

you are introducing attributes that do not perform as you would expect a defensive

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Battling Inflation

According to Nash, advisers are beginning to understand the benefits fixed

interest allocations can bring when it comes to financial planning. "The future of value of a bond is certain and it can be matched to a future liability – for example a trip around the world in two years time. This leads to more control over a portfolio."

Although liability matching is important, the rise of inflationary pressures also needs to be considered. This is where inflation linked securities come into play, Hart says.

"You have lower income in retirement, but research shows it is dispro-

portionally more affected by rising fuel and food costs. This has a greater impact on lower incomes," he says.

Nash feels the potential for inflationary price rises is an important issue for advisers and clients. "Inflation-linked bonds (ILBs) are very valuable as the RBA cannot control many headline inflation areas. We could see a period where headline inflation is within the RBA band, but some areas like food and fuel are much higher. This is a big

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Dr Stephen Hart



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concern for retirees as they face costs every day."

Rodriguez agrees inflation is a major issue for investors, particularly given the current trends in the global economy. "Investors are concerned because emerging markets are no longer deflation exporters, and there are increasing inflation trends around the world. Inflation-linked bonds are the asset class of choice for that problem and we are seeing a growing demand for those products."

According to Hart, ILBs are easy to access and offer a reasonable yield. He points to the 3 per cent real yield offered by NSW Treasury Corp and Queensland Treasury Corp instruments as an example.

"If you do not need liquidity, Sydney Airport inflation-linked bonds offer 5 per cent real yield which is effectively around 8 per cent nominal. This is an equity-like return with half the risk. You are a senior holder, and these are very attractive securities – and they also perform well in a recessionary environment," he notes.

Opening up the market

With interest in fixed interest growing, the proposed ASX launch of fixed interest exchange-traded funds (ETFs) is seen as being vital for boosting retail investment.

"ETFs will begin to open up the market, especially for those not wanting to use managed funds," Dorrian says.

"However, it is likely to be at the end of the year or early next year before we see the rules change to allow ETFs based on fixed interest."

Dorrian believes ETFs will open up fixed interest up to the broker advised and self-managed superannuation fund (SMSF) markets in Australia. Pimco currently offers a big suite of ETFs in the US, but is waiting for amendment of the ASX rules before launching products here.

Australia is likely to follow the global trend in this area, according to Curtis.

"Globally ETF numbers are meaningful and you would expect demand here would be strong."

When they are launched, ETF products are likely to offer investors new options by covering assets such as senior bank debt, Hart says. "ETFs are not likely to be based on the composite index due to the illiquid corporate names in that index. However, the semi-governments could go in and that would make a good index."

A stumbling block for smaller investors wanting to access fixed interest has been the minimum parcel size of \$500,000 offered by most issuers into the Australian bond market.

However, the move by brokers to buy wholesale parcels and break them up into smaller \$50,000 face value parcels is changing this situation. "Sometimes these smaller parcels are offered to investors with a price as low as \$35,000-\$40,000," Nash says.

FIIG Securities offers smaller parcels, together with a complimentary asset allocation service to assist financial planners put together appropriate client portfolios. "This is getting good traction with financial planners, particularly those with SMSFs and older clients wanting good cash flow," Nash notes.

"Financial planners like the direct control, transparency and the fact there are no fees if held to maturity."

Going deeper

Even with the arrival of ETFs and smaller parcels, the Australian market still has some way to go until it resembles overseas capital markets such as the US, which has a very broad and deep bond market readily accessible to retail investors.

"There are still not enough products available and this can be seen as the listed bonds that are available are very overbid," Nash notes.

He believes smaller retail parcels will help advisers gain the confidence to develop tailored portfolios. "With a \$200,000 portfolio of fixed interest, it can be a well diversified portfolio."

However, not everyone is certain this is the best approach.

As Curtis notes: "The lack of direct debt securities makes it hard for retail investors to get good diversification. Diversification in a debt portfolio is arguably more important than in an equity portfolio as the upside is capped for debt securities."

Dorrian is also sceptical. "If the parcel size changes, I am not sure it will lead to greater investor interest and financial planners will have problems with the concentration risk with a direct portfolio."

Everyone agrees there is a role for the Government in fostering the fixed interest market.

"It is in the Government's interest to get more people into bonds to reduce their future pension liabilities," Nash argues.

Hart agrees: "We need to see greater attention to the regulatory requirements so they lead to an increase in the number of issuers and increased interest by small issuers. Then they are not totally reliant on bank finance."

This issue has been recognised by the Senate Economics Committee, which recently recommended the Government establish a working group from Treasury, the Australian Prudential Regulation Authority, RBA and the banking and superannuation industries to explore ways to promote investment in deposits and fixed income assets by super funds and other funds managers. **MM**



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