



Fixed opinions

Lisa Pennell delves into the world of fixed interest and finds there's a strong case for bonds as a defence against plummeting sharemarkets.

Forecasting has become such a big business that it's now almost an industry unto itself. Virtually every financial institution has its own team of economists who, until recently, would confidently and loudly espouse their views on precisely where markets and interest rates were heading. They've not always been right of course, but lately the game appears to have moved to another level entirely. The forecasters' opinions have become consistently inconsistent, sometimes changing radically and often without warning. And it's making investors nervous.

This nervousness is only adding fuel to a lemming-like stampede - which began around the time of the global financial crisis (GFC) - towards the investment tools that are perceived to be the safest: cash and term deposits (TDs). It's true that cash and TD returns have been attractive, but used alone they may not be the best way to create a comprehensive long-term defensive strategy.

To understand the present, we need to look more closely at the past. Since the mid-80s, developed nations have been enjoying stable economic growth, predictable economic policies and low inflation - a period now known as "The Great Moderation". Some analysts have argued that this greater predictability caused companies to be more relaxed about their liquidity and investors to be less concerned about risk. Certainly when the GFC hit, many Australians were caught with superannuation funds that were highly exposed to equities, and portfolios were subsequently decimated.

A Government guarantee was introduced to secure the deposit base of banks, but caused problems for products like mortgage funds, which were not included in the guarantee. The volume of withdrawals from such funds caused many to freeze or to severely limit redemptions.

With their fingers burned by bad experiences with equity markets and frozen funds, Australians suddenly became more conservative than ever. Households began saving more of their disposable income than they had in 20 years, putting it where they believed it was safest - the bank. According to the Australian Bankers' Association, this has resulted in almost \$500 billion sitting in bank accounts at the end of May 2011, up a staggering 59 per cent since the beginning of the GFC in August 2007.

So far in 2011, conditions have continued to be volatile. Economists have been

pushing back their predictions for rate rises from month to month, while the Reserve Bank of Australia (RBA) has continued to hold fire. In mid-July, Westpac broke ranks to announce its prediction that the RBA would be forced to slash rates by one percentage point in a series of rapid cuts commencing in December.

Most forecasters dismissed Westpac's position as extreme. If there was anything close to a consensus opinion at this point, it was that rates would most likely stay on hold in the short term, only rising if employment and inflation continue to rise. But that's all conditional on what happens overseas. Interestingly, by the end of July the average three-year fixed mortgage rate was almost equal to the variable rate - an almost unheard of event. What's probably more widely accepted than any current forecast is that it's become more impossible than ever to say with any real certainty what's around the corner.

In this environment, getting the defensive allocation of an investment portfolio right is more difficult than ever. A clear trend towards fixed term deposits has been supported by many planners who are wary of their clients' fearful dispositions. With healthy guaranteed returns on offer and a low perceived risk, TDs now comprise much, or even all, of the defensive element of many portfolios.

But far from being risk free, TDs, like every other investment tool, have their own unique hazards.

The fixed income experts agree that perhaps the greatest risk of TDs is the lack of any protection from a surge in inflation. With the bulk of TDs featuring a fixed duration and high break fees, the investor is effectively locked in if interest rates rise.



Eu Joe Chan

As well as the growth in TDs, the Australian bond market has grown by an estimated 44 per cent since 2007, according to RBA estimates. According to a recent report, there was an estimated \$1.209 trillion of bonds on issue as at May 2011 - almost double the \$626 billion outstanding in 2005.

Similar to term deposits, but without the bank acting as a middleman, bonds are a formal contract between the borrower and the lender to repay borrowings after a fixed term, with interest paid at fixed intervals or at maturity. The amount of the bond is known as the face value or the principal. The bond issuer is the borrower and the bond-holder is the lender, with the interest payable on the bond known as the coupon.

Bonds and equities are both securities, with the difference being that the

stock-holder has an equity stake and the bond-holder has a creditor stake. This is one of the reasons bonds are viewed as far less risky than equities - bond-holders are the first in line to be paid in the event of a wind-up, while shareholders are the last, with hybrids in the middle of the two. The other key difference between bonds and equities is the fact that bonds have a fixed term, generally between one and 30 years, and at the end of the term, known as the maturity date, the principal is repaid. Stocks, on the other hand, may be outstanding indefinitely.

