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A fixed income primer

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PORTFOLIO POINT: Investors considering adding fixed income to their portfolio should ask themselves these questions.

Professional fund managers all include an allocation to fixed income in their balanced funds. They understand the benefits and although the percentages might differ, they all have an allocation. So, if you manage your own investments, why not start investing like the professionals and add some fixed income? This article explains how to begin.

Investors new to fixed income should consider several factors when choosing assets for their portfolio. While analysts focus on the credit worthiness of the issuers and identify the risks involved, investors need to ask themselves a number of questions:

1: What is your current portfolio allocation? You'll need to assess your current investment allocation between the major asset classes of equities, property and fixed income.

Does this meet your long-term objectives? Do you have enough "protective" fixed income investments? Remember that even though cash (including term deposits) is included in fixed income, those assets don't offer the same counter-cyclical benefits as bonds: when higher-risk asset classes underperform, bonds usually outperform, smoothing portfolio volatility (see *Fixed interest's promise*).

2: The capital you need to maintain your current lifestyle Assuming the very worst possible scenario and you lose capital, what is the minimum capital you'd need to protect your current lifestyle?

3: The income you need to maintain your lifestyle It's worth drawing up a list of your monthly expenses, including a buffer, to determine the income you need to maintain your lifestyle. One of the greatest threats to income is inflation. The Reserve Bank has been effective in limiting inflation to the 2–3% range, but a blowout is possible. Inflation-linked bonds are the only investment that offers a direct hedge against inflation.

4: Known liabilities Bonds can be acquired with cash flows and maturity dates to suit known future expenses.

For example, if you own a small business and have ordered equipment from the United States and the equipment needs to be paid for in six months' time, you can buy a bond with a six-month maturity.

Perhaps better still, you can purchase a US dollar-denominated bond, to lock in the current exchange rate, again with a six month maturity date.

5: Risk appetite Bonds can cater to a vast array of risk appetites. Australian Commonwealth government bonds are considered "risk-free" and earn in the range of 4.5% to 5.5%, depending on volume and maturity. Yet there are corporate bonds available that can still return better than 10% (these returns are known), which is an equity-like return for much lower risk.

6: Age The older you are the less time you have to recover lost capital. Also as you age, your earning potential may decline; again, you may not be able to work to recover lost capital.

Investors should consider that they generally need to be more protective of capital as they age and if you don't have enough capital to support your lifestyle when you retire, then it's not a good time to invest in high-risk assets. One rule of thumb is that the maximum equities you hold should be 100 minus your age, so if you are 70 your maximum equity allocation should be 30%.

7: Capacity to earn income to supplement losses This ties in with age; if you have the capacity to earn income you can invest in higher risk assets.

8: Diversification We all know of very sad stories about high-profile Australians who have invested all their capital in single high-risk investments and have lost the lot. If there is one piece of advice I'd give any investor, it's to diversify their investments across asset classes and to include an element of fixed income that protects the investor's lifestyle and standard of living. Investing all of your funds and leveraging into a single luxury property development, or Chinese supermarkets for that matter, is a very poor, very high risk strategy.

Part of a building a balanced portfolio is making sure the investments you hold are across different industrial sectors and have varying maturities and risk profiles. Ideally, new fixed income investors should seek investments in companies that they don't already hold in equities. For example, if you own Macquarie Bank shares and have a Macquarie cash account, I wouldn't recommend a Macquarie bond; but you could sell your Macquarie shares and buy a Macquarie bond, to reduce risk and uncertainty for a known income and return of capital at maturity.

There are many non-listed ASX bond issuers; some of my favourites at the moment are infrastructure companies that have guaranteed government cash flows but offer high returns to compensate for possible illiquidity.

New fixed income investors should aim to hold different types of bonds, such as fixed and floating-rate notes, inflation-linked and government bonds, across a range of sectors. In that way, if any one asset class or one specific sector underperforms, performance of the other investments supports the performance of the portfolio.

9: Liquidity Try to determine when you might need to access funds and have a range of maturities to coincide with your expectations.

It is always good to hold some very liquid investments in case of emergency. Term deposits don't count as liquid investments as they are not readily accessible without loss of value (that is, there are break fees and no guarantee the financial institution will release the funds to you). Equally, less liquid investments will normally pay higher returns, so holding some of these in your portfolio will boost overall returns, you just need to be aware that they may be difficult to sell quickly.

10: Returns This is often the first consideration of investors and although it is important, it should be considered in light of the above. Remember higher returns often mean higher risk.

By considering these factors and discussing them with your specialist fixed income dealer or financial adviser, you'll be better prepared when making decisions about which investments to include in your portfolio.

One final point: if you have proportionally large term deposit holdings, one easy way to start investing in bonds is by assessing securities those banks or financial institutions have that are lower in their capital structure, so theoretically should provide greater returns.

For example if you hold a Commonwealth Bank term deposit, then you have confidence in the ability of the Commonwealth Bank to continue to trade (its credit quality), then you could investigate other fixed income securities the Commonwealth Bank offers further down in its capital structure for a theoretical higher return.



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