

EUREKA *report*



Places to hide

By Elizabeth Moran
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PORTFOLIO POINT: Investors concerned about volatility on the sharemarket should consider investing in bonds.

Investors around the world recognise that not all is good with the global economy. Equity markets took a hammering as US policy-makers flirted with the idea of default.

None of us truly believed it would come to that but as the days dragged on the uncertainty increased. How could the world's superpower threaten economic upheaval on a global scale and retain its AAA credit rating?

You will have heard by now that S&P downgraded the US to AA+ and, importantly, put the rating on negative outlook, meaning it could be further downgraded over time (for more on this, click [here](#)). Clearly the politics in the equation is the destabilising factor but the \$US14.3 trillion debt burden (and rising) is a big contributor.

Stimulus to avoid recession and help get everyone back on track has not worked. Two rounds of quantitative easing by the US totalling \$US2.4 trillion helped avoid the worst of the downside, but are we now facing a deeper downturn than had we had taken our medicine two years ago? Given the circumstances, it seems unlikely that the US would agree to a third stimulus package.

Insolvent sovereigns and the actions they need to take to rein in debt should create a low or negative growth scenario, a very poor environment for asset classes that rely on growth for performance, such as equities and property. Lower-risk debt markets that offer investors known returns, repayment of capital at maturity and diversity offer a sound defensive strategy.

What happened to debt markets last time around?

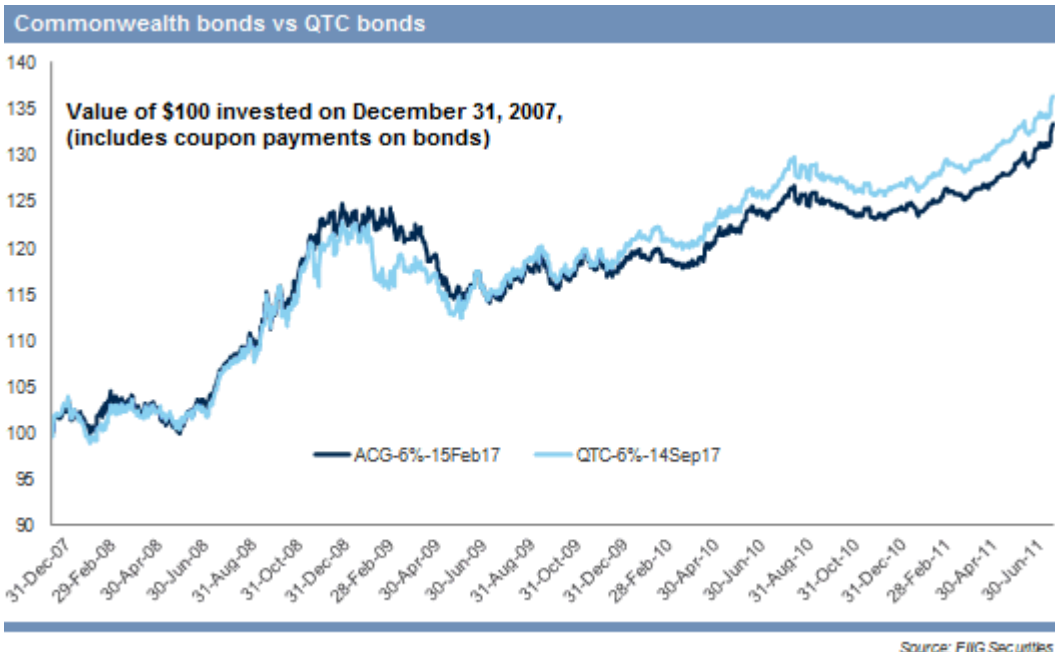
Bond markets identified the GFC downturn prior to equity markets as credit spreads widened. Over the past week we have seen credit spreads widen with the Australian Itraxx (comprised equally of the 25 most-traded entities in the Australian Credit Default Swap market) closing on Friday New York time at 134 points. The Itraxx at its highest during the GFC was about 443 points in March 2009 and its recent low point was January 2010 at 75 points. So, while spreads have increased, they are still low compared to the highs reached during the GFC.

But even with equity market losses, debt markets are still behaving as we would expect them to; showing spreads widening but having a reduced impact when compared to equities. The big advantage is that hold-to-maturity fixed income investors know that, unlike an equity investment, if they hold the bonds to maturity and the company continues to trade, they will receive their capital back at maturity.

