

In late April, the giant US-based technology company Apple issued \$US12 billion (\$12.9 billion) of bonds. It was able to issue the securities at interest rates roughly comparable with the rates at which the US Treasury issues bonds. It was a clear signal by investors that they regard the creditworthiness of at least one major corporation very nearly as highly as they rate the creditworthiness of the US government.

The reasons for the Apple issue are complex – it's believed Apple's rationale is that it is significantly cheaper to raise debt in the US than it is to pay tax if it were to repatriate cash it holds outside the US – but investors didn't care about that. They knew a good deal when they saw one.

The success of the issue also underlines the appetite among investors for high-quality corporate debt securities, as governments scale back bond issues of their own.

In Australia the corporate bond market is relatively underdeveloped, but that is beginning to change as new rules start to affect the ability of banks to lend to corporate clients. (See the In Focus feature on the corporate bond market, starting on page 24)

Opportunities to invest in the domestic corporate bond sector are also limited, both by the narrow range of issuers, and the limited mechanisms for investors to access the market.

One traditional route into relatively inaccessible asset classes – via managed funds – offers only relatively limited scope, too. Research group Morningstar covers six specialised corporate bond funds, and three of those are variations on the same product offered by AMP Capital. Other funds are offered by Colonial First State, and by Omega.

There is also an exchange-traded fund (ETF), the Russell Australian Select Corporate Bond Fund; and over recent years there have been a range of one-off, smaller funds, such as those created by Dixon Advisory for its own client base.

UNDERSUPPLY

Undersupply of corporate bonds is a real problem for Australian investors at a time when appetite for sources of reliable income streams is beginning to grow – driven, in large part, by the demographics and the arrival of the baby boomer generation on



Getting a fix on bond funds

New developments in Australia's corporate bond market could present fresh opportunities for investors – particularly SMSFs – looking to increase their fixed-interest exposure through managed funds. Simon Hoyle reports.

the threshold of retirement.

On the risk spectrum, corporate bonds sit between low-interest-paying but relatively secure government bonds, and riskier but potentially higher-returning equities. A report by the Australian Centre for Financial Studies (ACFS), published in late 2012, described corporate bonds as “the missing asset class”.

For financial planners, it's a gap in the line-up of available solutions that has been filled with the launch of an AMP Capital Corporate Bond Fund, aimed at self-managed super funds (SMSFs).

Like any managed fund, it offers exposure to underlying assets, with a relatively low initial investment. Buying corporate bonds directly typically requires an investment of \$1 million or more; an investment in the AMP managed fund, for example, requires a minimum outlay of \$30,000. This is equivalent to about 3.2 per cent of the average-sized SMSF (which has assets of \$928,724, as reported by the Australian Taxation Office, based on data extracted on July 8, 2013).

AMP Capital head of SMSF Tim Keegan says the launch of the fund recognises



TIM MURPHY
Co-head of fund research, Morningstar



DAVID CARRUTHERS
Head of core and credit, global fixed income, AMP Capital

that “SMSFs want better access to managed funds, including ease and accessibility of entry”.

There has long been concern about SMSFs not effectively diversifying their investments. As at June 2013, the ATO says, SMSFs had about \$4 billion of their \$505 billion total assets – less than 0.8 per cent – invested in “debt securities”, including corporate bonds.

Cash and term deposits accounted for about \$154 billion; Australian equities about \$158 billion.

Deborah Ralston, executive director of the ACFS and Professor of Finance at Monash University, says “the need to have a more diversified portfolio is very obvious when it comes to SMSFs”.

“At the present time they have a huge preference for either cash or equities, and probably an increasing recognition on the part of SMSF trustees and others in investor markets that to have a diversified portfolio you probably also need to have a portion of fixed-interest products – and they have not been readily available to that sector,” she says.

THERE IS THE LIFECYCLE APPROACH, AND THAT IS, AS YOU GET CLOSER TO THE POINT OF RETIREMENT, YOU MIGHT NEED TO REDUCE THE VOLATILITY OF YOUR PORTFOLIO; AND THAT’S SIMPLY BECAUSE YOU HAVE TWO KINDS OF RESOURCES. ONE IS FINANCIAL; AND THE OTHER IS YOUR HUMAN RESOURCE

“There is the lifecycle approach, and that is, as you get closer to the point of retirement, you might need to reduce the volatility of your portfolio; and that’s simply because you have two kinds of resources. One is financial; and the other is your human resource. As your years of working reduce and your salary component is going to be a smaller part of your income, you’re carrying more and more risk in your financial portfolio. It’s been said by some that your proportion of fixed-interest or defensive stock in your investment portfolio should be equivalent to your age. So if you’re 70, you should have 70 per cent bonds.

“I don’t think that actually fits very well in an Australian context – we seem to have a higher propensity for risk than that. But the principle of reducing the volatility in your portfolio as you age is quite an important one.”

