Implications and opportunities for Fixed Interest investors in a low yield world

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PERENNIAL FIXED INTEREST

Executive summary

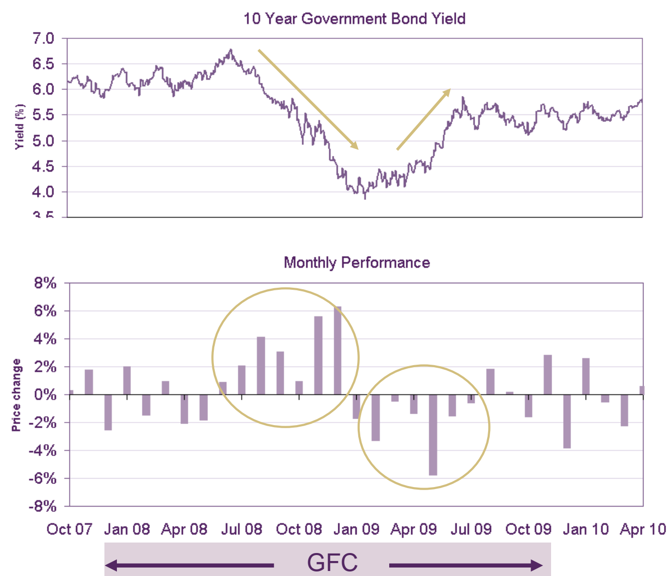
Traditional fixed interest has historically played a valuable role in the context of a broader diversified portfolio. Including long duration fixed rate bonds in investor portfolios over the past 30 years has demonstrated the value of diversification against growth assets and delivered handsome returns when bond yields fell globally. This has also served investors well during episodes of economic turbulence and market upheaval when growth assets have typically performed poorly. This paper looks at the key questions:

- In the current low yield environment, can fixed interest investors expect the same benefits as they have historically or are they locking their defensive allocations into poor future return outcomes?
- Could the choice of fixed or floating rate debt make a difference?
- Are there other parts of the bond market that offer better value such as high quality corporate debt?
- What role can hybrids play in defensive portfolio given the current attractive pricing?
- ***And is this a time for investors to take a more tactical approach with respect to their fixed interest allocations?***

The role of traditional fixed interest in a diversified portfolio

Long duration fixed rate bonds have many useful properties in the context of a broader diversified portfolio including capital stability, regular income, diversification and liquidity. However, the most valuable attribute is the low or negative correlation they typically have with growth assets such as shares and property owing to the inverse relationship of its price to yields[1]. Hence, traditional fixed interest is often referred to as 'portfolio insurance'. During good economic times, growth assets should be performing well while bonds are delivering pedestrian returns. This opportunity cost, by allocating a part of an investor's portfolio away from higher returning growth assets to lower returning fixed interest, is the 'premium' that investors pay for portfolio insurance.

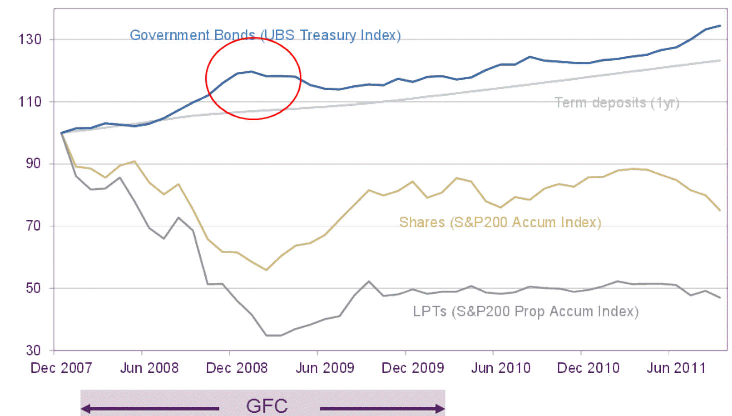
Chart 1: Inverse relationship of bonds yields to prices



Source: Bloomberg, Perennial

However, when fortunes turn for the worse and the economy faces a downturn, growth assets perform poorly and often provide negative returns. It is during these periods that the portfolio insurance policy of a fixed interest allocation 'pays out' and the otherwise 'dormant' asset class comes to its own. This is primarily due to the central bank cutting cash rates during economic downturns in a bid to make monetary policy more stimulatory. By extension, bond yields fall given that they in loose terms represent the expectations of the future path of cash rates. The inverse relationship of bond yields to prices causes fixed interest assets to rise in value providing the all important offset (negative correlation) to falling growth assets. This relationship was well observed during the GFC as illustrated in Chart 1 & 2 when the fixed interest[2] delivered +15.2% while shares[3] returned -34.7% and the property[4] returned -52.9%. The longer the duration of a fixed interest allocation, the better the portfolio insurance payout.

