Making Sense of the Fixed Income Landscape

Fixed income in a portfolio can provide liquidity, regular income and diversification benefits. Essentially, fixed income assets should provide some certainty and predictability, which can be the defensive anchor of a portfolio.

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 respect to 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, 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).

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 longer 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.

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?

Credit risk

The most significant risk for any lender is that the borrower defaults, i.e. 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, e.g. lending to the Australian Government.

Valuations and duration at work

There is an inverse relationship between bond prices and movements in yields. When prices rise, yields fall and when prices fall, yields rise.

For illustrative purposes, assume a $100 face value with an interest rate of 5% pa with a duration of 4 years.

Interest rate decrease

If interest rates decrease by 2% (to 3%) in the first year, the price of the bond would increase to $108.

Change in value = duration (4) x change in yield (2) = 8%

Interest rate increase

If interest rates increase 2% (to 7%) in the first year, the price of the bond would decrease to $92.

Change in value = duration (4) x change in yield (2) = 8%

When investing in fixed income, the duration of the investment is an important factor to consider given the potential implications to the investor.

Perpetual

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.

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 can also lead to more risk.

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

Duration and credit risk are further illustrated in Chart 1.

There are 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.

Maturity

How long you lend money for is also 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.

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.

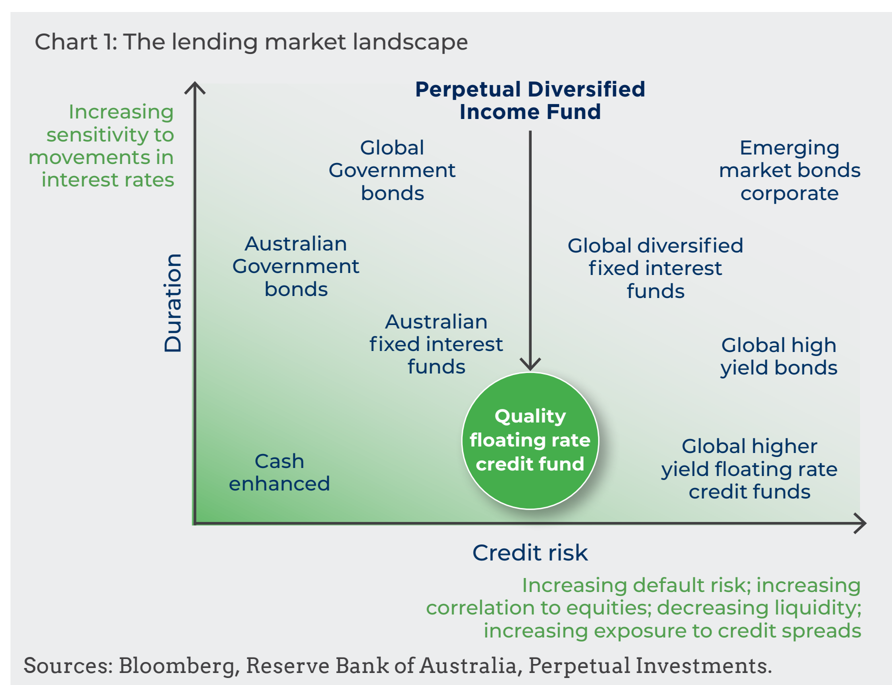
The longer the WAL, the more volatile a bond portfolio is likely to be, and the more correlated with equities it will be. Therefore, longer maturity bond portfolios tend to provide fewer defensive characteristics for investors.

Perpetual's diversified income fund

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 and regular income and have a low correlation to equities.

Our Perpetual Diversified Income Fund is focused on quality domestic, investment-grade, income-generating assets. The Fund's debt assets have floating rates (sometimes referred to as short duration) so increases in official interest rates flow through to investors as higher income, all else being equal.

Chart 1: The lending market landscape



Sources: Bloomberg, Reserve Bank of Australia, Perpetual Investments.

Where to now for fixed income investors?

Credit spreads, that is the returns provided for accepting credit risk, are currently at reasonable levels. We consider the current investment climate relatively supportive to holding credit risk in portfolios.

Cash and term deposit rates are moderately low. Fixed rate exposure isn't cheap and the interest rate duration of most bond indices has continued to lengthen. The risk is on the downside if rates begin to rise.

While a well-constructed fixed income portfolio should have elements of both interest rate and credit risk strategies as sources of potential return, a **bias to short duration credit in portfolios may well be prudent to hold in the current climate**.

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