Spot the difference

why bonds are not identical

AMP Capital's Anthony Edmonds explains how to avoid boredom – and loss of capital – by studying fixed interest investments a little more closely

By Anthony Edmonds

On the internet there is a list of things to do when you are bored to pass away pointless hours.

This includes trying not to think about penguins (harder than you would imagine), repeating the same word over and over until it loses its meaning and developing a nervous twitch.

I think they should add studying fixed interest securities to the list, right next to pinching yourself. Both seem painful and once you have finished, boredom will seem comparatively enjoyable.

But I am being tongue-in-cheek (as opposed to trying to swallow my tongue – which was also on the list). Because, though boredom may seem preferable, I think there is a very real need for the industry to remind itself of the different characteristics of fixed interest securities and of their purpose in a portfolio: to provide income and a defensive buffer in tough economic times when most growth assets suffer.

Lessons from history

The last 20 years has been a golden environment for fixed interest investors. Globally, yields (and especially in New Zealand) have fallen relatively consistently through this period (see chart one below). During this time there have been two major trends which have worked for investors, until recently, that is.

Trend one: Cranking up the risk profile of portfolios with credit securities

The first investor trend during this golden era for bonds has been for investors to crank up the risk profile of their portfolios by introducing lots of credit instruments and securities in the hunt for higher returns.

The evidence to support this trend is probably best seen by looking at the general move by the industry in around 2002 to use the Lehmans Brothers Global Aggregate Index (now Barclays Index) as the standard benchmark for global fixed interest funds.

Prior to this, the traditional index used (which was the Salomon World Bond Index) was entirely government debt. In contrast, the new index had a 50% government weighting and a 50% weighting to credit securities.

But not only did global fixed interest managers adopt a riskier index (from a credit perspective), they took this even further by investing more heavily in credit type securities than the actual index. The additional risk became a problem at the end of 2007 when the credit crunch really kicked in.

The penalty for this risk is highlighted when looking at the performance surveys for global fixed interest managers last year. At a time when fixed interest should have provided the traditional defensive buffer with good returns, the top-performing global fixed interest manager only matched the index for the year (Chant West Multi Manager Survey, 31 December 2008). The other 12 managers underperformed – some substantially. This was primarily a result of the managers being overweight credit relative to the index.

Looking back, it is easy to see where New Zealand retail investors have taken too much credit risk in their portfolios to try and get higher returns. The failed finance companies where

Chart one: 10-year government bond yields in New Zealand and the US

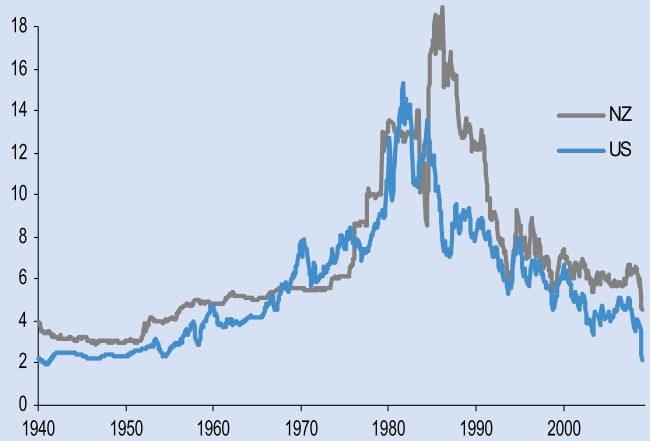
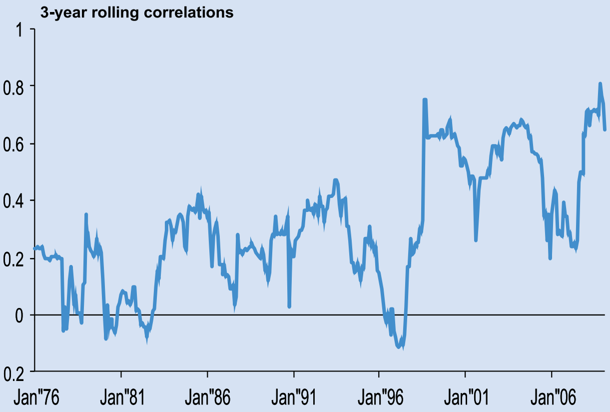


Chart two: The rising correlation between excess returns on shares and corporate bonds



Source: AMP Capital Investors

investors were hunting the high rates being offered by these companies are just one example. But despite all the money lost in this sector, investors are still rushing to invest in corporate bond issues.

