



*Following a tumultuous year for global capital markets, research groups say it is time for financial planners to get back to the basics of investing and revisit the role of fixed income within a client's portfolio.*

*Vishal Teckchandani reports.*

## BACK TO BASICS *for fixed income investing*

As the second quarter of 2009 begins, building a good fixed income portfolio for the long term will be a challenging task.

While 2008 was a tumultuous year for global stock markets, many fixed income managers cheered as domestic and international bonds rallied.

The Australian fixed interest index returned 14.95 per cent in 2008, while hedged international bonds gained 9.21

per cent in the same period, according to Morningstar data.

But as the second quarter of 2009 begins, most central banks in developed countries have exhausted the use of monetary policy to jumpstart their respective economies.

The Reserve Bank of Australia has aggressively slashed interest rates to 3 per cent to spur domestic consumption.

Outside of Australia, other central banks,

SALLYANNE COOK



including the United States Federal Reserve, Swiss National Bank, Bank of Japan and Bank of Canada, are on the precipice of pushing their countries into a zero interest rate world.

Although some observers suggest the global economy is stabilising, the situation is still fragile.

Credit spreads are pricing in a rerun of the Great Depression.

While fixed interest managers are talking about stellar yields and returns on some securities, these inevitably incorporate risk, and research groups say advisers need to think about what they are trying to achieve with fixed interest assets in a portfolio construction sense.

According to a report by JPMorgan Asset Management managing directors, diversification, risk management and prudent asset allocation are the basic tenets of modern portfolio theory.

As fixed income allocation has steadily shrunk in the past several years, the average portfolio has grown vulnerable to more shocks.

Throughout the global economic slowdown, investors with an allocation to core fixed income have generally fared better than those invested 100 per cent in equities, the report says.

The paper compared the returns and standard deviation of allocations in the different asset classes over 15 years (from 1994 to 2008).

A 100 per cent exposure to bonds as measured by the US Barclays Capital Aggregate Index would have provided a return of about 6.2 per cent annualised, with standard deviation of 4 per cent.

Conversely, a 100 per cent allocation to equities as measured by the S&P 500 index would have produced gains of nearly 7 per cent a year with around 17 per cent risk.

But a 60/40 placement in stocks and bonds respectively would have pushed the returns up to 6.7 per cent a year with standard deviation of around 11 per cent.

“Here a 60 per cent equity/40 per cent fixed income split provided investors with 95 per cent of the equity return but with 38 per cent less risk,” the JPMorgan report says.

“Clearly, fixed income can and should be an important component in a portfolio.”

Financial advisers should incorporate a back-to-basics approach to portfolio construction and think carefully about investment fundamentals again, Standard & Poor’s Fund Services director of wealth management services Jeff Mitchell says.

“In the defensive component of portfolios, what you are actually aiming to achieve from a portfolio construction perspective is the preservation of capital or capital stability,” Mitchell says.

“In terms of fixed interest, we’re normally talking about cash, traditional sovereign bonds and the debt of high-grade corporate issuers, and these are traditionally the key components of the defensive component of a portfolio.

“Now in our current portfolio construction there’s also the small component of the defensive sector, which can incorporate investment-grade corporate securities.

“Within the defensive sector what we say advisers should be wary of is to invest in high yield or sub-investment-grade credit simply because of the currently extremely high yields as the risk of default and price volatility is resulting in more equity-like characteristics, that is, acting like growth assets.

“While nearly all of us can agree at this point in the cycle that credit securities [are] generally the most beaten up sector and we would expect that on balance of probabilities that there will be a recovery at some point ... there are securities at the bottom end of investment grade that are still locked up, meaning there’s significant capital risk there; that’s not what you want in a defensive allocation.”

A defensive asset should also have daily liquidity and trade very close to its par value, he says.

While cognisant of the risks, S&P is making a small allocation to diversified fixed interest managers, which as part of their investment strategy are able to exploit the potential repricing opportunity that exists in credit instruments.

When investing with these managers it

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Standard & Poor’s

is important to focus on what is the lowest level of credit quality a manager can take on board, Mitchell says.

Another critical issue is risk budgeting.

“If your objective is to provide risk-adjusted returns, you’re going to get more compensation over the longer term for risk on the growth side of your overall portfolio than your defensive side,” Mitchell says.

“So at this point in the cycle, we’re not spending very much of the risk budget on the defensive side of the ledger; we’re more inclined to spend the risk budget on allocating to growth assets.

“Why would you take risk on high yield sub-investment corporate securities in the defensive component, for example, when you can potentially achieve superior longer-term risk-adjusted returns by spending your risk budget on a theme like a recovery in emerging markets equities?”

S&P has a slight preference for cash despite falling yields and a neutral weight to sovereign bond funds.

“The opinion on sovereign bond yields is very much divided. If there’s another leg down in the global economy, then potentially interest rates could fall further so there could be more upside to bonds,” Mitchell says.

“On the other hand, the amount of stimulus added to the global economy could add to inflation, which means we may have reached the low point for bond yields, meaning bond prices are near cycle highs and could experience a sell-off.”