Government bonds

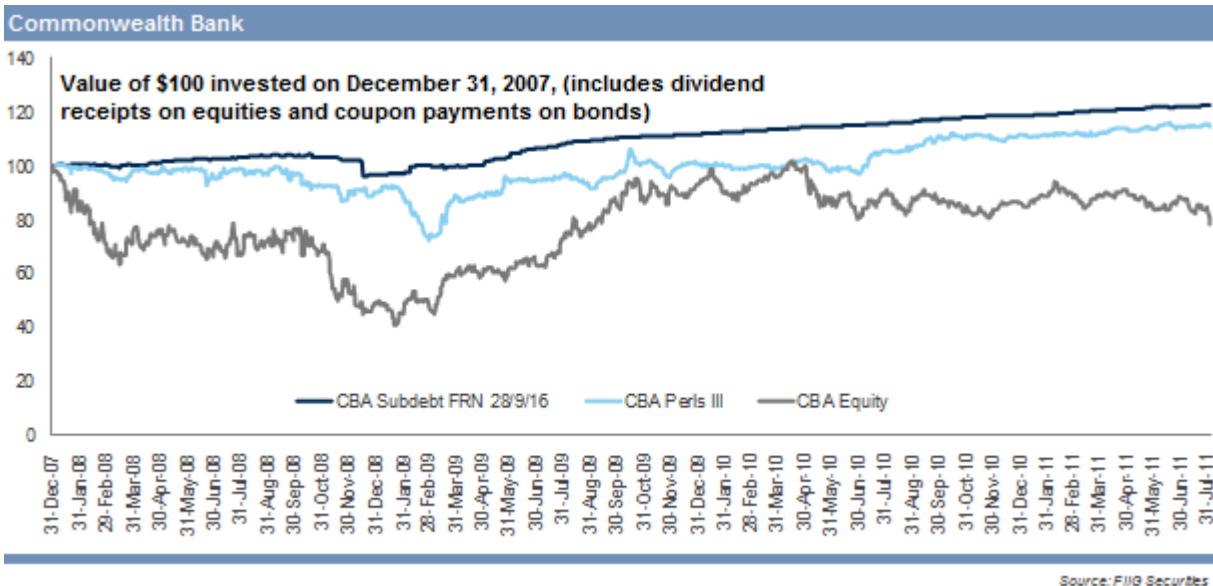
The yields on Australian government bonds, along with semi-government bonds, fell during the GFC as the prices were bid up. Investors were less concerned about their return than just protecting their capital and making sure distributions were paid. These investors also wanted to lock-in that yield for longer terms than term deposits, typically five to 10 years of known returns.

They also savoured the benefits of liquidity, which is offered to buyers of very low-risk, high-grade bonds. Investors in term deposits do not have the same liquidity. To break the agreement, term deposit holders often suffer a penalty. So, if you want to park your money, a Commonwealth government bond, while offering a lower yield, provides quick access in the event markets turn and you'd like to access your funds to invest. Below is a diagram showing the performance of a Commonwealth government bond and a QTC bond if purchased on December 31, 2007.



Australian financial institutions

Generally, the debt ranked higher in the capital structure of financial institutions is less susceptible to bond market volatility. The Commonwealth Bank, perhaps the safest ASX-listed entity and Australia’s largest bank, saw assets across its capital structure perform as indicated below. You’ll see the subordinated debt (highest ranked and lowest risk) was the most stable asset. The hybrid, Perls III, showed more volatility and the equity the most volatility dropping, over 50% if acquired on December 31, 2007. If the graph showed the senior debt, it would show even less volatility than the subordinated bond.

