EUROPEAN ITRAXX VS AUSTRALIAN ITRAXX

ADAM CURTIS
Head of Investment Specialists
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Portfolio Management in Equities is well known. It is arguably less well known as it is applied to Fixed Income strategies. However, in many cases, fixed income portfolios are actually more actively traded. In this edition of Investing Matters, we seek to illustrate one of our trades executed in the Diversified Income Fund earlier in the year.

Compression Trade

By way of background basically a Credit Default Swap is a derivative which insures bond holders against default. The cost of the insurance, similar to premiums for house insurance, is known as the spread. Itraxx is an index provider in the fixed income world which builds a range of indexes that track different baskets of spreads. When spreads are low, Itraxx is low and vice versa. The Australian Itraxx index follows the spreads on a basket of 25 CDSs covering major Australian corporate security issuances. Alternatively, the Itraxx Europe tracks the spreads on 125 CDSs written on European issuances. Earlier in the year, we'd formed a view was that given the risks in Europe, particularly around Greece and the Eurozone, the gap between Australian and European spreads (as reflected in CDS pricing) was too large.

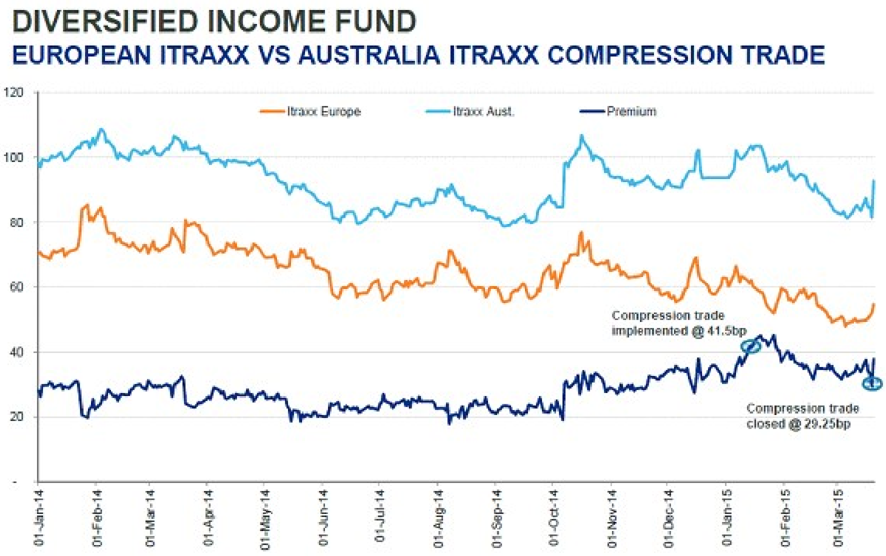
In an attempt to profit from this gap narrowing we put on **a "compression trade".**

In essence, this involved selling the Australian Itraxx (i.e. long position on Australian securities) and buying the European Itraxx (i.e. short position on European securities), so that regardless of which way either moved, the position would profit provided the gap between them closed.

When we entered the CDS trade the Australian Itraxx spread was 41.5bps over the European equivalent. We considered this was a good entry point given the average difference between the two over the long term is about 18bps.

Both spreads actually contracted over the period, but importantly the gap between the two closed, as increasing concerns over Greece prevented European spreads from contracting as far as Australian spreads. We exited when the premium had contracted to only 29.25bps.

The position (approximately 2% of portfolio) generated a holding period 68bps of return in just over two months and added nearly 2 bps on the entire portfolio return.



Summary

The way we manage money and construct portfolios should bring comfort and ultimately improved risk adjusted returns. We tend to have higher levels of active management (in terms of trading activity) than competing strategies. Our philosophy is to always take lower risk opportunities where we are able. This means that because of our active trading approach, the credit quality of our portfolios is often higher relative to alternative strategies looking to generate the same excess return.

We are highly active across the breadth of the market in which we are interested and the market often sees us as a source of liquidity. Our presence in the market, and our dealing capabilities ensure that often we achieve price outcomes that consistently better the market. We actively position and monitor “roll-down” opportunities. Our process biases towards actively trading higher rated securities. This is efficient in generating roll-down benefits as higher quality securities tend to be more liquid, have lower transaction costs, are issued in greater volume and often exhibit a more consistent probability of spread contraction. In an environment where credit is not necessarily cheap, this active approach to portfolio management should pay dividends.

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Adviser Services 1800 062 725
Investor Services 1800 022 033
Email investments@perpetual.com.au
www.perpetual.com.au