



# Linkers offer safety and oomph

## An inflation-proof bond could be good for your portfolio

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INFLATION-linked bonds might not sound exciting, but the “linkers”, as they are called, have certainly provided some oomph to a lot of portfolios lately.

Fixed interest did a lot better than shares last year, and linkers were the best-performing asset class, earning 19 per cent (according to the UBS Inflation-Linked Bond Index), well above their nominal counterparts, which earned 11.4 per cent (according to the UBS Composite Bond Index).

For the three years to December, the linkers earned 8.8 per cent a year, as against 6.3 per cent for bonds, while for the five-year period nominal bonds, at 7.4 per cent a year, shaded the linkers on 6.8 per cent a year.

Inflation-linked bonds offer investors protection against inflation, with the coupon (interest) payments adjusted for changes in the consumer price index. Linkers pay a lower interest rate for the life of the bond to compensate for the fact that the capital value will increase with inflation. This means that, unlike nominal bonds, linkers pay a known real (after-inflation) return.

Linkers are issued by the commonwealth government — which has committed to issuing up to 15 per cent of its debt in inflation-linked form — as well as by state and territory treasuries, banks and companies.

There are about \$25 billion worth of linkers on issue.

Tano Pelosi, portfolio manager of Antares Capital's Australian Inflation-Linked Bond Fund, is a big advocate of the sector.

Linkers represent “a pretty good place to start” for anyone looking to protect the purchasing power of their income in retirement, he says.

But he warns their perform-

ance last year was unusual.

“We saw bond yields collapsing around the world last year, inflation got up to about 3.5 per cent, and we had a very strong capital return component. One of the inflation-linked bond funds we run for institutions and high-net-worth individuals has returned 15 per cent over the past eight months. But the more normal expectation across the five-to-10-year cycle would be something more in the order of 6-8 per cent — then again, that's with full inflation protection.”

Pelosi says there are three main components to the return from a linker. “Firstly, there is the running return that comes from the coupon,” he says.

“The second thing is inflation comes through every quarter, as we get CPI, and you're getting that uplift as well. The third is the capital: if bond yields collapse, you're going to get a big price return, as we saw last year.

“In fact, because of their longer duration — linkers are often nine or 10-year issues, and our fund has a weighted average duration of five to six years — they are very sensitive to those movements in interest rates.”

Stephen Nash, director of strategy and market development at specialist fixed-income broking and advisory firm FIIG Securities, says linkers have usually been considered an institutional product, but they have “considerable appeal” to retail investors as well.

“Insurance companies like them, and defined-benefit (where the end payment on retirement is known in advance) superannuation schemes use them because they require inflation-linked assets to match inflation-linked liabilities,” he says.

“Really, the linkers appeal to anyone that has a future payment that's linked to CPI and wants an asset with a real return stream to offset that liability.”

Nash says that covers retail investors, particularly as the baby boomers move towards and into

retirement. “When you move into retirement, inflation — and protecting the purchasing power of your income — becomes a much bigger problem than it is when you're working. Also, your CPI basket effectively shifts much more towards essential items, utilities and so on.

“Your ability to withstand large increases in the CPI falls away, so having some inflation protection is a good idea. In particular, self-managed super funds should be interested in them.”

Like most bonds in the local market, linkers are most often issued in \$500,000 parcels, but Nash says FIIG can break that down to a \$50,000 minimum.

“It depends on the documentation,” Nash says.

“Some are reserved for wholesale and sophisticated investors, but we can usually break them into smaller parcels.”

Commonwealth government linkers are hard to break down this way, he says, but retail investors can readily buy a range of state and territory treasury linkers as well as corporate ones.

Investors should focus on the real return at which the linkers trade, says Nash.

“Depending on the maturity, commonwealth linkers are trading at about 1.35 per cent real, those from semis like QTC or NSW TCorp are trading in the 2-2.75 per cent, the major banks' linkers are trading at around the 3-4 per cent real return level, and a corporate/infrastructure issuer like Sydney Airport, for example, has May 2020 and May 2030 issues that are both trading at around 5 per cent real.”

Increasingly, he says, investors want equities that look like bonds, and vice versa.

“Effectively some of these securities are giving them an equity-like return, while they're in a very senior position in terms of credit, so the investors have the best of both worlds.

“SMSFs have a very low exposure to fixed interest: we think





inflation-linked bonds are a good way to get good, longer-term exposure," says Nash.

"But you don't want to be trading them every five minutes."

Sovereign linkers are "as close as you can get to a true risk-free asset", says Pelosi. "Theoretically, the risk-free asset in any market is the sovereign bond, but as we've seen, that only applies if you know you can hold it through to maturity. And inflation is the big risk to that, because there is a risk that inflation erodes your purchasing power while you hold the bond. In this case you can get the sovereign bond in a real-yield format (because) you're taking the inflation risk out of it."

Pelosi can see the need for this

protection becoming more pronounced. "Through the next 10 to 20 years, we don't know what inflation is going to do, but we do know there is a global dimension to what's going on with inflation.

"The RBA remains committed to its target band of 2-3 per cent, but we think it's going to be buffeted by global forces," he says.

"China, food inflation, what's going on in terms of quantitative easing in the US and the Long-Term Refinancing Operation in Europe are all inflationary forces, and they could easily overwhelm what a small central bank can do. So we think it's prudent to at least think about putting in place some insurance against inflation."



**'It's prudent to at least think about putting in place some insurance against inflation'**

**TANO PELOSI**  
PORTFOLIO MANAGER

