FIXED INCOME IN A RISING RATE WORLD – WHAT'S THE RISK?

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Commentators are now talking about rising interest rates. That's a big issue for investors in fixed interest (especially government bonds and bond funds). We take a look at what could happen if rates rise.

In mid-June, the US Federal Reserve raised the official overnight interest rate for the fourth time in this cycle (albeit after a seven year period where this rate was under one percent!).

While the official rate is currently on hold in Europe, Japan and Australia there are two intertwined forces that mean interest rates in those economies may at some stage head higher.

1. A strengthening global economy means governments and central banks have less need for the extraordinarily loose interest rate policies they pursued to drag economies out of their post Global Financial Crisis funk. That means rates may finally start to move up from their historic lows.
2. A strengthening global economy also means more demand for capital (whether for consumers to spend, businesses to invest or Governments to push into infrastructure). This pushes up the cost of capital – ie interest rates.

WITH INTEREST RATES, THE UPSIDE HAS A DOWNSIDE

But what do rising rates mean for an investor who seeks income from the relative stability of bond-based products? To understand the implications of rising rates, let's look at the nature of fixed income products like bonds.

When you buy a share you become a co-investor in a business – you share in its success or failure. Investors in bonds are different – they're *lenders* of capital. It is this basic principle which determines the risk and return characteristics of the asset class.

As a fixed income investor lending capital to a borrower, it is the *terms* of this loan which determine whether that investment will meet your objectives for capital protection, liquidity and income.

As a bond investor you lend:

- a known amount of capital to the borrower (ie governments or companies)
- over a specific term
- in return for a series of either variable or fixed interest payments (what experts call coupons)
- with the expectation your principal will be repaid at a specific point in the future.

In a bond or bond-like product, three criteria drive your risk and likely return:

1. who you are lending to (what experts call credit risk)
2. how long you are lending for (maturity - or what experts call duration)
3. your exposure to interest rates (fixed or floating).

Understanding the first two risks is pretty simple. Credit risk means – "Can I rely on the borrower to give me my money back?" The less sure you are, the more you'll charge to compensate for the higher possibility of loss.

Similarly, maturity – the length of the loan - has equally obvious implications. The far future is always more uncertain than the near future – so the longer the loan (maturity date) the more interest you want to charge.

The third aspect is: are you invested in a fixed rate security that gives you the same coupon amount every six months? Or are you invested in a floating rate product where the amount of interest (coupon) you receive changes at every payment period depending on market interest rate movements?

FIXED INCOME, MOVING RATES

This difference is important because of the way in which fixed income investments are affected by moving interest rates.

It helps to think of the bond as a contract with a given value. If you have lent money at a fixed interest rate and official rates fall, that loan becomes more valuable (because your bond is paying a more attractive rate than the market).

Similarly, when interest rates are low and rising, the value of your bond (prior to maturity) falls. Lenders would only buy your bond at a discount – because they could find high interest rates elsewhere.

THE IMPLICATIONS

At Perpetual, we believe most investors choose fixed income funds for their defensive characteristics. Currently, cash and term deposit rates are still low and yields from government bonds are at or close to record lows. As we've shown above, the risk for bonds is that if rates rise, their value will fall (if you sell prior to maturity).

An alternative for investors who like fixed income but don't want to be exposed to any bond-market risk from rising interest rates is a product like the floating rate Perpetual Diversified Income Fund.

FLOATING CAN BE SOOTHING

Our highly experienced Fixed Income and Credit team have the ability to focus on shorter-term, investment-grade, income-generating debts issued by corporations and financial institutions. By focusing on floating-rate rather than fixed rate loans, increases in official interest rates flow through to investors as higher income rather than lower capital value when the individual floating rate securities reset to market interest rates.

Your capital amount (subject to no credit changes in the borrower – such as a default) remains the same.

With a rising interest rate environment in prospect this type of floating rate, fixed-income investment may better suits some fixed income investors' needs – and the times we are about to live in.