Sector returns during GFC



Source: Bloomberg, Perennial

[1] RBA Bond formula demonstrates the inverse relationship between bond yields and prices: http://www.rba.gov.au/mkt-operations/resources/tech-notes/pricing-formulae.html

[2] As measured by the UBS Composite 0+ Fixed Interest Index for the year ending 31 January 2009

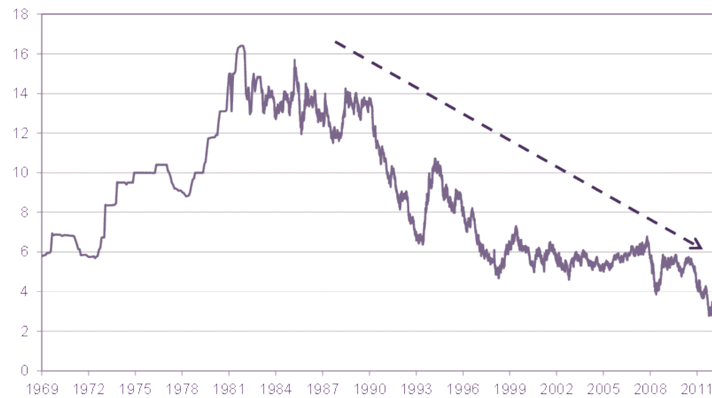
[3] As measured by the ASX 300 Accumulation Index for the year ending 31 January 2009

[4] As measured by the ASX 300 Property Accumulation Index for the year ending 31 January 2009

Low bond yield environment

Globally bonds have been in a bull market for much of the past three decades with yields falling to near and record lows in many developed countries including Australia as shown in Chart 3. Current bond yields reflect a pessimistic view of future economic performance and are very low by historical standards and economic fundamentals. Bond yields are also influenced heavily by many developed market central banks holding cash rates at or near zero per cent and undertaking quantitative easing. This is being done in order to bring down longer term bond yields in a bid to reduce borrowing costs for households and businesses right along the yield curve to stimulate credit growth and ultimately for this to support economic growth. Australia also finds itself in a more unique position in that it does not necessarily have the economic woes of many of its larger developed counterparts. But it has become one of a very few in a shrinking pool of AAA rated sovereign bond markets where yields are still high relative to say the US, Europe or Japan. As such, it has attracted offshore investors who have been purchasing Australian government bonds putting further downward pressure on our bond yields.

Long term Australian bond yields



Source: Bloomberg, Perennial

With government bonds now trading around 2.8% for 3 years and 3.4% for 10 years, investors are faced with three key challenges:

Firstly, investors are locking in for a very low 3.4% return per annum over the next decade. When investors look back at this investment in 10 years' time, they may well find that their investment barely delivered a real return once inflation is accounted for.

Secondly, when the global and domestic economies start looking a little brighter and the prospect of monetary tightening enters the markets' mindset, bond yields are likely to rise. Potentially by quite a lot, delivering investors with very low or even negative returns from what is viewed as the defensive bedrock of investors' portfolios. While, this risk is not imminent and much of the developed world has some way to go in terms of restoring their economic growth prospects, it is certainly not out of the question. The Federal Reserve in the US or other central banks could be contemplating moving away from zero per cent interest rates in 2014 or 2015. And markets including bond pricing always tries to move ahead of actual changes in monetary policy.

The third challenge is one related to the future benefit of diversification from fixed rate bonds. During the GFC, 10 year bond yields fell from 6.8% to 3.8%, a fall of 3% when cash rates were cut to 'emergency easing' levels providing that very valuable capital appreciation of fixed rate assets which helped cushion investor portfolios from the negative returns they experienced in growth assets (see Table 1). However, if the starting point now is a 3.4% yield on a 10 year government bond, the prospects of bond yields falling meaningfully from here are quite limited. Hypothetically, even if the Australian economy faces the problems experienced by troubled economies such as the US or Europe and yields Australian fell to their levels, the maximum fall is in the order of 1.5 to 2.0%. That fall will not provide the same level of cushioning that fixed interest has provided against falling growth assets during previous crisis including the GFC.