And this brings us to the problem with investing in lots of credit assets. 2008 has demonstrated that, under stress, credit assets can start behaving like shares. This happens when real doubt emerges around the prospects of actually getting your money back. In addition to finance company debentures, there are also offshore CDOs, and a myriad of debt-type securities – all of which have performed poorly in what should have been a bonanza fixed interest environment.

The correlation between shares and corporate bonds is shown in chart two (opposite page).

As shown, corporate bonds are becoming more correlated with shares. And, as we know, the purpose of fixed interest in a diversified portfolio is to protect the value of the overall portfolio when the world goes pear-shaped and growth assets fall in value.

This is because interest rates should fall in this environment, which will provide investors with capital gains in their bond portfolios. However, 2008 demonstrated that most credit assets do not always provide this protection. Under pressure, their returns have been 'equity-like'.

If your clients are scared of shares at the moment, it is worthwhile asking them why they are comfortable buying these new issues of corporate debt. Do they actually understand that while the returns promised are higher, the risks involved are too? Will they do the real research needed to fully understand what they are getting into – the quality of the company, the assets and the management of the company? And how do the rates compare with similar securities globally?

I think there is a tendency for people to anchor their investment decisions on how favourable the rates on these credit securities are when compared to on-call cash, and this strategy seems flawed (as it has proved to be in the past with the collapsed finance companies). Investors should consider a lot more factors than just how the yield on these new issues compare with on-call deposit rates.

If, as an adviser, you subscribe to the view that global economies and markets are more likely to deteriorate (than improve) from here, then you might want to be a little cautious about advising clients to sink too much of their money into corporate debt – especially because a lot can happen between now and when the stuff matures.

Trend two: Buy-and-hold fixed interest strategy

Since the mid 1980s, with long-term interest rates trending down, another interesting trend is that many advisers and their investors have adopted a simple buy-and-hold type fixed interest strategy.

This has ended with little or no regret as rates have been consistently trending down over the last 20 years (as shown in chart one). A relatively straight-forward approach has literally paid off.

But how appropriate is this type of strategy in an environment where rates might be constantly on the rise? (See chart one and think how this strategy would have worked in times like those between 1960 and after 1980.)

A good way to think about this is to pretend you are a banker. In a rising interest rate environment you don't want to be selling 'fixed rate' mortgages, when you could write the same mortgage next month at a higher rate. The same holds true for fixed interest investors.

If you follow the school of thought that we might be heading towards an environment of hyper-inflation (on the back of governments having to print money), then maybe you should keep the duration of your clients' fixed interest assets short, and start thinking about putting their money into shares.

There are plenty of companies out there offering dividends far in excess of the yields on these corporate bonds.

Furthermore, the next big trend we might see in the New Zealand market is companies issuing capital to strengthen their balance sheets, and this is likely to produce some excellent buying opportunities.

Under stress, credit assets can start behaving like shares

Good old-fashioned rules of thumb

And this is a good point to go back to a couple of rules of thumb I think work when it comes to good portfolio construction and the role of fixed interest in this.

Look for assets that aren't correlated. In a diversified portfolio, regardless of its risk profile, you want to get the benefits of diversification. Remember that generally you want to invest in a range of assets that aren't correlated. A good example is shares versus fixed interest assets. These two asset classes normally make good bedfellows, because of the low correlation that exists between them. However, as we have seen, when it comes to credit assets, they do not always provide this protection. I believe it is vital that investors hold some defensive fixed interest assets, that won't behave like shares under stress.

Don't put capital at (serious) risk when investing in fixed interest securities. This reflects that the maximum return is capped, as the lender never opts to pay more interest than otherwise entitled. When I put my capital at risk, I put my money in shares, and demand an equity-type return so that my upside potential is unlimited.

Last year served us with a reminder that shares can be risky – and there was nothing new in this. One thing people should take time to contemplate is that fixed interest assets should perform brilliantly in years like 2008, and they did! The NZX Government Stock Index returned 15.8% for the year ending 31 December 2008.

If your clients' fixed interest portfolios didn't produce such a stellar return in 2008, it might be a good time to do a little bit of reflection and learning around what went wrong. This will serve as a good reminder of the role of fixed interest in portfolios: to provide income and a defensive buffer in tough economic times when most growth assets suffer. With this in mind, I think now could be a good time for advisers to review their clients' portfolios and ensure their fixed interest investments do not carry serious risks without the corresponding high returns. A

Anthony Edmonds is a senior executive with AMP Capital Investors.