

2009 shaping up as a great vintage

The return of governments to global bond markets is forcing a fundamental restructuring of markets and provides some golden opportunities for investors. Simon Hoyle reports

Investors in boring old bond funds have recently had more reason to smile than most other investors. The performance of some fixed interest funds has been a notable bright spot on an otherwise fairly gloomy investment landscape.

Bond funds outperformed equity funds by something in the order of 65 percentage points in calendar 2008. Equity funds lost about half their value (some faring better than others, of course), while the typical fixed interest fund gained in value by about 15 per cent.

Not a bad result for an asset class often derided as dull, and looked down upon as the “defensive” part of a diversified portfolio.

But 2008 was a tale of two halves. As research

firm Zenith Investment Partners explains in its 2008 fixed interest sector review: “While government bonds have showed their diversification appeal, credit funds have behaved like ‘low beta’ equity investments, providing limited diversification benefits and negative absolute returns – in some cases making a mockery of their absolute return benchmarks.”

“The events of 2008 have been described as the ‘perfect storm’ for credit markets,” Zenith says.

“Falling prices have placed margin call pressure on leveraged investors and this situation was further compounded by higher borrowing costs (relative to risk-free rates) and large-scale redemptions – no doubt made worse by government guarantees

on bank cash and deposit accounts.

“It is difficult to forecast when buyers will return to credit markets and when the de-leveraging process will end, but...credit market valuations now look attractive to longer-term investors if they can forgo short-term liquidity and are prepared to weather short-term volatility.”

However, the same global crisis that has wreaked havoc on some sectors of the fixed interest sector is also likely to cause a fundamental structural shift, and to present fixed interest investors with a once-in-a-generation opportunity to access very attractive rates of return, with relatively low levels of risk.

Governments around the world are scrambling

fixed income

“Deleveraging is a normal and quite rational response to the current economic climate.”

Mark Beardow,
Head of Fixed Income
AMP Capital Investors

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to issue bonds to fund budget deficits to support their massive stimulus packages; it's a fixed interest securities buyer's market at the moment, effectively reversing the situation of the past decade, or longer.

Governments need to make bond issues attractive to the market, as they compete for a finite source of funding. As attractive sovereign bond issues begin to flow into markets, the role of fixed interest as an asset class, and fixed interest funds as a means of accessing that asset class, may need to be reappraised.

In response, there's a clear "back to basics" message from fixed interest fund managers. When your asset class holds the potential for returns of CPI plus 3 to 4 per cent, without having to resort to the fancy product and financial engineering of recent years (which in many cases amounted to nothing more than gearing), there's no need to over-think how to approach it.

That may come as a welcome relief to managers and investors alike, after a prolonged period in which each party's resilience, ingenuity and integrity was put to the test.

"If fixed interest funds historically have been

considered a routine asset class, events in the latter half of 2007 and calendar year 2008 certainly provided the sector with a fair share of the headlines," says research firm Standard & Poor's, in its most recent Australian fixed interest sector report.

"Investment managers have had to contend with issues ranging from liquidity and significant liquidity premiums, historic widening in credit spreads, increased redemptions due to investor sentiment, the introduction of the Australian government's deposit and wholesale funding guarantee, the rapid round of interest rate cuts, and the sudden demise of Lehman Brothers and other financial institutions."

Jeff Brunton, head of credit markets for AMP Capital, says some of the events currently shaping fixed interest markets represent "generational change".

"The complexion of the market is changing; with sovereign issues in many countries there are credible estimates that the market is going to double or triple in the space of a few years," Brunton says.

"The credit market is providing investors with

very wide spreads; we have very low cash rates and government bond yields are very low in most countries.

"Investors have access to meaningful returns above the risk-free rate. For investors who are targeting a CPI-plus-3-to-4-per-cent return, given their investment objectives and time horizon et cetera, you have many parts of the fixed interest market pricing at or near those levels."

However, even if the absolute returns from fixed interest assets - particularly sovereign bonds - prove to be strong in coming years, the role of fixed interest as an asset class will still be "the bedrock for diversifying other risks in your portfolio", Brunton says.

At the same time, complexity in fixed interest products is best avoided. Investors are again being adequately - some would say handsomely - rewarded for the risks associated with bonds; there's no need for product manufacturers to aim to boost yields through fancy financial engineering and leverage.

If you think of fixed interest as being a "vintage", then "the bonds of 2009 are going to be high qual-

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“As the economy slows, companies, just like consumers, tend to spend less, save more and try to pay off debt; a practice commonly known as deleveraging. When companies raise equity to reduce debt on their balance sheet they are less likely to default on their debt obligations. As default risk reduces, lenders start to become more confident and credit starts to flow again. It's all part of the economy healing itself.”

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Jeff Brunton,
Head of Credit Markets
AMP Capital Investors



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ity, as they are being created in an environment that is very risk-averse," Brunton says.

Robin Bowerman, principal of retail business for Vanguard, says asset allocation remains the critical decision to get right when determining an appropriate exposure to asset classes.

Bowerman says no matter how good your stock picking skills, you probably lost money in the Australian sharemarket during 2008.