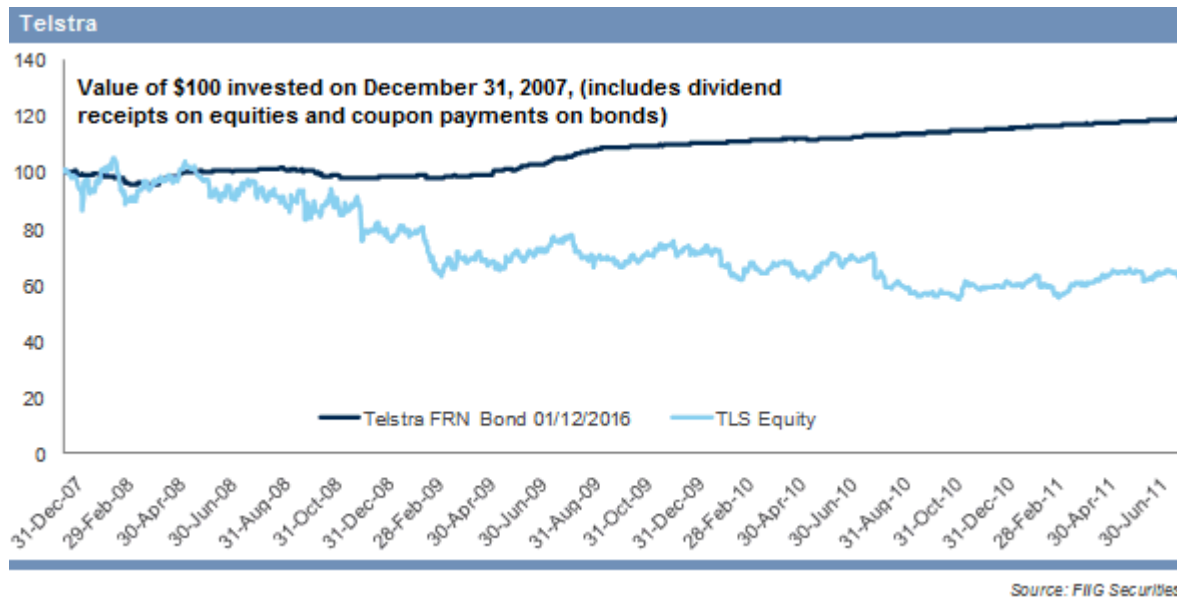


During the GFC, we saw Australian banks’ subordinated debt trade at higher yields than hybrids (an anomaly offering good relative values given higher risk hybrids were returning less than lower risk subordinated debt) and a long way ahead of senior debt, providing an exceptional investment opportunity for those in the know. FIIG was able to offer investors subordinated debt in the major Australian banks at yields as high as 12% to call and regional banks offered wider returns still.

Australian corporations

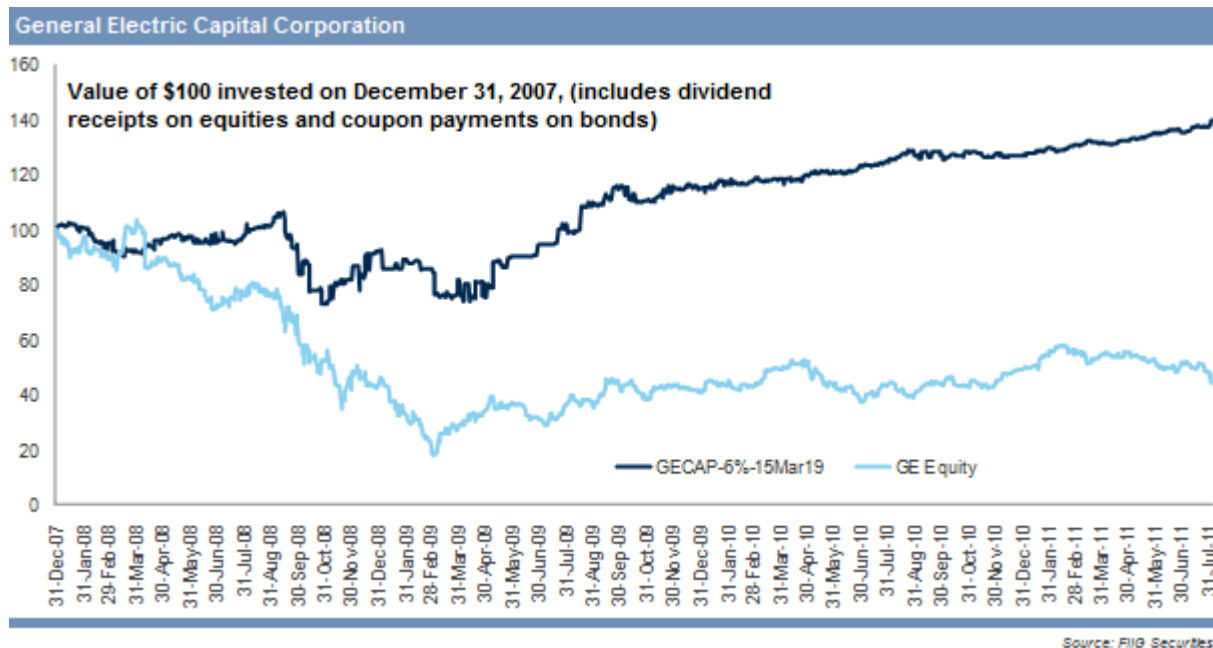
Credit spreads for Australian corporates widened and we saw some extraordinary value in some bonds. The following

graph compares Telstra equities to Telstra bonds, the bonds have clearly outperformed had you acquired them on December 31, 2007.



International financial institutions and corporations

Bonds such as General Electrical Capital Corporation, a subsidiary of GE traded below \$60 during the GFC. While the subsidiary suffered due to credit markets, it was granted the protection of “bank status” and although demands from shareholders to sell off the then unprofitable subsidiary were strong, GE retained its financing arm and credit spreads were eventually restored, making some investors close to 80% on their investment.



What's different this time?

Markets cannot expect any stimulus from governments, yet corporate and bank balance sheets are stronger. Many bond issuers have extended debt maturity profiles and reduced debt, leaving them better placed to cope with stressed conditions.

I can't say with any certainty what will happen next but I do expect ongoing uncertainty and volatility. Debt markets have also experienced some spread widening but to a much lower degree than equities. Hold to maturity investors can be assured that as long as the issuer survives they will receive their coupon and repayment of capital at maturity a

much more stable offering than the equity market.



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