There are some other key benefits to bonds as a defensive component of a portfolio, including their liquidity. Unlike a term deposit, a bond is a tradable instrument and can be bought or sold before maturity for a profit or loss. In Australia, there is no centralised place or exchange for bond trading, although there are a small number of exceptions that do trade on the Australian Securities Exchange (ASX). The overwhelming majority, however, are traded over the counter (OTC).

Investors have moved towards TDs because they're seeing them as the best and "safest" return on their investment. Interestingly though, a recent white paper by Anita Daum and Darren Langer, heads of portfolio management at Tyndall, showed that the UBS Australia Composite Bond Index rose by about 70 per cent between January 2002 and June 2011, while RBA data showed term deposits returned just over 40 per cent during the same period. For bonds, this represents a significant premium in return for a minimal increase in risk.

Perhaps most interesting is the



Victor Rodriguez

comparison between the returns from equities and bonds over the past five years - the defensive versus the growth side of the portfolio equation. In the three years to June 30, 2011, the Australian bond market as measured by the UBS Composite Bond Index returned 8.06 per cent per annum, while according to the S&P/ASX 200 Accumulation Index (which includes dividends), the Australian sharemarket returned just 0.32 per cent per annum.

Over the five years to June 30, Australian bonds returned 6.50 per cent per annum versus 2.38 per cent per annum for Australian shares. Some bond funds also showed competitive returns over 10 years, including Pimco's Australian Bond Fund, returning 6.99 per cent (post-fees) per annum, and Aberdeen's Australian Fixed Income Fund, returning 6.51 per cent (post-fees) per annum, compared to 7.21 per cent per annum for Australian shares.

On balance, it's clear that investing in Australian bonds can be a good way to both reduce portfolio volatility and generate income. But as Victor Rodriguez, head of Australian fixed income for Aberdeen, points out, there's an important tactical question of how to use them effectively.



"Thinking you can have it all in fixed income is overly optimistic. There's a real need for diversification within the asset class," Rodriguez says.

"It's impossible for retail investors to time their entry into the bond market; nor should they try. It should be about creating an overall portfolio to meet set objectives.

"In managing a fixed income fund, a lot of the strategies are very 'big picture.'"

Rodriguez explains the average maturity of the portfolio, known as the duration, is just one of the major considerations; and forecasting the RBA's position on interest rates plays a significant role.

"A portfolio with a shorter duration will be positively impacted if the cash rate goes up and, conversely, a longer duration will benefit from rate cuts," he says.

"Hence a fund manager will always have a view on interest rates, even in times of volatility, and we will adjust our portfolio accordingly. Ultimately, investing in fixed income is a long-term strategy."

The category and type of bond selected are the second major consideration. While the global bond market is much larger than the local market, there are several major categories of bonds in Australia with yields differing according to the risk. The main categories here are government (issued by state or federal governments), corporate (issued by companies) and asset-backed bonds. The last category relates to fixed-interest securities back by pools of individual loans on assets, with the most common of these being mortgage-backed securities (MBS).

As well as categories of bonds, there are also different types of bonds. Although there are numerous other instruments available to fund managers, the main types available to investors are fixed rate bonds, floating rate notes and inflation-indexed bonds. With fixed rate bonds, the coupon is set at the issuance of the bond and does not change over time. With the other two types, the rate changes - floating rate notes have a variable coupon equal to money market reference plus a spread; inflation-indexed bonds pay interest tied to inflation, cutting out inflation risk.

Lastly, the financial robustness of bond issuers can vary greatly, and corporate bonds have a wide variety of credit ratings. Australian corporate bonds are split into two broad clas-



sifications - investment grade credit and speculative (high-yield) bonds.

Eu Joe Chan, an investment analyst at van Eyk, says while investors perceive bonds as a safe haven, they need to be selective when using them as part of a defensive strategy.

"We have a preference for Australian bonds compared to global bonds due to the Government's credit position and the fact we do not have the systemic issues of some other economies," Chan says.

"Our banking sector is in good shape and our interest rates have been raised in advance of other economies."

Peter Dorrian, head of global wealth management for Pimco, says he wouldn't argue one or the other when it comes to Australian versus global bonds, saying there's always a balance between risk and return.



"The Australian bond market is considerably smaller than the equity cap, whereas in the US, the bond market is double the size of the equities market at about US\$73 trillion. Yes, we are concerned about the unresolved US issue and the volatility overseas, but risk also equals opportunity," Dorrian says.

