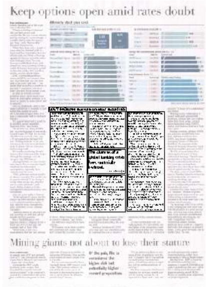

Australian Financial Review, Australia
15 Feb 2012

Portfolio, page 26 - 186.30 cm²
Australian National - circulation 73,158 (MTWTFS)

ID 133723631

DON'T OVERLOOK SEMI-GOVERNMENT SECURITIES

Bond prices were the unexpected medal winner in 2011 and may rise further despite their near 60-year highs. They're being driven by huge foreign demand, coincidentally also pushing the dollar up, as speculators and large offshore funds seek the best return for the least risk.

That demand in turn is a function of fragile confidence in global financial markets and a succession of credit ratings agency downgrades of banks and entire countries.

Yields on Commonwealth bonds are below 4 per cent, well under the official cash rate and term deposits.

Their price gains made them the best-performing financial asset last year, returning 11.4 per cent, a reminder that the interest on a government bond is only half the story. Unlike term deposits, bonds also have capital growth potential if sold in the market. But held to maturity, the principal is government guaranteed and so is as safe as a term deposit.

Just a few months ago when three-month term deposits were paying 5.25 per cent, a 10-year bond yielding 4.6 per cent had little appeal. But in fact the bond earned more than the term deposit over the three months – returning 7 per cent because its price had risen.

While even managers of bond funds rule out a repeat of last year's double-digit return, the rally may still have legs. The Federal Reserve is keeping US rates at near zero until late 2014, and there is no risk to Australia's sovereign rating, so bonds will continue to be attractive to foreign investors.

"Safe-haven demand for Australian bonds may have further to go as more countries are at risk of losing their AAA rating," says the head of investment strategy and chief economist at AMP Capital Investors, Shane Oliver.

But Victor Rodriguez, head of fixed income at Aberdeen Asset Management, which was one of the top-performing bond funds last year, says 5 per cent is a more realistic return this year.

> **The chances of a global banking crisis have materially reduced.**
>
> Victor Rodriguez

"The market is pricing in too many rate cuts and the chances of a global banking crisis have materially reduced from last year," Rodriguez says.

But one opportunity has emerged for investors in the bond market.

While foreign funds are rushing Commonwealth bonds, they are ignoring higher-yielding semi-government issues such as those by state treasury corporations.

"Offshore investors are buying sovereign, not semi-government securities; that's great for Australian investors," says Chris Dickman, senior portfolio manager at Altius Asset Management.

A 10-year NSW Treasury bond, for example, has a yield of about 1.1 per cent above a Commonwealth bond for the same term.

"Semis definitely have a better running yield and we think this will compress – that is, provide a capital gain – with (Commonwealth) government bonds," says Dickman.

Bonds can be bought through fixed interest specialists such as FIIG, or direct from the Reserve Bank of Australia, which sells selected Commonwealth maturities.

Irrespective of the potential returns, Rodriguez says the strength of a managed bond fund is that it provides insurance for a share portfolio.

"It's insurance if equities were to fall 20 per cent," he says, because that would mean rates would fall as well, and the prices of bonds would rise, providing some compensation.

Actively managed bond funds can also take advantage of frequent anomalies in the wholesale credit markets.

"The reason you go in a bond fund is so you can get what the institutions can buy," says Dickman.