Will the real fixed income please stand up?

As we slowly emerge from the extended period of historically low interest rates and witness the gradual turn in the global interest rate cycle, it's important to remember the key role fixed income plays and understand the essential qualities of a 'real' fixed income portfolio.

Fixed income is well-known to investors for its core defensive qualities. Fixed income's 'claim to fame' as a defensive asset class is derived from the following key characteristics:

1. Predictability of investment returns – bonds offer predictability by paying interest (coupons) on a regular cycle and returning principal on a fixed maturity date.
2. Low correlation to growth assets – returns are signficantly less volatile and help cushion the drawdowns from riskier assets such as shares.
3. Diversification – a high quality fixed income portfolio is invested across a mix of bond issuers from different sectors and industries.

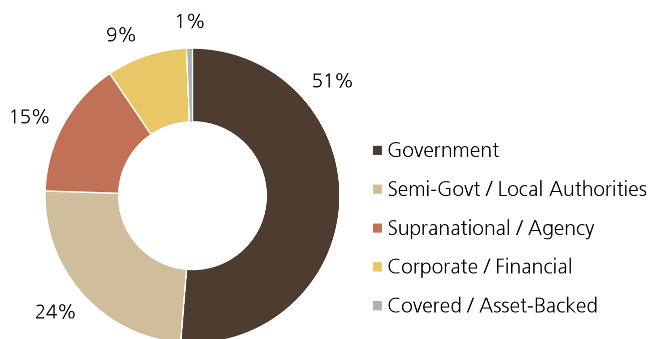
Comparing apples to oranges

Despite fixed income's inherent defensive characteristics, concerns persist around rising interest rates and the potential valuation impact on a traditional bond portfolio due to interest rate risk (i.e. duration). These concerns have prompted investors to look to a range of solutions to substitute their core fixed income asset allocation. These substitutes include term deposits, hybrids or even high dividend stocks such as bank shares. Whilst these alternatives do provide income, they lack many of the essential ingredients that shape the revered qualities of a core fixed income portfolio.

The power of predictability

An effectively managed core fixed income portfolio acts as a defence when financial markets experience adverse conditions. It aims to provide predictability for investors, returning regular income and protecting capital. It seeks to offer certainty by providing exposure to high quality entities that are expected to remain reliable even during the toughest financial conditions. A typical core Australian fixed income portfolio provides exposure to a diversified mix of bonds, such as those presented below by the Bloomberg Ausbond Composite Index.

