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Money

The benefits of the bond market

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Conservative assets have been best defence in tough times, writes John Kavanagh.

The bond market has played its role this year as a good defensive asset in times of uncertainty. While investors in shares and property have been anxiously watching the weakening trends in those markets, bond investors have enjoyed solid returns.

The performance benchmark for bonds, the UBS Composite Bond Index, rose 2.5 per cent during the three months to the end of May - a period when the sharemarket benchmark, the S&P/ASX 200, fell 1.6 per cent.

Bonds were a consistent performer throughout the global financial crisis and have been since. The UBS Composite Bond Index has increased by an average of 7.9 per cent a year during the three years to the end of May - a period when the sharemarket went backwards. The index was up 6.4 per cent in the 12 months to the end of May.

Safety first

The bond index is comprised of government and semi-government bonds, investment-grade corporate debt securities and asset-backed securities, such as mortgage-backed bonds.

Australian investors have been playing it safe with their funds since the financial crisis but, when it comes to defensive assets, they have a preference for savings accounts and term deposits over bonds. According to the Australian Bureau of Statistics, 25.3 per cent of household financial assets are held in bank deposits and other cash holdings. This is above the long-term average cash holding of 22 per cent.

Is there a case for bonds over term deposits in the defensive part of an investment portfolio?

The head of credit markets at AMP Capital Investors, Jeff Brunton, says: "The GFC precipitated a significant change in thinking as people reassessed the risks of their investments, especially those designed to give them a steady flow of income.

"With world equity markets falling to bear-market lows in 2009, investors turned back to traditional income investments like bonds and term deposits.

"Term deposits pay a fixed rate of interest. They do not generate capital growth and they are not tradeable, which means they must be held to maturity.

"Because bonds are traded in the capital market, bond investment provides two types of returns: income through the receipt of the bond coupon [the interest rate]; and the potential for capital growth - the appreciation in the market value of the bond. Of course, there is always potential for value depreciation."

Bonds usually pay a higher yield than term deposits but that has not been the case during the past year. Because of the strong competition for retail deposits, banks have been offering attractive rates on term deposits.

There are a score of financial institutions offering 6 per cent or more for six-month and 12-month term deposits, with rates as high as 6.6 per cent, while the 10-year Commonwealth government bond yield is 5.1 per cent and the three-year yield is 4.6 per cent.

Deposit war

The managing director of specialist fixed-interest broker Curve Securities, Andrew Murray, says demand has been for term deposits.

"Investors recognise that there is a deposit war going on and they are asking for advice on where to find the best rates and how best to structure the mix of rates and maturities to meet their needs," he says.

"I would say that only very conservative investors are buying government bonds at the moment. The yields are low.

"We don't see much demand for corporate debt securities."

The managing director of fixed-interest broker FIIG Securities, Jim Stening, says the group offers its clients access to more than 30 corporate debt securities, as well as government and semi-government bonds. FIIG has a custodial service that enables it to sell government bonds in $50,000 parcels.

Stening says clients are buying debt securities across the spectrum.

"The corporate bonds we have offer yields ranging from 6.5 [per cent] to 10 per cent," he says. "We explain the extra risk that an investor takes on when they go for higher yields and the client makes a call on the risk-and-return trade-off.

"The question we ask our clients is why they would want to sit in the equity market, uncertain about the dividend they are going to receive, when they could get a consistent return on the debt issued by the same company."

Bond fund

The head of derivatives at broker Evans & Partners, Mike Saba, says bonds are structured with either fixed rates, where the same rate of interest is paid for the term of the security, or floating rates, where the rate moves in line with movements in a benchmark short-term rate (such as the one-month bank bill rate).

Saba says: "Floating rates overcome one of the risks with term deposits, which is that rates will rise and the relative value of their investment will fall. Investors can use the bond market to set up a portfolio that produces a mix of fixed and floating rates."

The head of Asia-Pacific credit portfolio management at Pimco, Robert Mead, says the yields in the Australian bond market have attracted investors from overseas markets, where rates are low.

What sort of income securities should you invest in?

Term deposits: These offer a fixed rate of interest for a fixed term. They are not tradeable so in most cases, investors have to hold them to term. Part of their appeal is they are covered by the government guarantee on bank deposits.

- **Direct investment in bonds:** Some brokers, such as FIIG Securities, offer direct access to government and corporate bonds. Direct investment allows investors to buy a series of bonds with different maturities to match their income needs. Direct investors can hold a security to maturity, which means they can focus on the yield and not worry about changes in the capital value of the asset.
- **Exchange-traded debt securities:** Last year, the Australian Securities and Investments Commission changed the prospectus rules for companies that wanted to list their debt securities on the Australian Securities Exchange. ASIC's move made it easier to issue a prospectus - part of a move to develop a listed retail debt market in Australia. Since then, Commonwealth Bank, Bendigo and Adelaide Bank, Primary Health Care and others have issued bonds through the Australian Stock Exchange. The latest was Australian Unity, which issued Australian Unity Notes in April, with a five-year maturity, a BBB rating and an initial yield on the floating rate notes of 8.47 per cent.
- **Managed funds:** Investors in a managed bond portfolio can benefit from the fund manager's trading decisions. According to Morningstar, the average return of the 47 Australian bond fund managers in its performance table was higher than the increase in the UBS Composite Bond Index, which means the average manager was able to add value for investors. The reason many private investors don't like managed bond funds is that they mark to market, which means the unit price will move in line with gains or losses in the underlying securities. Any losses will be subtracted from the yield before distributions are paid out. This creates uncertainty for investors who are buying bonds for income.