Morningstar consultant Sallyanne Cook says it is important for financial planners to look at different risk/return profiles of the sub-components of fixed income when making asset allocation decisions.

“Fixed income as an asset class is very large these days. It includes sovereign bonds, sub-investment-grade stuff, asset-linked securities and the like,” Cook says.



ROGER MCINTOSH

“Each of those sectors have performed differently to each other in the past year. Sovereign bonds have outperformed credit, for example. High yield has remarkably performed better than investment-grade credit, which suffered from a drying up of liquidity.

“When you’re making your asset allocation, you’ve got to take into consideration the different risks associated with each sub-sector.”

Most credit funds are still down 10 per cent to 20 per cent whereas pure sovereign funds are up around 10 per cent to 15 per cent, she says.

“So if you were looking at a fixed income allocation for a client with a balanced portfolio, you should have a traditional diversified fixed interest fund as the core holding,” she says.

Cook says she likes the Vanguard Index Diversified Bond Fund, Macquarie Master Diversified Fixed Interest Fund, Credit Suisse Diversified Fixed Interest Fund and PIMCO Diversified Fixed Income Fund.

“A diversified bond fund with a mix of Aussie/global bonds allows the underlying manager to decide the portfolio mix,” she says.

“This core holding could constitute 60 per cent to 70 per cent of the fixed income allocation.

“With the remainder of the asset allocation, depending on the client’s profile, you may add a bit of spice to the portfolio by allocating 5 per cent to 10 per cent into a credit strategy, like an investment-grade bond fund.

“Then, if you have a higher risk profile, you might also want to put an allocation into a high yield or sub-investment-grade fund.”

But a key issue in the fixed income space is whether it is time to invest now or would it be wiser to hold off until global economies recover and spreads normalise?

Aberdeen Asset Management Australia chief investment officer and chief executive Bill Bovingdon says investing now in a diversified fixed interest fund with exposure to investment-grade credit that is also able to invest in government guaranteed bonds will likely produce double-digit returns for low capital risk over the next few years.

“Currently there is an abundance of opportunities in the Australian fixed

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COOK  
Morningstar

income market due to credit spreads widening to unprecedented levels coupled with market distortions from government guaranteed bonds,” Bovingdon says.

“The spread on corporate bonds over government bonds are at levels never seen before in Australia and in the US only exceeded by those seen in the Great Depression.”

Over the next few years spreads are likely to contract, which will see corporate bonds outperform government bonds by a substantial margin, he says.

“When one considers that the average credit bond in the Australian dollar market is earning around 4-4.5 per cent more than government bonds, with a total yield of around 7.5-8 per cent, even a modest contraction of spreads of 1 per cent or so would result in total returns in the double digits for credit markets,” he says.

“On a one to three-year horizon, we see investment-grade credit as a fantastic risk/reward proposition.”

But a lot of observers have noted defaults have not even hit or exceeded past downturns yet.

Many countries are expected to experience the worst economic erosion since the post-war era due to the global financial crisis.

“The default rate has actually increased quite a bit. Having gone from 0.5 per cent a year ago, it is now at 2.3 per cent for all issuers and 1.5 per cent to over 5 per cent for high yield issuers, though we think there is little doubt that it will continue to rise,” Bovingdon says.

“The last two global recessionary periods in 1991 and 2000-02 saw default rates peak around 4 per cent for all issuers and around 12 per cent for high yield.

“This recession is already shaping up to be considerably worse than the previous two and based on that we believe default rates are likely to exceed these levels.”

These risks highlight the importance of having an active credit manager to help avoid potential defaults, he says.

“Credit spreads implicitly price in a default and loss environment as bad as the 1930s, and we do not expect the current recessionary environment to be so severe,” he says.

However, Schroders head of fixed income and multi-asset Simon Doyle is less optimistic.



SIMON DOYLE

“The relatively slow pick-up in defaults largely reflects the fact that financial issuers have been supported to date by government and central bank bailouts,” Doyle says.

“As economic weakness continues to spread through the broader economy, defaults will continue to rise.

“Our expectation is that the level of defaults will exceed recent cycle peaks and will approach the levels seen during the 1930s.”

The Schroder Fixed Income Fund gained 11.5 per cent for the year to February, 300 basis points below its benchmark, the UBS Composite Bond Index.

The product held a large chunk of cash in 2008 and Doyle is now rebuilding exposure to corporate bonds and cautiously adding high yield securities, which he says are providing double-digit returns.

Spreads or risk premium have been rebuilt across the credit curve and moving into credit and high yield now is providing sufficient compensation for default risk, he says.

“We are still retaining government exposure in the portfolio, mainly through government guaranteed bank paper and semi-government debt, as this provides a good risk hedge should global economic conditions deteriorate and credit continue to struggle,” he says.

“In recent months we have been rebuilding our exposure to corporate bonds and cautiously adding high yield to our more aggressive portfolios.

