

Income Examiner

Investing in fixed income for self managed super funds



Investors in self managed super funds (SMSFs) represent the largest and fastest growing segment of superannuation in Australia. As Jon Crook, General Manager Income and Multi Sector Sales explains, opportunities in fixed income can be particularly attractive for SMSF members, but are not easily accessed directly.

The SMSF market in Australia

The SMSF sector is today the largest superannuation sector with over \$332 billion of total assets, according to 'A statistical summary of self managed superannuation funds' published as part of the Cooper review of Australia's superannuation system¹. This equates to over 30% of the total superannuation market in Australia.

The report shows that the bulk of assets in SMSFs are held directly rather than through managed funds, and SMSFs have a high propensity to invest in domestic equities, term deposits and cash. In fact, the report states that nearly 60 per cent of assets (are) held in cash, term deposits and Australian listed shares.

This corresponds to the widely held view that investors are primarily attracted to SMSF structures to:

- maintain control of their investments
- reduce the costs of managing those investments.

Although it is hard to get a complete picture of the exposure of the SMSF sector to fixed income (including sovereign bonds and credit securities), the report shows that less than 1% of assets are invested in direct debt securities.

Given a typical allocation to fixed income across large public offer superannuation funds is around 25%, why are SMSFs so underexposed to this asset class?

Investing in fixed income for SMSFs

We believe there are two key issues for SMSFs which have resulted in their relative underexposure to fixed income assets. These are:

- 1. Difficulty accessing direct fixed income assets.** Although the fixed income market in Australia is approximately 40% larger than the Australian equity market, the bulk of these assets are traded in over-the-counter wholesale markets². This means the primary purchasers of these assets are fund managers, large superannuation funds, banks and insurance companies. The minimum parcel size for typical debt instruments is \$500,000. As a result, SMSFs have little visibility of the market and, even if they were fully aware of the opportunities available, they have limited ability to take advantage of them as the average SMSF total asset balance is under \$900,000.

¹ <http://www.supersystemreview.gov.au>

² RBA

A very small segment of the Australian fixed income landscape is listed on the Australian Securities Exchange (ASX) in the form of hybrid securities. However these securities provide a number of challenges for investors around a unique set of risks. For more information refer to our March 2009 edition of Income Examiner about hybrid securities available from our Adviser website (newsletter section).

2. Relative complexity of the asset class. In general, fixed income assets are not as well understood as equity investments. Concepts such as interest rate and credit duration, lending covenants, spreads and priority in the capital structure are specific to each security and influence valuations. However they are not typically front page news in financial press. As a result, direct investors are less inclined to invest in the asset class.

Given these issues, what do large institutional superannuation investors see in fixed income assets and why should SMSFs rethink their underexposure to the asset class?

The value of fixed income

In a portfolio context, owning quality fixed income assets has proven to significantly reduce the volatility of a portfolio compared with a portfolio of equities (based on data from 31 December 1979 to 30 June 2009³.)

Table 1 - Risk and return of different portfolios

	100% Australian equities	50/50 Australian & international equities	70% growth portfolio
Return (%pa)	11.8	11.7	11.5
Volatility (%pa)	17.8	13.7	10.1
Worst cumulative 3 year return (%)	-28.0	-30.4	-15.2

Source: DataStream

As table 1 shows, introducing 30% defensive fixed income and cash assets to a portfolio only had a marginal impact on returns over a very long period of time, however the worst cumulative three year return is almost halved.

From a risk and return perspective, adding fixed income assets to a portfolio of equities makes a lot of sense.

The attractiveness of fixed income assets comes from the following properties:

- investing in fixed income assets increases the diversification in a portfolio
- high quality fixed income assets offer good liquidity
- fixed income assets offer a regular income stream
- the assets offer a known return which means, providing the assets do not default and are held to maturity, investors have certainty about the reward for their investment
- good fixed income assets can be a safe haven when equity markets sell off.

If there is value in fixed income assets and they are difficult to access directly, why don't SMSFs invest in fixed income via managed funds?