Economic downturns

Event	Period	10 bond yield % (start)	10 year bond yield % (end)	Change
GFC	2008-2009	6.8	3.8	3.0
Tech bubble	2000-2001	7.0	5.3	1.7
LTCM	1996-1998	8.9	5.0	3.9
'Recession we had to have'	1990-1993	13.6	6.7	6.9

Source: International Monetary Fund (IMF)

Fixed vs. floating rate

In a low yield environment, the returns achievable from traditional fixed rate portfolios will be low and have a risk of being negative sometime in the medium term future. Further, the diversification benefits (portfolio insurance) of bonds in a broader portfolio are compromised when bond yields are so close to their lower boundaries. Given the risks and limited benefits now associated with fixed rate bonds, investors may be better served with a greater proportion of their defensive allocation in floating rate debt securities.

By avoiding fixed rate investments where investors are effectively 'locked' into a particular yield and focussing on floating rate investments, where the coupons are reset periodically to reflect the prevailing rate of interest, investors participate in any future rise in interest rates. Further investors don't face the negative capital impact that is usually associated with rising yields on fixed rate bonds.

The credit 'sweetspot'

While long government bonds are expensive by a number of measures and are not an attractive investment for the reasons given above, there are a number of very good opportunities for the defensive part of investors' portfolios. These include state government debt, supra-nationals or government guaranteed debt and investment grade corporate debt. The latter stands out as an attractive investment for defensive investors.

By investing in corporate debt, investors benefit from the additional spread or margin (credit spread) which is the additional compensation investors receive for lending to high quality companies (credit risk) as opposed to the government. However, it should be noted that when investors increase their allocation to corporate debt at the expense of government debt, credit quality is instrumental to ensuring the defensive allocation behaves like it should during stressed market conditions.

Since the GFC, credit risk and by extension credit spreads has been re-priced materially as shown in Chart 4. Even though the easy money has been made when credit spreads were at their highest in early 2009 and the associated capital gains that occurred as credit spreads fell over the past three years, the current level of spreads are still attractive and more than compensate investors for default risk.

The fundamentals of corporate debt are equally as attractive as current valuations. Since the GFC, many companies have de-levered their balance sheets by reducing debt and have boosted liquidity buffers. While these measures are not necessarily attractive from an equity investor's viewpoint, they are all very positive developments from a credit investors (lenders) perspective. Companies are also now more prudent when it comes to dividend payout ratios, cashflow management and diversification of funding sources as well as debt maturities. All of these aspects make them safer animals to lend money to.

Australian Credit Spreads

Source: UBS, Perennial using the UBS Credit spread to Bond Index

The areas of the corporate debt market that stand out as the 'sweet spot' for investors are banks, infrastructure debt and listed property trusts where much of the cash flow used to service debt securities are either linked to inflation or regulated and the fundamentals are strong. The credit spread on these corporate debt securities are typically in the range of 1.5 to 2.5% above the equivalent government bond for a 5 year term making the overall yield of corporate debt the best part of double its government counterpart. In a low yield environment, this additional spread is very valuable to investors in achieving reasonable rates of return from their defensive allocations.

For fixed interest investors, incorporating high quality corporate debt is a valuable sector for enhancing running yields without necessarily compromising the defensive attributes of their portfolios.

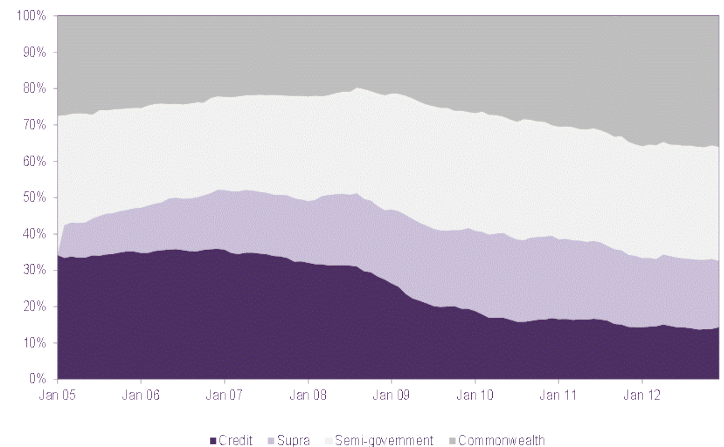
The index has changed its stripes

Most traditional fixed interest products, be they active or passive use the UBS Composite 0+ Index as their benchmark. While this has served investors well in the past, the composition of this Index has changed materially since the GFC .