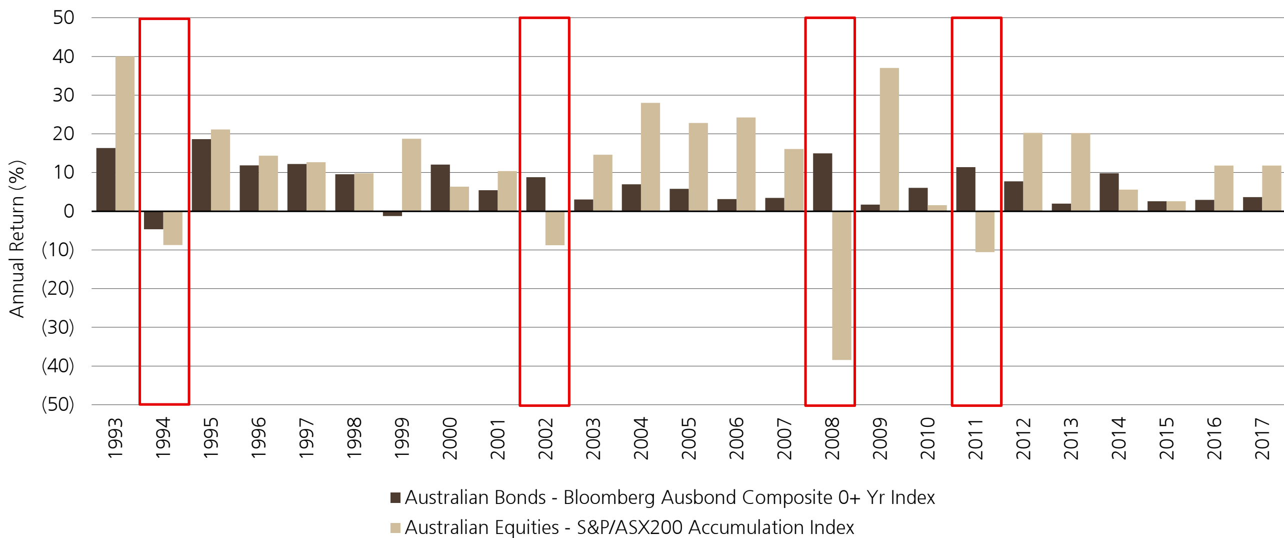
A typical Aussie fixed income portfolio



As at 30 April 2018. Source: Bloomberg

A large portion of the index comprises of bonds issued by highly-rated governments - what many consider to be a 'safe haven' if things go awry. When financial conditions are under stress, governments are expected to remain sufficiently solvent to pay bond investors their coupon income and repay principal at maturity. Moreover, duration becomes your ally as investors will benefit from a rise in bond prices as market yields fall in periods of financial stress. To demonstrate this, consider the calendar year annual returns of the Bloomberg Ausbond Composite 0+ Yr Index vs the S&P/ASX200 index since 1993, as shown on the next page. Bond markets provide a clear 'buffer' for investors, particularly during periods of sharemarket weakness.

Bonds can act as a 'buffer' when equities underperform

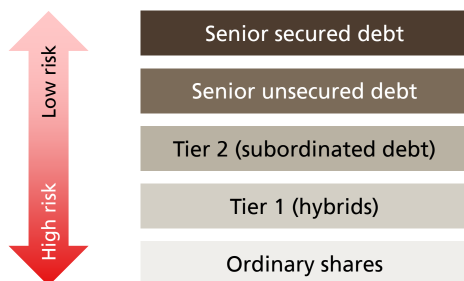


Source: Bloomberg

How do you rank?

Outside of the government sectors, we find that a core fixed income portfolio will generally have exposure to the top tiers of the corporate capital structure. As creditors, most of a company's bond investors have a lower level of risk relative to holders of other capital market securities because they rank higher in terms of priority of payment if the issuer becomes insolvent.

A core fixed income portfolio typically invests in corporate bonds issued as 'senior secured' and 'senior unsecured debt', as shown below.



Below senior forms of debt we have 'Tier 2' then 'Tier 1' securities, which includes subordinated debt and the more commonly known hybrid securities. 'Hybrids' posses both debt and equity-like characteristics, providing income (coupons or dividends) on a regular cycle but also carrying a host of 'equity-like' features, which we'll look at later. At the bottom of the capital structure we find ordinary shares, ranking last in terms of priority of payment in the event of a corporate liquidation. Simplistically, these rankings within the capital structure decide who gets paid first. The higher the priority, the greater the certainty of a return (for both income and capital) and the lower the level of default risk.

Wolves in sheep's clothing

Hybrids remain popular with retail investors as they are issued by recognisable entities (typically banks), offer high yields, are readily accessible and can be traded on the Australian stock exchange. Common types of hybrids include convertible preference shares, capital notes and subordinated notes. There continues to be an ongoing misconception, however, that hybrids represent 'real' fixed income. Yes, they possess bond-like characteristics by paying investors regular interest payments, but they sit further down the capital structure for good reason. Hybrids carry equity-like features and therefore equity-like risks, examples of which include mandatory conversion to ordinary shares, potential deferral of coupons, or deferral of principal repayment with no fixed maturity date (effectively ending up as a perpetual security!). Hybrids issued by Banks typically have loss absorption features that are triggered if the issuer is in financial difficulty, often termed as a 'capital trigger event' or 'non-viability trigger event'. In such an event, the security is converted into ordinary shares and the unwary investor will end up at the bottom of the capital structure.

