FIXED INCOME: NO LONGER THE FORGOTTEN ALLOCATION

Compared to global peers, Australians tend to have a very low allocation to fixed income (bonds) in their investment portfolios. Yet bonds can be a reliable and stable income investment, providing capital stability alongside meaningful diversification from growth assets such as equities. The purpose of this paper is to provide a deeper understanding of the fixed income asset class and the benefits of holding fixed income investments in a broadly diversified investment strategy.

Bonds vs cash

Investors have typically underinvested in fixed income, preferring to allocate funds to cash and term deposits (TD) instead. There is undoubtedly a structural element to this allocation based on investor biases and market structure as historically Australians have enjoyed high TD rates. However, investors have maintained low bond allocations, 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 US and Europe, Australian investors find themselves with low deposit rates and shrinking income opportunities. At Western Asset, we expect returns on cash and TD to be low for the foreseeable future and it is this type of environment that tends to push investors into 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.

While cash plays an important role in a client's overall asset base depending on their circumstances, its characteristics are very different to Australian fixed income. In today's low yield environment, cash does not provide the characteristics desired in a well-diversified portfolio. Hence, 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.

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, highly rated companies, such as the ASX Top 50 or large international companies with operations in Australia (eg Apple). Bonds can be 'fixed rate', where the interest paid (known as the coupon) is set at the outset, or 'floating rate' where the interest rate paid is referenced to a market rate that is directly influenced by changes to the Reserve Bank of Australia (RBA) cash rate.

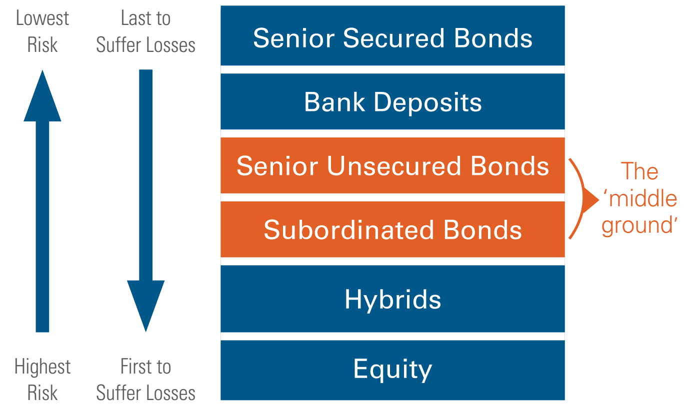
Not all assets are created equal

Different types of securities, such as bonds or equities issued by a company, come with different risks. The riskiness of a particular security is determined by its relative positioning within the capital structure as this is the order in which assets are distributed in the event of a default.

Due to this order of preferential treatment, 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.

Figure 1 (below) details a basic bank capital structure. At the top, term deposits have the lowest capital risk; at the bottom, equity is the first to suffer losses during a default and the last to have profits (or sometimes capital) returned by way of dividends. That said, this hasn't stopped investors '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 and sitting higher than bonds on the risk spectrum.

Figure 1: Basic bank capital structure



Source: Western Asset

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 typically generates more dependable income and therefore bonds exhibit lower volatility of returns.

While term deposits, bonds, 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, hence they are not necessarily interchangeable. As always, balancing the overall return objective, required liquidity, risk tolerance and correlation impact will determine the asset mix that best suits an investor's goals.

BNDS

Three key reasons to invest in fixed income

Australian fixed income plays three primary roles in a diversified portfolio: income, liquidity and negative correlation to equities in "risk-off" environments.

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

2. Liquidity *–* The Australian bond market is very deep, with over A$1.2 trillion^ worth of bonds on issue. For a professional investor, most of this market is easily tradeable at low cost, providing a source of liquidity to an overall portfolio.

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

Are current low yields a risk to Australian fixed income?

Domestic interest rates have fallen dramatically since 2008, leading market commentators to sight an impending doomsday as the so called 'bond bubble' bursts and pushes bond yields back up to more 'normal" levels. We view this as an over simplified scenario.

Many who prescribe to this fear scenario quote bond maths, 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 mitigating 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).

Actively managed bond funds are also 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.

Bonds & active management

Traditional passive fixed income benchmarks, in our view, have flaws as generally the higher the level of indebtedness that a company has, the more weight it has in the benchmark. We believe that investing in an actively managed bond fund can be a good alternative to such benchmarks.

Skilled active fixed income managers not only have the ability to lower portfolio duration in the face of rising rates, they can also adjust the portfolio's exposure to any of the factors listed above to generate returns. 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.

Introducing BNDS: the first fixed income Active ETF in Australia

The BetaShares Legg Mason Australian Bond Fund (managed fund) (ASX: BNDS) is an Active ETF that aims to deliver income and maximise the investment opportunities from Australian fixed income markets whilst also providing investors with the defensive attributes that high quality fixed income has to offer – relative capital stability, diversification and liquidity. The Fund is managed with the proven investment expertise of active fixed income specialist, Western Asset, one of the world's leading dedicated fixed income managers.

Jonathan Baird, Investment Specialist, Western Asset

WESTERN ASSET

The Fund can be bought and sold like any share using the **ASX code: BNDS**

www.betashares.com.au/leggmason4letters