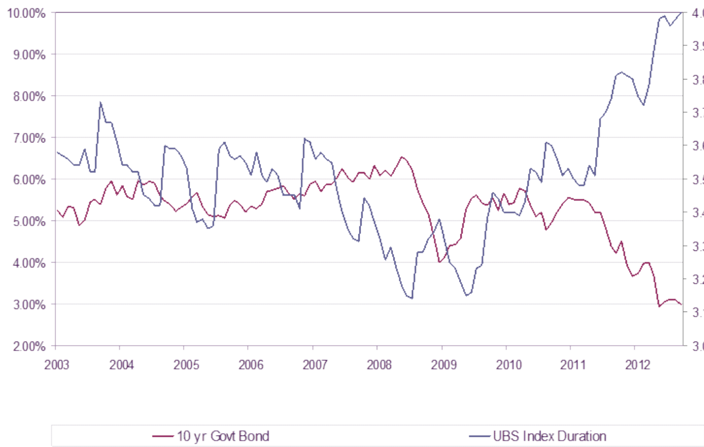
Two noteworthy changes are longer duration and lower exposure to corporate debt. Both of these have materialised due to companies issuing less debt since the GFC and the government / state government sector borrowing more over the same period. This has meant that the weight of corporate debt has fallen from about 35% to less than 15% at present, as shown in Chart 5. Further, given governments typically borrow for longer terms than companies, this has caused the duration to also extend from some 3 years to 4 years.

Composition of the Fixed Interest Index:

Credit allocation in the UBS Composite 0+ Index



UBS Composite Bond Index Duration vs. 10 Year Govt Bond Yield



Source: UBS, Perennial

Given earlier comments about the least attractive investment for investors being fixed rate (or longer duration) government debt and the sweet spot being high quality floating rate (or shorter duration) corporate debt, the current composition of the UBS Composite 0+ Index is the least preferred portfolio for defensive investors. As a result, an active approach that constructs portfolios independent of the Index is required to avoid the shortcomings of the Index.

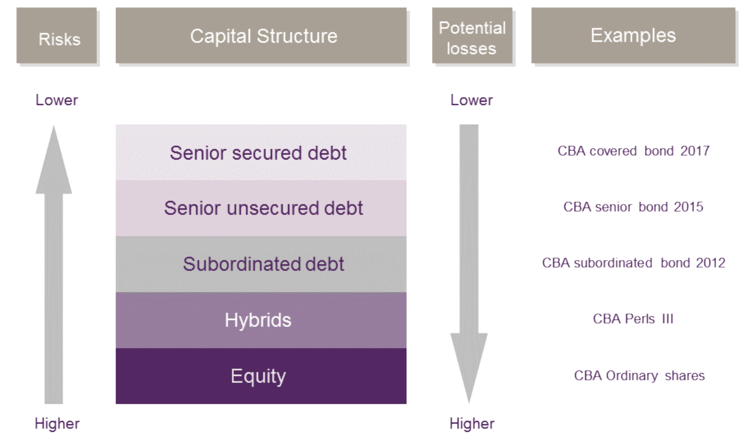
The role of hybrids in a defensive portfolio

There has been renewed interest in hybrids by investors over the past year or so. A number of companies have accessed the hybrid market for funding given traditional bank sources remain relatively expensive following the GFC and higher funding costs faced by banks themselves. Issuers are also relieved, at least partly, when counting hybrid funding from their gearing calculations because credit rating agencies allow the security to be treated as equity rather than debt for a period of time.

