FIXED INCOME:
NO LONGER THE FORGOTTEN ALLOCATION

Fixed Income: No longer the forgotten allocation

In comparison to our global peers, Australian investors have a very low allocation to bonds.

Yet bonds offer a reliable and stable income investment, providing capital preservation characteristics alongside meaningful diversification from growth assets such as equities. The purpose of this paper is to help provide a deeper understanding of the fixed income asset class and the benefits of holding fixed income investments in a broadly diversified investment strategy.

Typically we have underinvested in fixed income asset class. Generally, these assets have historically been allocated to cash and term deposits (TD). There is undoubtedly a structural element to this allocation based on investor biases and market structure as historically we have all enjoyed high TD rates. However, investors have maintained this low allocation, despite watching Australian fixed income outperform cash over the past decade.

The key concern now facing investors is the difficulty in generating income from their investments in a low yield world. Like Japan, the U.S. and Europe, Australian investors find themselves with low deposit rates and shrinking income opportunities. Interestingly even the RBA have grappled with the issue of lower yields, acknowledging that Australia might be faced with the dilemma of structurally lower yields well into the future. Only a few years ago, investors could rely on low risk investments such as TD's to provide yields in excess of 6%, but yields have now fallen dramatically. At Western Asset, we expect returns on cash and TD to be low for the foreseeable future and it is within this type of environment where there tends to be a stretch for yield. We're witnessing investors chasing yield in equities, hybrids and illiquid instruments that may not offer the same protection as high quality fixed income securities.

So while cash plays an important role in a client's overall asset base depending on their circumstances; its characteristics are very different to that of an Australian fixed income portfolio and in today's low yield environment do not provide the desired characteristics in a well-diversified portfolio.

As a result, more emphasis needs to be placed on the 'middle ground' in the capital structure, where liquidity, diversification and consistent income can all be found in the form of bonds.

So let's get back to bond basics

Bonds generally represent an investment in the debt of governments (Sovereign Bonds), to fund deficits, or companies (Corporate Bonds), to help finance business activities.

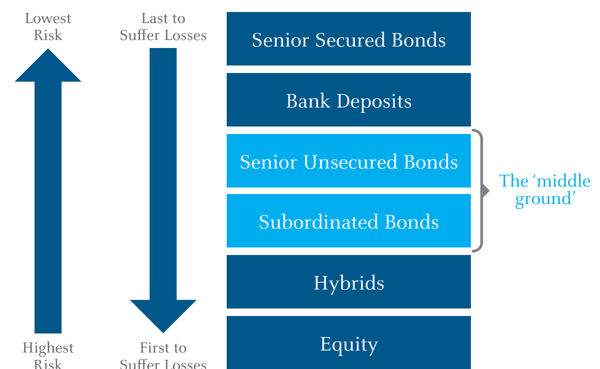
Corporate bonds in the Australian market are predominately issued by large well-known and highly rated companies, such as those you would see in the ASX top 50 or large international companies with operations in Australia such as Apple. These bonds can be fixed rate, where the interest paid (known as the coupon) is set at the outset or a floating rate where the rate paid is referenced to a market rate directly influenced by changes to the RBA's cash rate.

Not all assets are created equal

Different security types such as bonds or equities issued by a company come with different risks. What determines the riskiness of the investment is the relative positioning of a security in the capital structure. It determines the order in which profits and assets are distributed and the pecking order in the event of a default. Due to this preferential treatment, those securities which reside at the top of the capital structure generally offer what seems like a lower return, however they also offer a commensurately lower level of risk.

As an example, below we set out a basic bank capital structure. At the top term deposits have the lowest capital risk; at the bottom equity is the first to suffer loss during a default and the last to have profits (or sometimes capital) returned by way of dividends. That said, this hasn't stopped many in the market stretching into this sector to generate higher levels of income in a lower return world. But this 'bondification' of equities can distort portfolios if not managed carefully.

Hybrids sit one level above equities, generally paying a higher level of income than term deposits and corporate bonds that can seem particularly attractive for investors. The additional risk of these investments is that in a period of stress many such securities can stop paying income and can be converted to equity even without a default event. This generally results in hybrids acting like bonds in good times and behaving like illiquid equities in times of stress as investors fear equity conversion.



Source: Western Asset

The middle ground

Bonds sit above hybrids and equities in the capital structure, with the issuer contractually obliged to make coupon payments and return the principal at maturity. This generates more dependable income and therefore these instruments exhibit lower volatility of returns.

While term deposits, bond, hybrids and equities can all play a role in a portfolio, the different risk and return expectations for these securities means that each provides very different characteristics and are not necessarily interchangeable. With any such decision balancing the overall return objective, required liquidity, risk tolerance and correlation impact will determine the asset mix that suits the investor's goals.

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Three key reasons to invest in fixed income

In diversified portfolio investment there are three primary roles that Australian fixed income plays in the overall portfolio: income, liquidity and negative correlation to equities in "risk-off" environments.

Income – the majority of fixed income total returns are derived from the contractual payment of regular coupons – this income is far more consistent and predictable than that of riskier asset classes.

Liquidity – the Australian bond market is very deep, with over A$1.2 trillion^ worth of bonds on issue. Most of this market is easily tradeable at low costs, providing a source of liquidity to an overall portfolio.

Diversification - When equities go down, bonds normally go up - bonds therefore are seen as a safe haven in times of market stress. Government bonds usually appreciate in value when interest rates go down - which typically provides ballast to a portfolio during periods of significant economic stress.

Why Australian fixed income is on the local agenda for your clients

We have seen a dramatic decrease in the level of domestic interest rates since 2008, with the 10 year bond yield falling from around 6% to a low of under 2%. This multi-year rally in bonds has led to numerous market commentators sighting an impending doomsday as the so called 'bond bubble' bursts if bonds return to their 10 year average.

An over simplified scary scenario

Many who prescribe to this fear scenario, quote frequently used bond math such as effective duration to justify their expectations of an extended period of negative returns for bond funds.

However, experience shows that simply using effective duration to measure the total return of a bond portfolio over a period of interest rate increases, fails to account for other factors such as; coupon returns, roll down (capital appreciation as bonds get closer to maturity) and the effect of credit spreads (typically falling as rates rise).

Further to this, active bond funds are consistently re-investing across the yield curve and if rates do increase, they are able to reinvest coupons and maturities at the higher prevailing rates further cushioning on the downside risk.

Active management matters

Skilled active fixed income managers not only have the ability to lower portfolio duration in the face of rising rates, but also adjust the portfolio's exposure to any of the factors listed in this paper. Furthermore, there are other tools such as inflation linked securities or derivatives that can be employed to implement conditional strategies that may dampen or negate the negative mark-to-market returns from rising rates.

The final touch

Legg Mason affiliate manager - Western Asset have built their reputation and business on managing active fixed income portfolios since 1971. Today they oversee A$559 billion* on behalf of a global client based from the largest institutions through to everyday retail investors. The global investment team is represented across five continents that seek to identify the relevant global trends and convert these insights into attractive returns for your clients. In Australia we offer the highly rated Legg Mason Western Asset Australian Bond fund, the Global Bond capability and the exciting Macro Opportunities Bond strategy. Whatever the future, this range is designed to give your clients the flexibility and choice needed to solve for a more complex world.

Jonathan Baird, Investment Specialist, Western Asset

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*As at 30 June 2017. ^ www.aofm.gov.au/statistics/securities-on-issue/

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