"Asset allocation is the critical issue," Bowerman says.

"It's about how much money you have in equities versus fixed interest, for example."

Bowerman says that no more than half a century ago it was more common for portfolios to be invested 70 per cent in fixed interest securities and 30 per cent in equities. Since then the position has reversed.

That decision, far more than manager selection or those managers' stock selections, has driven portfolio returns, both good and, more recently, bad. Bowerman says that if asset allocation is the primary driver of portfolio returns, there's a strong case to be made for index funds management, at

two levels.

First, there's strong evidence that so-called "active" fund managers are really quasi-index funds anyway; their performance is closely correlated to index funds.

And second, since outperforming a benchmark is apparently difficult (either because of a manager's choice to hug an index or because of the fundamental nature of markets), paying fees for active funds management is not likely to produce superior performance.

But there's disagreement over the role of indexing.

Simon Doyle, head of fixed interest and multi-asset for Schroder Investment Management, says index investors will "clearly need to increase their exposures to government bonds to remain in-line with benchmark".

"In some ways this is a relatively irrational investment decision - increasing exposure to a market after it has rallied hard and at a point in time when supply is about to explode," he says.

"On this basis, risk is being assessed relative to benchmark - not from the perspective of what mat-

ters to investors.

"A more rational approach is to construct a fixed income portfolio which is more focused on the investment outcome delivered to the investor rather than the benchmark. In this regard, understanding the underlying investment characteristics of the investment universe - government bonds, credit, cash, et cetera - and constructing a portfolio that matches these characteristics with the investors' objectives, makes more sense."

Doyle says Schroder uses a "core-plus" approach, which has "a core exposure to the UBS Composite Bond Index with the 'plus' coming from a wide variety of return-enhancing and risk-reducing strategies across the fixed income universe".

These strategies include: exposing the fund to different types of credit; interest rate strategies; and regional strategies. Doyle says the objective is to "achieve a return 1 to 1.5 per cent above benchmark but with lower than index volatility".

Darren Langer, head of portfolio management for Tyndall Investment Management, says:

"We really have not changed the way we manage fixed interest.

fixed income

"The deleveraging stage of the credit cycle is a sweet spot for credit investing."

Mark Beardow,
Head of Fixed Income
AMP Capital Investors

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“We’ve seen since the late 90s through most of the 2000s, that credit has become a much bigger part of the indices. That doesn’t change the way we manage things; we still tend to pick things from the more conservative side of things.

“What we think has been the biggest problem in the last 10 years was everyone expected 100 per cent of their portfolio to behave as if it were invested in equities.”

Langer says the role of fixed interest as a defensive asset class, diversifying the risk associated with equity and equity-type markets, was too often overlooked.

“I didn’t classify a lot of the retail product out there as being traditional fixed interest; a lot of it was highly structured, highly leveraged. While a lot of them didn’t look like options, they were options. They are not good for individual investors. They are not things that mums and dads - the people talking to financial planners - can tell apart for themselves.”

Langer says that when equity markets are producing “returns of 10, 15, 20-plus per cent, people forget that’s not sustainable”. But the expectation of returns from the equity portion of a portfolio

has a sort of domino effect on what investors then tend to expect from even the defensive portion of a portfolio.

“It’s a matter of balance, and how much they want their clients’ portfolios to be able to weather a downturn,” Langer says.

“It’s hard to say how much they should have; but what you want is something that’s going to protect you.

“You do not need all the bells and whistles and heavily structured yields to get you all of that.

“A 10 per cent increase in bonds when equities have fallen 20 per cent isn’t bad protection.

“It’s generally going to give you a return better than cash.”

“One of the things financial planners don’t do is understand fixed interest well, and I think that’s partly the fund managers’ fault over the years,” Langer says.

He has spent “plenty of time” talking to planners and appearing at seminars to talk about equities, but “in fixed interest I can count on one hand how many times I have done a seminar or something like that”, he says.

All investors in fixed interest products need to “learn how to estimate what is reasonable, and not get caught up in some of these fraudulent schemes”, Langer says.

“Product-wise, we are trying to get a lot of feedback on what people want - but it’s not always clear that everyone knows what they want,” he says.

“We are not trying to give them 15 to 20 per cent return every year; we’re trying to give them something that’s reasonable when their growth assets aren’t doing so well.”

The way that investors access fixed interest markets clearly has a great bearing on their eventual investment outcome. As Zenith notes in its fixed interest sector report, government-bond funds performed quite differently from credit funds during 2008.

S&P says: “Unfortunately for the financial planning community, not all products are alike. Bond funds are not cash funds, which are not enhanced cash funds, which in turn are not income/high yield income funds.”

The following table outlines the different funds’ “basic architecture”.

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“The credit crisis has created a scarcity of lenders and increased their risk aversion. But companies still need debt to fund their activities, so they are offering favourable terms and conditions on new bonds. This means investors can potentially be paid a higher premium to reward them for taking on the risk of lending to companies.”