Similar to investment grade credit discussed earlier, valuations on these lower ranking debt securities remain attractive for investors as a means of enhancing the running yield of defensive portfolios. Investors can currently enjoy 3 to 5% additional yield by investing in various hybrids. However, there are a number of additional risks investors need to take into account:

As investors move down the capital structure, they expose their portfolios to greater potential losses in the event of default (below). Many hybrid issuers can also defer coupons and have the option not to repay the principal on the nominated 'call' date for a variety of reasons without being treated as an event of default. This is not the case with senior ranking corporate debt whereby a missed coupon or non-repayment of principal in full on the maturity date constitutes an event of default. Another recent development is that where the issuer is a bank, there are new capital rules by APRA under the Basel III framework that mean under certain stressed conditions where a bank's capital falls below a threshold, the regulator has the right to instruct the troubled bank to convert the hybrid security into ordinary shares or even worse write off part or all of the principal.

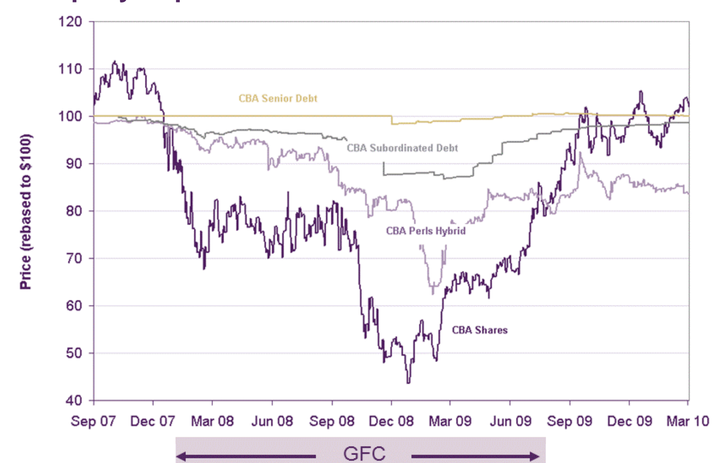
Company Capital Structure



Source: Perennial, Commonwealth Bank

While the risk of these events unfolding is remote, the market's pricing which anticipates certain stressed events occurring are more common. To illustrate the point, the chart below shows four different ranking securities during the GFC issued by the Commonwealth Bank of Australia (CBA) and how $100 invested in each moved in price over this period. Very few investors actually thought that the CBA would become bankrupt but market participants certainly had concerns on the likelihood of dividends being cut on the ordinary shares, the potential of coupons on the PERLS hybrids being deferred and the expected dates for principal repayments being pushed out, in the worst case, in perpetuity. All of these considerations caused lower ranking securities such as hybrids to materially underperform senior debt and behave much more like shares.

Company Capital Structure



Source: Perennial, Commonwealth Bank, Bloomberg, UBS

These attributes make hybrids a lot more correlated to shares and as such are not a defensive asset. Security selection is also crucial in avoiding issuers whose credit quality may deteriorate over time. There have been many examples of hybrid issuers whose businesses have deteriorated over time including Paperlinx, Elders, Gunns, etc.

Hybrids can be a very useful sub-sector of debt markets in enhancing the yield investors enjoy and are likely to be quite stable assets during good economic environments. Current valuations provide some good opportunity for investors. However, given hybrids behave more like shares during periods of stress when investors most need their portfolio insurance, they should be used in moderation and should never represent a material percentage of a defensive portfolio.

Taking a tactical approach

Traditional fixed interest has played a valuable diversification role within broader diversified investor portfolios. However, in a low yield environment where long term fixed rate government bonds are expensive, future returns will be low and potentially negative. The diversification benefits that investors enjoyed in the past have also been compromised. In view of these considerations, investors may be better rewarded in increasing their defensive allocation to floating rate assets with a focus on high quality corporate debt.

Given the very low allocation to the credit sector in commonly used fixed interest indices and the lengthening duration, a more active approach may benefit investors.

Market pricing of bond yields and credit spreads move around all of the time and shift quite meaningfully over short periods of time making a strategic allocation to these assets difficult. Given that there will always be an interest rate cycle and a credit cycle, a more tactical allocation to the defensive part of investors' portfolios rotating between cash, fixed rate government bonds and corporate debt should better protect capital and enhance returns. This approach should also provide investors with a more stable return outcome over time without compromising the defensive qualities investors require. Opportunistic allocations to higher yielding securities such as hybrids can also be useful in enhancing yields for investors
provided it only ever represents a small proportion of a defensive portfolio. This should ensure that the portfolio insurance policy is of high quality and pays out when investors need it.

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