Steve Lambert, executive general manager of debt markets for National Australia Bank, says increasing exposure to fixed-interest securities as retirement approaches addresses an issue called “sequencing risk”.

“There is some academic and other thinking around the idea that you buy less risky asset classes [as you approach retirement],” Lambert says.

“THE NEED TO HAVE A MORE DIVERSIFIED PORTFOLIO IS VERY OBVIOUS WHEN IT COMES TO SMSFS”

“I’m not a buyer necessarily of a simplistic age-based investing idea, but the concept that as you get older you should hold more of your assets in less volatile assets, there’s a lot of sense in that at a practical level.

“That’s why I think for people moving into self-managed super, it’s not rational if you do not have a chunk of your money in something that’s going to give you a more fixed-income-like performance.

“But it’s also about how it ties into inflation, how does that tie in to your overall portfolio – all those sorts of things.”

Tim Murphy, co-head of fund research at Morningstar, says there are two reasons why there is currently a lack of managed fund options available for retail investors.

“One is that the corporate bond market itself is fairly non-existent; it’s fairly narrow;

it’s mainly driven by the big four banks in terms of issuance, so the breadth isn’t there,” he says.

“And [second], for retail investors, the rates you can get on some bank accounts, term deposits, et cetera, compared to what bank paper is issued at, isn’t that much different anyway.

“So the underlying demand for that kind of thing is fairly limited.”

But that may be starting to change.

David Carruthers, head of core and credit, global fixed income, for AMP Capital, says “there’s no doubt” that in the aftermath of the global financial crisis, banks’ activities in the term deposit (TD) market “did start to change the landscape to some extent”.

“But what we are seeing in the TD market is rates are coming down quite substantially, and those structures are changing quite a lot,” he says.

“There’s break costs, which are changing as well. If we think about the running yield on our corporate bond fund [which] is around 5.6 per cent, so that’s a combination of the high coupon that we look at and the term we invest in. The yield to maturity on that fund is about 4.5 per cent, and...95 per cent of that portfolio is invested in investment-grade companies. We can invest up to 10 per cent in what’s called high-yield companies, but predominantly it’s a true-to-label Australian corporate bond fund.

“We’re targeting stability of income and trying to preserve capital. We’re trying to avoid a lot of volatility coming from the

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outright bond market or from interest rate moves.”

Murphy says there would be some real benefits for investors if reforms to debt markets resulted in more widespread issuance of corporate bonds.

“From a retail investor’s perspective, there would be an ability to invest in a more diversified range of fixed-interest investments – particularly outside the banks,” he says.

Banks also dominate the equity market and, of course, the term deposit space, Murphy says.

“In every level of investment people are so exposed to banks,” he says.

“Going out and buying a corporate bond fund now just takes on more exposure to those entities.

“What is that doing for me? Whereas, if you had broader corporate issuance you would have higher yields...and more diversity, which would potentially draw in more retail investors.”

Murphy says Morningstar encourages its adviser clients to consider global credit funds in favour of domestic credit funds.

“There’s only a handful of domestic funds anyway,” he says.

A KEY ASPECT OF CHOOSING A CORPORATE BOND FUND IS TO LOOK AT THE TRACK RECORD AND THE EXPERIENCE OF THE MANAGEMENT TEAM

“And most of the global funds have greater diversity from a sectoral perspective, and a credit perspective.

“You are adding a lot more [diversification benefit] from a global credit exposure than you are by choosing a domestic one.”

Carruthers says that while the AMP fund is an Australian corporate bond fund, and strives to remain true-to-label, it nevertheless has a wide range of investment opportunities. He says AMP Capital covers about 450 companies in total, from which it makes its security selection decisions. As well as financials, it increasingly includes infrastructure and real estate companies.

“In many cases we’re looking to invest in companies that are improving their credit profile, so they’re looking to deleverage the balance sheet, they’ve got quite strong monopolistic positions, they’ve got really strong cash flows,” he says.

“In many cases the analysis on the documentation

around the particular corporate is really important. So if you look at airport infrastructure and real estate, a lot of those transactions that we do look at are secured against hard assets. So in the case of default, for instance, you’ve got the value of assets, which is providing a strong recovery value.

“In fact, because of our relatively large size in the Asian fixed-income space, we’re able to negotiate very strongly on terms and conditions to improve the benefits for the investor.”

Carruthers says a key aspect of choosing a corporate bond fund is to look at the track record and the experience of the management team. Ideally, they will have lived and managed money through several market cycles.

Right now, Carruthers says, the focus of the AMP team is to “manage outright interest rate risk”.

“We have [a] shorter duration target for this fund because we think rates will tend to increase over time,” he says.

“We believe the RBA domestically, and certainly global central banks, are looking to increase interest rates. A lot of long-term duration funds will tend to underperform when rates increase. The key with corporate bonds, and what you’ll find with other funds, is we’re actually much shorter in duration, and we try to remove that interest rate sensitivity. If you’re looking at key aspects of different funds, it’s that ability to manage duration over time.

