

EUREKA *report*



One year on, a happy return

By Elizabeth Moran
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PORTFOLIO POINT: Our model bond portfolio returns almost \$70,000 in its first year, while the market has gone backwards.

More than a year has passed since I started contributing to Eureka Report. So it's time to assess the returns of my initial portfolio (see **Your \$1 million bond portfolio**) and demonstrate the benefits of adding an allocation of fixed income.

When I first set out the portfolio, I had in mind a person nearing retirement who wanted to increase certainty with a known income stream. The portfolio was meant to complement an existing share portfolio, so I also had a preference for issuers that weren't listed on the ASX. The ultimate goal was to return 4–5% over inflation (assuming inflation stayed within the 2–3% band) with the aim of a nominal return of 6–8%.

I'm very pleased to announce the portfolio income was \$69,240 (7.23% return) for the 13 month period and, if extrapolated for the 12 months, made a healthy return of 6.88% (see the first table). Moreover, unlike an equity portfolio over the past 13 months, the value of my capital has actually increased. The ASX 200 index has fallen 14% since September 2010, whereas my portfolio has seen the capital price increase by just above 2% over the same period.

If you are a hold-to-maturity investor and the ongoing income was key to you enjoying your retirement, the portfolio delivered that benefit. As expected, none of the issuers went into liquidation.

Portfolio revaluation

Security	Purchase Price (3 September 2010)	Coupons per quarter*					Total Coupons	Market price (3 October 2011)	Bond price Gain/ (Loss)	Total Coupons + Gain/ (Loss)
		1	2	3	4	5				
Rabobank (Fixed)	\$464,264		\$16,038		\$16,038		\$32,075	\$481,825	\$17,561	\$49,636
GE Capital (Fixed)	\$99,146	\$3,000		\$3,000		\$3,000	\$9,000	\$97,760	-\$1,386	\$7,614
AXA SA (Fixed)	\$85,653		\$3,750		\$3,750		\$7,500	\$80,696	-\$4,957	\$2,543
Macquarie Bank (FRN)	\$48,441	\$636	\$665	\$670	\$677		\$2,649	\$49,320	\$879	\$3,528
Rural Bank (Fixed)	\$105,999		\$4,750		\$4,750		\$9,500	\$106,908	\$909	\$10,409
Sydney Airport (ILB)	\$51,368	\$562	\$566	\$574			\$2,270	\$55,739	\$4,371	\$6,641
QTC (ILB)	\$52,436	\$393	\$395	\$398	\$402		\$1,588	\$57,431	\$4,995	\$6,583
Credit Union TD	\$50,000		\$702				\$702	\$0	\$0	\$702
CBA retail bond (FRN)	\$50,000			\$923	\$744		\$1,667	\$49,485	-\$515	\$1,152
Cash account	\$0						\$0			
Total							\$66,950	\$979,164	\$21,857	\$88,808

Source: FIIG Securities

* Coupon periods are quarterly - a rough guide only

Note: CBA retail bond acquired 24 December 2010

Credit union term deposit expired 2 December 2010

Bond price (gain/ loss) is the current market value of the bonds. Gains and losses are only crystallised on sale of the bonds.

Assumes that coupons payments were deposited into an "At Call" account that compounded at 6%

What's interesting is how the prices of the bonds have performed. When I chose the above bonds I had a view that interest rates were close to peaking and this differed to the market's view at that time in that many thought the cash rate would rise by about 1% to 5.50%.

That meant there was a general preference by investors to buy floating-rate notes that would capture the

additional cash rate rise. Because of this view, the price of the fixed rate bonds were mostly lower than the floating rate notes; in other words, they were trading at a lower price than the floating rate note equivalents. I was happy to lock in the bulk of the portfolio and thus increase certainty of my returns.

Since then, the market has revised its cash rate expectations and we've seen a general swing back towards a preference for fixed rate bonds. Many investors now think the cash rate might decrease and returns on floating rate notes will also decrease. What has this meant for the portfolio?

The prices of the bonds in my portfolio have generally increased and if I decided to sell the entire portfolio today, I would make a capital gain of \$21,857 and a total return of 9.52% (annualised 8.76%) (see the table below). If I just sell Rabobank, Sydney Airport and QTC bonds, I'll have made a capital gain of \$26,927. If you were in my position, would you take the profit, or would you hold?

Total 13 month income return		Return on sale of whole portfolio	
Income	\$66,951	Coupon	\$66,950
Interest	\$2,289	Capital gain	\$21,857
Total	\$69,240	Interest	\$2,289
		Total	\$91,096
Period Running Yield	7.233%		
Total 12 month income return		Return assuming	
Income	\$63,951	you sell the portfolio	9.516%
Interest	\$1,945	(holding period return)	
Total	\$65,896		
Period Running Yield	6.883%		

Source: FIIG Securities

I think the answer very much lies in your thoughts about interest rates. There are three possible scenarios:

- If you think growth in Australia will stagnate and the Reserve Bank will have to lower interest rates to stimulate the economy, you'd hold onto this portfolio. Cuts to the 4.75% cash rate should further improve the capital value of the portfolio.

Remember that inverse relationship between bond prices and yields – a key principle when investing in fixed income. Lower returns (yields) on fixed rate bonds mean the prices of fixed rate bonds should rise.

- On the other hand, if you think the cash rate will rise, you would sell the bonds and pocket the capital gain. In this scenario, higher returns (yields) would lead to lower bond prices.
- The final option, which is where you think interest rates are fairly neutral – that is won't change much either up or down – is a little more complicated. I guess if you opt to sell some of the bonds for a capital gain and reinvest in floating rate note equivalents, you are making the assumption that the capital gain now will compensate you for possible lower income in future. This would be most critical to those in retirement, relying on the income.

Over a year and in a different economic environment, the credit worthiness of the issuer may have changed, which could also impact the price. Discounting any changes to the assessment of the credit, I'm going to stick to my original premise that the known income is more important to me, so at this point I'll continue to hold onto the bonds I originally bought. Still, the \$21,857 capital gain would pay for a nice overseas trip!

I've tried to give you all an appreciation of the possibilities of allocating a portion of your investment portfolio to fixed income. On the one hand, you can sit back and relax with the known income. For other investors who are prepared to invest a bit more time into their portfolios and have a view on interest rates, there is the potential to earn much more than just the coupon.

Earlier, when I compared the portfolio returns to that of the ASX 200 index, it showed that the largely fixed rate bond portfolio had made a capital gain versus a loss on the ASX 200. The fact that the two asset classes are counter-cyclical demonstrates the protective capacity of fixed income when equity and property markets decline.

One last point I want to make is that it's important to get to know your broker. If they have a good understanding of your goals, they can help advise you of when they think it's time to buy or sell.



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