

Income Examiner

Making sense of the fixed-income landscape



With many fixed income investments proving not to provide 'defensive' characteristics through the market turmoil of the last two years, investors have been left wondering how to make sense of the fixed-income landscape.

With fixed income typically constituting 15% to 70% of investors' portfolios, Richard Brandweiner, Group Executive, Income and Multi-Sector, explains what needs to be considered when constructing fixed-income portfolios.

Fixed-income assets and funds are typically utilised in a portfolio to provide liquidity, regular income and to diversify away from equity risk. Essentially, fixed-income assets should provide some certainty and predictability which can be a defensive anchor in a portfolio.

But there are many income funds available for investment, each with different underlying investments and often with similar names. It can be difficult to understand the risks, and the market conditions in which they perform well and in which they don't.

To understand how fixed income can play a defensive role in a portfolio, investors must first go back to the basic principles of fixed income investing.

Income investing fundamentals

Investors in fixed income are lenders of capital. It is this basic principle which determines the risk and return characteristics of the asset class.

Essentially all bond investments are based around an investor lending capital to a borrower and it is the terms of this loan which determine the nature of the investment and, most importantly, whether that investment will meet their objectives in terms of defensiveness, liquidity and income.

A bond investor (either directly or via a bond or income fund) lends a known amount of capital to the borrower over a specific term in return for interest payments (or coupons) and repayment of the loan at some specific point in the future (face value of the bond).

When lending money the risk, and therefore likely return, is dependent on a number of key variables. Most importantly, are you charging fixed interest rates or a floating rate? Who are you lending to and how long are you lending for? These variables are known respectively as duration, credit risk and maturity.

Making sense of the lending market

When it comes to investing in fixed income, a full understanding of your exposure to interest rates (duration), the risk associated with who you are lending to (credit risk) and how long you are lending for (maturity) will give you a good sense of how your income investments will perform and how defensive they will be.

Duration

A lender typically has two options when it comes to the income they receive for providing a loan: fixed rates or variable rates. Duration is just the technical term to describe how the value of the loan moves when official interest rates move.

The higher the duration, the more the value of the loan will vary with interest rates. For example, if you have lent at a fixed interest rate and official rates fall, that loan becomes more valuable.

This is why fixed rate bonds can often perform well when equity markets are in decline, if the equity market decline is accompanied by official interest rate cuts. This is a true defensive characteristic.

Similarly, when interest rates are low and rising the value of fixed rate loans fall; after all, why would lenders lock in a rate when they could be rewarded with higher interest rates in the future?

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Credit risk

The most significant risk for any lender is that the borrower defaults, ie they are unable to meet interest and/or capital repayments.

The most secure lenders are typically considered to be governments around the world and the best sovereign debt is considered to be almost risk free, eg lending to the Australian Government.

There is an extremely large universe of other borrowers from high quality through to what is considered higher risk, such as high-yield borrowers who issue what is known as sub-investment grade debt.

The credit ratings published by agencies such as Standard and Poor's and Moody's are grouped into two categories – investment grade and sub-investment grade. To be considered investment grade, the rating must be between 'AAA' and 'BBB'. A sub-investment grade rating is given to anything below 'BBB'.

The credit rating system used by Standard & Poor's is shown in Table 1 below.

Table 1 – Investment grade versus sub-investment grade

	Rating	What it means
Investment grade	AAA	Highest credit quality
	AA	Very high credit quality
	A	High credit quality
	BBB	Good credit quality
Sub-investment grade	BB	Speculative
	B	Highly speculative
	CCC	High default risk
	C	High default risk
	D	Default

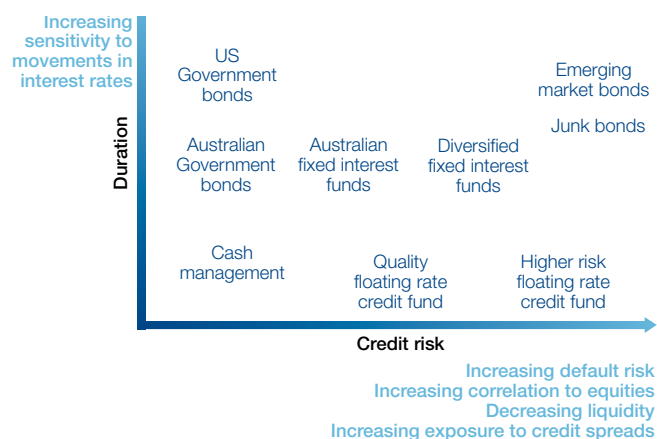
Source: www.asx.com.au

When you lend, the trade off between risk and return can be very transparent. Taking more credit risk can lead to higher yields but it also leads to more risk.

Higher credit risk means the more likely that borrowers will not repay their capital, the more the value of the loans are likely to correlate with equities and the less defensive are the assets.

Duration and credit risk are further illustrated in Chart 1 below.

Chart 1 – The lending market landscape



Source: Bloomberg, Reserve Bank of Australia

While this principle seems relatively clear, there are in fact many contributors to credit risk, such as the industry in which the borrower operates, the credit rating, whether the loan is secured by assets or unsecured and whether the loan is senior or subordinated to other creditors.