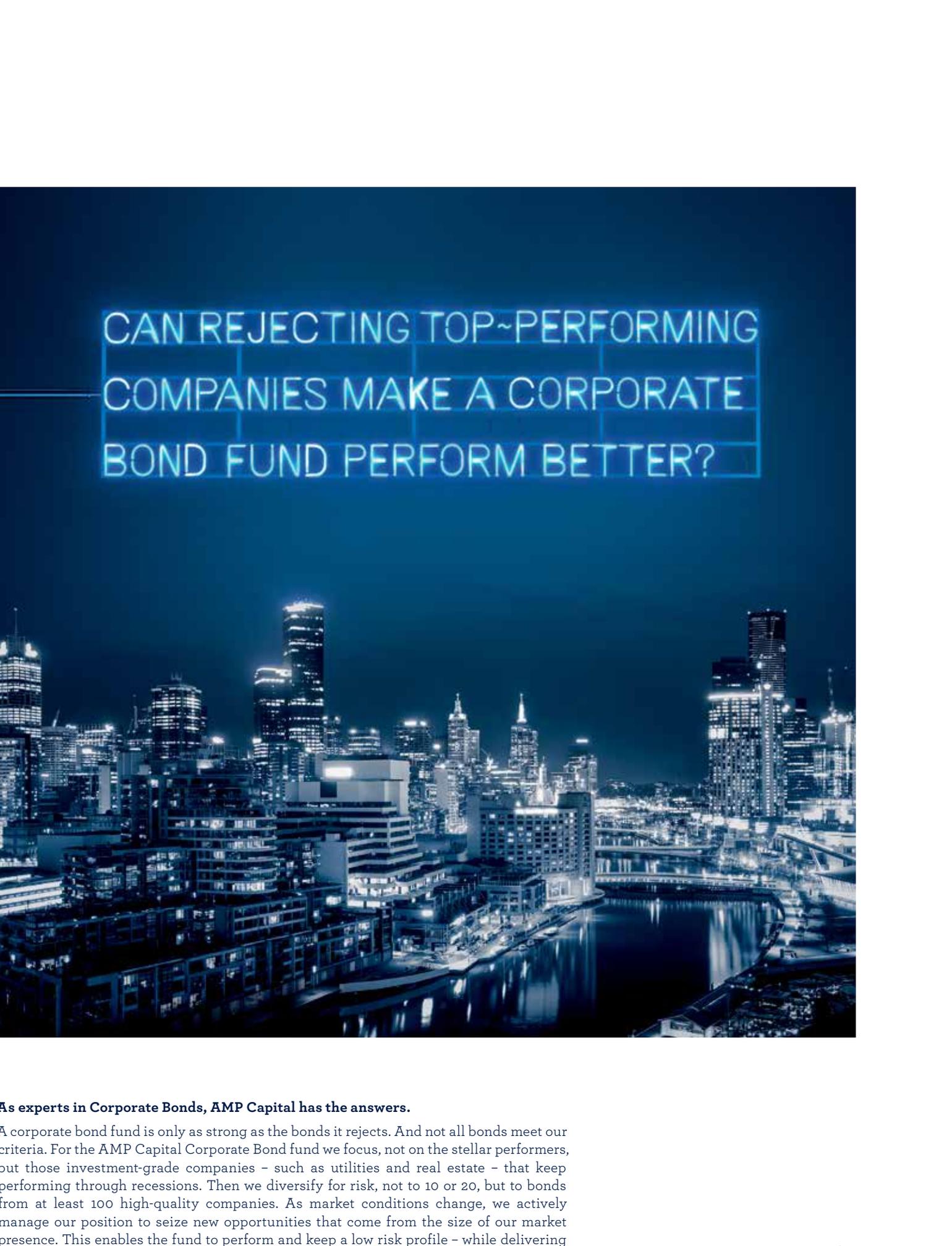
“I raise that [as an issue] right now. In the past, when rates were falling, it was good to have interest rate duration. But right now it’s important that you shorten that duration up.”

Ralston says that befitting any asset class that’s opening up to retail investors for the first time, some homework is required. There’s a bit more to assessing the quality of a corporate bond issue than there is to assessing a government bond issue.

“There absolutely is, and they range enormously in terms of the level of risk that you are exposed to,” Ralston says.

“It does require an investor to be knowledgeable and make sure they acquaint themselves with the facts, and understand the relationship between the credit rating of the firm, and likely outcomes. Also, the class of bond on issue – whether they are in danger of risking their capital or not.

“There is quite a bit to know; it’s not a simple process once you start to get into different classes of bonds. So the investor needs to be cognisant of that, and of the class of bond and the rating of the organisation – two key factors to take into account. ■



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