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David Carruthers,
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TABLE 1

Fixed Interest Funds**Benchmark:** UBSA Composite Bond Index**Duration:** Benchmark duration of 3.5 years with active deviation of +/- one year**Investment universe:** Benchmark contains government, semi government, supranational and corporate issues. Mandates include these plus structured securities, hybrids, non-\$A offshore debt, and active derivative use.**Cash Funds****Benchmark:** UBSA Bank Bill Index**Duration:** Benchmark duration of 45 days with active duration of +/- 25 days**Investment universe:** Benchmark references bank bills. Mandates include commercial paper (CP) including asset-backed commercial paper (ABCP).**Enhanced Cash Funds****Benchmark:** UBSA Bank Bill Index**Duration:** Benchmark duration of 45 days with permissible active duration of more than 0.5 year**Investment universe:** Benchmark references bank bills. Mandates include CP, ABCP, and mortgage-backed securities (MBS).**Income/ High Yield Income Funds****Benchmark:** UBSA Bank Bill Index**Duration:** Benchmark duration of 45 days with permissible active duration of more than one year**Investment universe:** Benchmark references bank bills. Mandates include corporate issues, capital notes, convertible notes/ preference shares, credit linked notes, floating rate notes, income securities, MBS & ABS, Tier One capital securities, and active derivative use.

S&P says the key product differences that planners should consider are in the fixed interest and income/high yield income categories.

“Fixed interest funds can be split into those that offer a more core solution versus those products

that will take on a higher degree of active risk – particularly credit,” its report says.

“Credit exposure and the tolerance for securities that sit lower in the capital structure are important to understand and will affect the return profile of

the product.

“Additionally, we are now starting to see a far greater use of credit default swap (CDS) strategies than previously observed. While we acknowledge the efficiency gains and opportunities that arise through the use of these instruments, the additional risk resulting from their use and the contribution they bring to the funds’ return have been, and remain, key areas of our focus when reviewing a product.”

S&P says that the “income” category of funds includes both income funds and high yield income funds, and the key difference between the two is the amount of the latter’s “sub-investment grade/lower credit quality exposure”.

“Capacity and liquidity are a key focus with evidence that high yield funds with lower levels of funds under management (FUM) and a portfolio of predominantly exchange-traded instruments have had the ability to transact in the markets (in low volume),” it says.

“These products have had the ability to execute their desired investment strategy and have fortunately been in a position to provide liquidity when

fixed income

“We like to think of Australia as an island, but we’re actually part of a complex global financial system.”

Dr Shane Oliver,
Head of Investment Strategy
and Chief Economist
AMP Capital Investors

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required.”

Schroder's Doyle says the global financial crisis (GFC) is having a pronounced effect on the structure of fixed interest markets, and how managers are responding.

“The shift in borrowing from the private sector to the public sector will fundamentally reshape major fixed income benchmarks in coming years,” Doyle says.

“While in global benchmarks, the impact of a surge in US treasury issuance will have a major impact, the local benchmark will also change. The Commonwealth Government is re-entering debt markets after being on the sidelines for a number of years, while state government borrowing is also on the rise.

“This does highlight one of the fundamental problems with fixed income benchmarks, namely that the biggest constituents are the biggest debtors/borrowers, which is not necessarily aligned with investor objectives.”

Doyle says the changing nature of markets does not fundamentally affect the role of fixed interest as an asset class in a diversified portfolio.

“Fixed income should be held for defensive purposes, and in particular to diversify equity risk,” he says.

“The problem has been that it has been misused with investors pushing out the credit curve and assuming ‘equity-like’ risk in the defensive part of their portfolio.

“The fundamental issue here is that the fixed income universe is broad and varied. Some securities and security types are truly defensive while other types (particularly lower-rated credit type securities) are much more equity-like. While these asset types have a role in a broadly diversified portfolio, they often don't fit neatly in the defensive part.”

Doyle says there are “a number of implications of recent developments for financial planners”.

“The first is that planners should focus on the role different assets have in the client's portfolio - not simply on maximising short-term return,” he says.

“For example, advisers have typically shunned traditional bond funds [as being] too boring, but these have performed incredibly well in an environment where risk assets have performed poorly.

They provide good insurance to the portfolio.

“The second implication is the importance of asset allocation. The biggest driver of return to clients is the portfolio's asset allocation - not which managers the client is invested in. I'm not suggesting this is not important - but it will typically have less of an impact on client returns. Asset allocation is not easy - but can be done better at an industry level.

“In terms of actually selecting bond fund managers, an important criteria is the alignment of fund strategy and manager philosophy with that of the planner and client. Not all bond funds are the same, and the difference in risks across the fixed income opportunity set means the range of outcomes in fixed income portfolios can be enormous.

“Extrapolating past performance is a poor guide. Learning about risk from past performance - especially recent past performance - is likely to be significantly more relevant.” ■

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“Credit investing relies on understanding the global economic framework. A credit investor must take into account themes that may emerge offshore in order to understand how Australia will perform. This understanding ensures the optimal investment mix in a corporate bond portfolio. Deleveraging, government stimulus packages and the move to defensive investments are all themes occurring in markets across the globe. Opportunities for investors can arise by identifying companies that may benefit from these themes.”

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