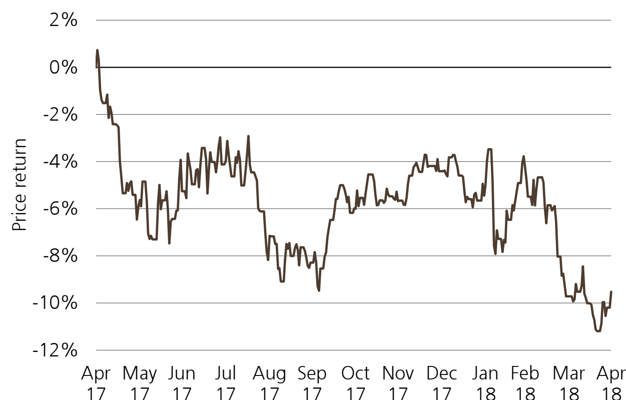
> Hybrids carry equity-like features and therefore equity-like risks...

High dividend stocks are also a popular way for investors to obtain regular income. But, as highlighted previously, they rank last in the corporate capital structure and shareholders will therefore be the last to be paid back if the company is wound up. Dividends are also not fixed or guaranteed, weakening that core tenet of predictability.

Furthermore, shares are a risk asset that will move up and down in line with investor sentiment and can experience significant price volatility. As an illustration, consider a sample portfolio of common high dividend stocks invested over a twelve month period. Whilst the average gross dividend yield of the following sample portfolio sits at an attractive 8.24% (as at 30 April 2018), the capital value of this sample portfolio has dropped almost 10% over the twelve month period ending 30 April 2018. A far cry from the capital preservation qualities of a core fixed income portfolio!

Hybrids, given their 'equity-like' characteristics, follow the price trends of their equity counterparts and subsequently experience similar volatility. Both income alternatives therefore lack the essential low correlation benefits offered by a core fixed income portfolio and do not provide sufficient diversification within a balanced portfolio.

An example of an income-focused share portfolio



*For illustrative purposes only. Consists of an equally-weighted portfolio invested in AMP, ANZ, CBA, IAG, NAB, TLS, WBC, WES and WOW, from 30/4/2017 to 30/4/2018. Source: Bloomberg

Not putting all your eggs in one basket

Term deposits, hybrids and high dividend stocks will generally entail concentrated exposure to one type of issuer – the Australian banks. By comparison, a high quality core fixed income portfolio invests in a well-diversified mix of bond issuers, by geographic region, market sector and industry type. As an example, a typical Australian core bond portfolio includes exposure to the Australian Federal government, state governments, supranationals (such as the World Bank) and corporates (across banks, industrials and utilities). Investors in a core fixed income portfolio therefore carry signficantly less concentration risk compared to other income alternatives.

Liquidity is key

Term deposits offer certainty of income, locking in a fixed interest rate over a pre-defined investment period. But what happens if you need your investment proceeds prior to the term deposit maturity date? A core fixed income portfolio offers similar (and often higher) investment returns to term deposits but with all-important liquidity, through the ability to trade 'over-the-counter' on the wholesale secondary bond market (for institutional investors), or daily liquidity offered by a managed fixed income fund. A core fixed income portfolio also typically provides regular distribution of income, further aiding investor liquidity requirements. By having liquidity, 'real' fixed income investors gain peace of mind from being able to access their money if and when they need to.

A core fixed income portfolio provides a unique combination of benefits

A core fixed income portfolio aims to:

- Offer predictability of investment returns, providing investors with a regular and known income stream and returning principal on a fixed date.
- Provide a 'safe haven' when financial markets are doing it tough, acting as a defence in down markets and cushioning the blows from volatility in riskier assets.
- Seek exposure to a well-diversified mix of bonds issued by a wide range of high quality issuers.
- Provide liquidity and easy access to money invested.

With market volatility stepping up and global interest rates on the rise, it's critical for investors to take a hard look at their defensive asset allocations. Through difficult market conditions – and even with global bond yields rising over the last two years – core fixed income portfolios have delivered on their inherent defensive qualities. There is no substitute for the 'real' fixed income.

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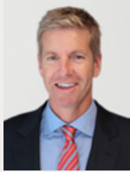

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