The other key contributor to credit risk is the time to maturity of the loan which we explain further below.

Maturity

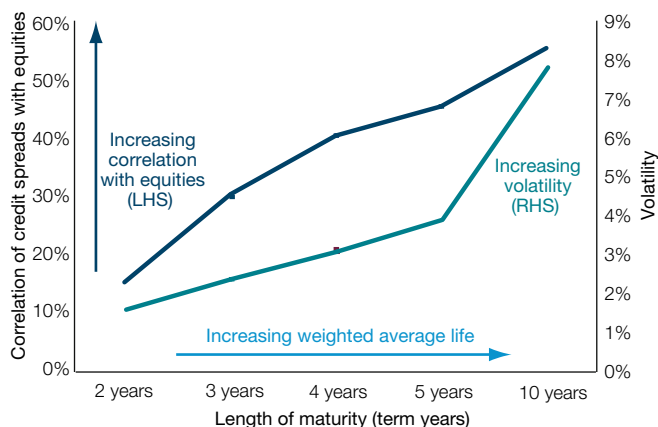
How long you lend money for is critical in determining risk. After all there is more certainty about a borrower's ability to repay in the short term, and increasing uncertainty as the loan term increases.

Therefore, investors need to understand the concept of weighted average life (see below) which gives a sense for on average how long the loans are for in a bond portfolio.

The weighted average life (WAL) is the average number of years for which each dollar of unpaid principal on a loan or mortgage remains outstanding. It tells us how many years it will take to repay half of the outstanding principal.

As Chart 2 below demonstrates, the longer the WAL the more volatile a bond portfolio is likely to be, and the more correlated with equities it will be. Therefore, longer maturity bond portfolios tend to provide fewer defensive characteristics for investors.

Chart 2 – Increasing weighted average life leads to higher volatility
Correlation of credit spreads equities



Source: Bloomberg, Reserve Bank of Australia

So why did much of the 'defensive' fixed income universe blow up in 2008?

Essentially many investors exposed themselves to too much equity-like risk in their fixed income investments prior to the credit crisis by holding lower-quality assets, being highly exposed to a single sector or having portfolios with long weighted average lives.

The fixed income checklist

To help you and your clients assess both the risks and rewards of fixed income investments we have created the following simple checklist.

Interest rate risk

What is the fund's interest rate duration? The longer the duration, the more it matters if interest rates go up or down. For example, if the duration is less than one year, the fund is less sensitive to interest rate movements.

“ At Perpetual we believe that most investors look to fixed-income funds mainly to provide defensive characteristics. This means they should be diversified, hold quality assets, provide liquidity through all market conditions, provide regular income and have a low correlation to equities. ”

The UBS Composite Bond Index, which is the benchmark for most fixed rate bond portfolios, has a duration of around 3.3 years.

That means, for example, that for every percentage move up in interest rates, the portfolio value will decline by 3.3%, all else being equal.

Credit risk

How much credit risk is the fund exposed to? This is often not immediately obvious. To get a real sense of the level of credit risk, you should ask:

- How much of the fund is in sub-investment grade investments?
- What is the average rating of the securities within the fund?
- How much of the fund is senior debt?
- How much is subordinated debt or hybrid?
- What is the fund's diversification?

Some exposure to higher-risk loans is not necessarily a bad thing, but too much can reduce the defensive characteristics of the portfolio.

Weighted average life

What is the portfolio's average length of loans? If it is lending for a long time, eg seven years or more, then this will increase volatility and uncertainty for the portfolio.

The credit opportunity

So where does this leave us now? Credit spreads, that is the returns provided for accepting credit risk, are still at attractive levels despite significant contractions in recent months.

Cash rates are on the rise and longer bonds have now crept up to a level where they are not expensive, though they do not represent compelling value either.

Fixed rate exposure is not cheap anymore – and the risk is to the downside if rates continue to rise, but the return from taking on credit risk is still very attractive.

So if you are willing to invest in credit now is a good time to consider it.

Perpetual's fixed income approach

At Perpetual we believe that most investors look to fixed-income funds mainly to provide defensive characteristics. This means they should be diversified, hold quality assets, provide liquidity through all market conditions, provide regular income and have a low correlation to equities.

Our Perpetual Diversified Income Fund is focused on quality domestic, predominately investment-grade, income-generating assets. It can actively move in and out of different assets through the investment cycle.

Our disciplined process aims to protect investors' capital while taking opportunities where risk is being best rewarded.

The Fund's loans have floating rates so increases in official interest rates flow through to investors as higher income, all else being equal.

It lends predominantly to investment grade borrowers over short weighted average lives – currently less than three years.

To summarise, it is important to remember that risk management is paramount when it comes to fixed income.

At Perpetual, we believe that the keys to successful credit investing are to invest only in high credit quality securities, value risk and liquidity properly, and build well diversified portfolios.

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Want to learn more?

For more information on fixed income markets, please contact your Perpetual Account Executive or contact Perpetual's fixed income investment specialists on the numbers below.

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