“This reflects the fact that spreads, or risk premium, have rebuilt across the credit curve and in our view are providing sufficient compensation for default risk.

“We are yet to move overweight credit or push too far out the credit curve as we believe continued weakness in global economic conditions and rising defaults will curtail the credit rally in the near term.

“However, once defaults peak, credit could rally significantly.”

DANIEL NEEDHAM



It is also important for investors to note that well-constructed defensive portfolios can start to capture the credit risk premium to maintain solid returns for investors without undue risk.

Investors today have a choice between equities and credit-based assets with both asset classes expected to have similar returns, but credit does sit further up the corporate capital structure, therefore an investor would get more money back if indeed there is a default.

Vanguard Investments Australia head of fixed interest Roger McIntosh says his biggest concern is investors increasing allocation to credit securities purely on the assertion that spreads are wide and should come back in.

“Our colleagues in the US produced a very useful paper which explains that wider spreads do not necessarily relate to higher relative returns for corporate bonds in subsequent periods, there was only a weak positive correlation between wide spreads and subsequent positive excess returns,” McIntosh says.

Deteriorating credit quality in 2009 could lead to an increased risk of spreads widening and additional downgrades of credit ratings, the study, compiled by Vanguard economists Roger Aliaga-Díaz and Joseph Davis, says.

“In that case, a corporate bond portfolio’s total return could significantly lag the portfolio’s yield and even trail the return of a broader taxable bond market index such as the Barclays Capital US Aggregate Index,” the study says.

“In short, we would caution investors against overweighting corporate bonds simply on the basis of trailing credit spreads.

“Investors inclined to deviate from a broad benchmark by overweighting corporate bonds will need to gauge the effectiveness of their forecasting process in balancing the near-term prospects for credit-spread tightening versus the risk associated

with ratings downgrades and defaults.”

In essence, if economic conditions deteriorate there would be an increase in the rate of defaults, but this would hit sub-investment-grade assets harder than investment-grade credit securities (with a category rating of BBB or greater), McIntosh says.

“An important protection mechanism against defaults is to hold a portfolio with a focus on investment-grade assets and be highly diversified. That way any single default event has only a small impact on the portfolio,” he says.

McIntosh also says indexing is the logical starting point for any asset allocation decision.

“Data provided by Mercer for Australian and global fixed interest managers show that many managers have failed to achieve excess returns over and above the fees they charge for the portfolio and in many circumstances the returns provided through the period of the stock market downturn have also been negative,” he says.

“Many products offered different attractions to try to obtain higher yields and mostly ended up with equity-like exposures that failed the portfolio theory 101 test – that an allocation to bonds should be defensive and negatively correlated with equity market returns.

“Unfortunately, with a combination of aggressive credit bets, sub-investment-grade assets, structured and now illiquid and/or worthless bonds, many active managers’ products have had negative returns, which is catastrophic when relying on these investments to mitigate the negative returns from allocations to growth assets.”

While researchers and fund managers have their views on portfolio construction and tilts, it is worth mentioning an additional strategy within fixed income that could bolt on to portfolios if thoroughly understood: global inflation-linked bonds (GILB).

GILBs are bonds that generally have coupon payments and the principal adjusted to offset inflation, Daniel Needham, the head of investments at Intech, which runs the Global Inflation-Linked Securities Trust, says.

“We’re in an environment where governments, in the face of the worst post-World War II global recession and significant deflationary risks,

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*SIMON DOYLE*  
*Schroders*

have passed measures aimed at significantly ‘re-inflating’ the economy,” Needham says.

“As such, we are seeing unprecedented government stimulus, including the use of quantitative easing, that has the potential to be highly inflationary in the medium term and this, in turn, increases the risk of the upside inflation surprise in the future.

“We view GILBs as an attractively-priced hedge against that inflation surprise for an investor holding nominal government bonds.”

Their inflation adjustment is ordinarily based on the previous quarter’s movement in inflation.

They have a greater sensitivity to changes in real interest rates than nominal government bonds do, as they tend to have longer-dated maturities and a large portion of the GILBs value is derived further in the future.

“The returns of GILBs are determined by the real yield and future inflation over the life of the bond. For investors, this provides a hedge against unexpectedly high inflation and maintains the real purchasing power of their investment over the life of the bond,” Needham says.

Deflation, on the other hand, will have different effects on different GILBs – some governments will not allow the principal and coupons to be lowered below the par value, while others will.

It may be worthwhile for planners to debate what the future scenario will most likely be: inflation, hyperinflation, disinflation or deflation?

“For investors looking to protect their portfolio from the possibility of unexpectedly high future inflation, but with the security of investing in government bonds, global inflation-linked bonds provide a unique opportunity,” Needham says.

“GILBs can be used as a relative value play within the defensive asset portfolio, looking at the absolute and real yield relativities between cash, nominal bonds and inflation-linked securities.

“Despite the still significant short-term deflationary risks, due to global deleveraging and the widening output gap, GILBs make a sensible addition to the investment strategy of a diversified investor with exposure to nominal government bonds.” ◀