Rodriguez believes the merits of fixed interest as a defensive asset class only apply to high-credit-quality, investment grade bonds and says if a particular security doesn't meet the quality criteria, Aberdeen will not touch it. He cites the performance of the Aberdeen Australian Fixed Income Fund as a measure of success from this approach, which he says has never had a security in its portfolio downgraded to non-investment grade, let alone a default.

"We see our role as fixed income fund managers to avoid the losers, not just pick the winners, and we don't agree that everything has its price," he says.

Stephen Hart is the director of planner services for FIIG Securities Limited, Australia's largest non-aligned fixed income broker, which enables planners and their clients to invest directly in bonds. He says direct investment is an attractive option over bond funds for investors who are able to mix different types of bonds to suit their own portfolio criteria.

"Direct investing in bonds means more liquidity, lower fees and full transparency and control compared to holding units in managed funds," Hart says.

"Until recently, corporate bonds were limited to minimum parcel sizes of \$500,000 face value; however, FIIG has recently opened up the market for parcels of \$50,000 and upwards.

"Allowing direct access in amounts from \$50,000 has made it an attractive option for investors and trustees of self-managed super funds. Particularly in a lower return environment, cutting fees is important and we have been fielding an enormous number of enquiries recently from planners."

Chan believes direct investing is closed to small investors due to minimum parcel sizes and that the bond market is one where investors need third-party advice regardless.

"I would say an investor would need a minimum of \$2 million to be able to play in a market that's not exchange traded. In any case, the funds have access to opportunities that are not shown to retail investors," he says.

Dorrian agrees, pointing out that as one of the largest players in the bond market, Pimco is offered opportunities to bid for bonds that never go near retail investors. He says the most important aspect to consider in the direct versus bond fund debate is diversification.

"There's an obvious risk in owning one bond - the same as only owning one share. I would say unless you're undertaking constant research, direct investing in bonds would be high risk," Dorrian says.

"The landscape has changed dramatically in the past three years and there is credit risk everywhere."

Rodriguez says the need for diversification is in fact much higher than in the equities market.

"With bonds, the opportunity to double your money doesn't exist, but the downside is, if the issuer folds, you can lose. You don't want to put all your eggs in one basket," he says.

"Remember, bonds are the defensive part of the portfolio. We don't hold more than 1 per cent of our total fund in any one bond and the retail market just can't offer that level of diversification.

"On top of that, a direct investor would be missing out on the fund manager's ability to add value above the market."

Paul Banner is the director of Provenance Advice in Sydney and invests both directly and via bond funds on behalf of his clients. He says that in selecting parcels of bonds to buy directly, he only looks at durations longer than five years, staggering the maturity dates to match the cash-flow requirements of the client's portfolio.

"I find I can get a reasonable diversification in a portfolio with four good-quality corporate bonds and around five hy-



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brids, although the hybrids have more risk and require a more sophisticated understanding," Banner says.

"With direct, I don't actively trade the bonds like bond fund managers; the plan is to keep the bond until maturity, although the option to trade is always there. It's all about certainty, control and a rate that's going to be certain.

"I believe it's been understated by the investment community just how badly burned not just investors, but planners are right now - hence the trend towards TDs and cash.

"I do use TDs for some clients, but bonds allow for maximum flexibility. Direct investment is compelling for clients as it's only one step away from a TD. A little more risk for a little more return, perhaps even in the same institution as a TD."

Chan and Rodriguez both agree, saying investors should consider having a portion of their portfolio in TDs, but that there is a real need to diversify the fixed income allocation and limit the exposure to any one area.

"People see TDs as risk-free, but they're not - they have limited liquidity which represents a real risk," Chan says.

"We do believe that TDs have a part to play in the fixed income arena, but if an investor has a high exposure to equities, as many Australians do, then cash or TDs won't give you much of a buffer," Rodriguez points out.

"Used properly, bonds are a solid defence against a fall in the value of shares while providing income and strong capital protection. Right now, bonds are an asset class that is simply underinvested in."

Dorrian says timing is all-important with TDs and he reiterates that if an investor gets it wrong, they'll encounter substantial break fees.

"There's been a massive flight towards quality in the way individual investors think about their portfolio, particularly with retirees. The timing issue is less relevant with a bond fund."

Banner sums it up with a simple perspective on the two.

"You always have the reinvestment risk with TDs; it's like kicking a can down the street. The risk versus return equation on bonds is compelling." ■