The unique benefits managed funds offer for fixed income

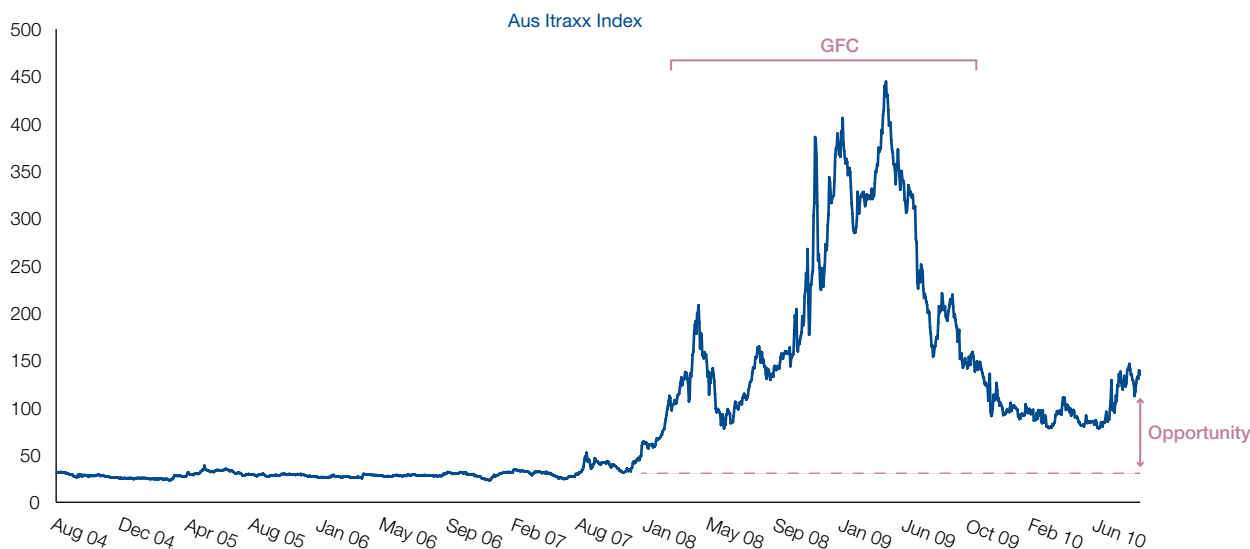
While investors can buy the top 10 ASX listed stocks and access approx 60% of the total equities market by capitalisation in Australia, they cannot take a direct approach in fixed income with the same efficiency.

Managed funds offer unique benefits in fixed income for the following reasons:

- Access** – investors are typically unable to access high quality, fixed income securities directly due to the \$500,000 minimum parcel size of these assets. A prudent investor would hold a large number of securities to diversify risk which is not practical for most SMSFs. Pooling assets enables investors with smaller portfolios to achieve adequate diversification.
- Under-compensation for risk** – the small number of ASX-listed hybrid securities is not an investment grade universe of securities and they are at the bottom of the debt capital structure. The complex nature of risk in these securities means retail investors are often under-compensated for the risk taken. For more information refer to our March 2009 Income Examiner about hybrid securities available from our Adviser website (newsletter section).
- Risk management and diversification** – fixed income securities feature asymmetric risks. That is, the best outcome for an investor is to receive their investment back, plus the coupon or interest payment. The worst case is that they lose money if the bond issue defaults. Much of the skill in fixed income investing is making sure risk is being rewarded appropriately on a relative basis, that default is avoided, and that risks are diversified across a large number of securities – ideally more than 100 different issuers. This is best done by a professional fixed income portfolio manager.
- Active management** – while the buy and hold approach to investing in fixed income is straightforward, fund managers are able to add value above this approach by using relative value, sector rotation, arbitrage and roll-down trades. Each of these approaches to active management requires dedicated and skilled managers to identify and action appropriate opportunities.
- Access to institutional pricing** – while some local brokers allow access to the minimum \$500,000 parcels of fixed income securities, to earn a margin the pricing is typically more expensive than similar securities in the institutional market which are accessed directly by fund managers dealing in large volumes.
- Relative value** – fixed income markets trade in an over-the-counter market. In contrast to equities markets where all participants have access to accurate, real time market prices, in fixed income markets professional portfolio managers with intimate knowledge of market prices and dynamics can take advantage of opportunities to buy less risky securities with higher spreads.
- Global assets** – fixed income assets are issued domestically and offshore. Investors are typically unable to directly access global markets and undertake the often complex currency and interest rate hedging required.

³ 70% growth fund asset allocation: 40% Australian equities, 25% international equities, 5% property, 20% fixed interest, 10% cash. Passive rebalancing assumed monthly. Buy/sell spreads for rebalancing assumed to be 0.30% each way on Australian equities, international equities and property and 0.1% each way on Australian fixed interest.

Why quality fixed income assets offer compelling value now



Source: DataStream

Credit spreads, or the additional return investors receive for taking risk above the risk free or government bond rate, today offer compelling value. The chart above shows the Australian Itraxx Index, a synthetic index charting the movement of credit spreads for the top 25 Australian corporates. It shows that credit spreads traded in a narrow margin around 30 basis points above the risk free rate in the years leading up to the global financial crisis and then spiked, reflecting

the extreme dislocation in financial markets during 2008 and 2009. While the environment has now stabilised and spreads have contracted significantly from their wides in early 2009 to around 130 basis points, the compensation for credit risk is approximately four times more than pre-GFC. We believe this offers investors a significant opportunity to purchase quality assets at historically good valuations.

Accessing high quality fixed income

Perpetual's Diversified Income Fund is a high quality, floating rate credit fund which invests in predominately Australian investment-grade assets. The floating rate nature of the Fund means all other things being equal, higher interest rates will flow through to higher returns to investors. The Fund is currently generating a running yield of over 8% on a weighted average life of over two years, giving investors a high degree of certainty around what the Fund return will be, assuming interest rates remain stable and none of the securities in the Fund default.

Conclusion

While fixed income assets offer SMSF investors clear rewards, lack of access and a preference for holding direct assets has prevented these investors from benefiting from the asset class. Managed funds offer investors in this asset class unique advantages which should be reconsidered by fund trustees and quality credit assets today offer compelling value.

Want to learn more?

For more information on fixed income markets or accessing them through the Perpetual Diversified Income Fund, please contact your Perpetual Account Executive or contact Perpetual's fixed income team on the numbers below.

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