Not all Australian income funds are fit for purpose

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SUMMARY

Driven by uncertain financial markets and changing demographics, many investors have developed a preference for headline yields, paying scant regard for what is under the hood. Declining interest rates globally have made heroes of bond, infrastructure, property and equity investors alike – but the structural tailwinds favouring these asset classes are abating and the return outlook is muted and far lower than recent experiences and expectations. The structure of Australia's domestic bond market has evolved over time – for instance, government debt issuance has grown enormously, along with greater liquidity and continued overseas investor interest in our market. However, many managers are hamstrung due to sub-optimal product design and approaches to investment management. As the Australian bond market grows and sub-sectors emerge, investor must ask – is my defensive allocation true-to-label? In fact, not all Australian income funds are fit for purpose.

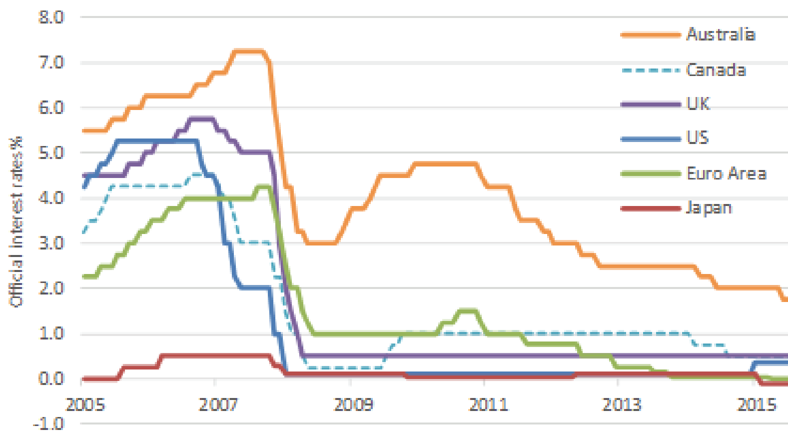
INTRODUCTION

For academics, contemporary financial market conditions have offered a virtual laboratory to evaluate some of their classroom theories against real-world outcomes. *How should governments – especially those of the developed world – deal with economies still largely in healing mode? What are the virtuous ways to breathe life into economies while navigating debt overhang afflicting both the public and private sectors? And, what is next following over 650 rate cuts since the global financial crisis, as well as the consequences of the many quantitative easing programs around the world?*

These well-documented dynamics have been impactful on assets with higher returns along with generally lower observed volatilities, as illustrated in Figure 1.

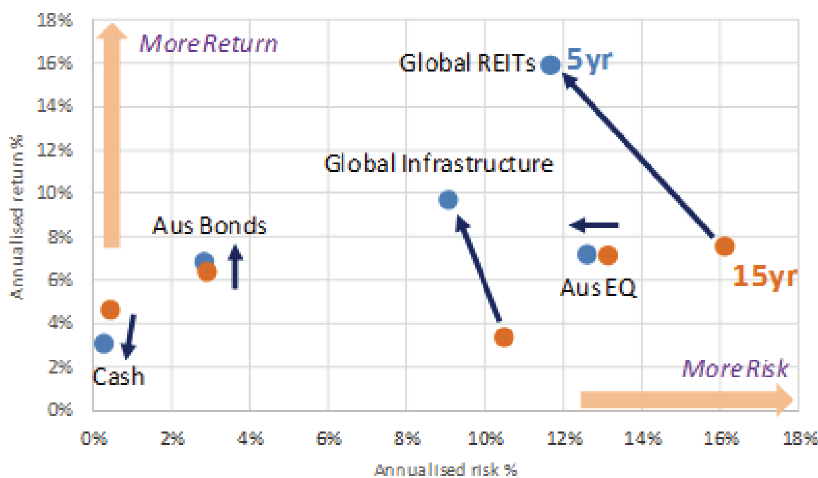
Figure 1: Central banks attempting to breathe life back into local economies: above trend returns, below trend volatilities.

A. Central bank policy levels for major regions
(to July 2016)



Source: Reserve Bank of Australia.

B. Asset class per annum returns for Australian investors
(5 and 15 years to June 2016)



Source: Bloomberg to June 2016. Aus EQ: S&P/ASX 300 Accumulation Index, Global REITs: FTSE EPRA/NAREIT Developed Index in AUD, Global Infrastructure: S&P Global Infrastructure Index in AUD, Aus Bonds: Bloomberg Aus Bond Composite Bond Index, Cash: Bloomberg Aus Bond Bank Bill Index.

The markedly different five-year returns versus longer trend results have been heavily influenced by near-term monetary policy. The powerful forces of declining interest rates

have helped investors by lowering discount rates for assets such as equities and infrastructure, lower funding rates for leveraged property and provided capital gains for bond holders.

Unfortunately, this one-off revaluation is largely complete given the weakening business and economic drivers identified by Dobbs, Koller et al (2016) – namely:
1. soft global growth estimates;
2. tepid inflation expectations in the main;
3. the speed and terminal level of future rate rises; and,
4. corporate profitability being under pressure.

Where performance for assets has been robust – especially in recent memory – expectations are being recalibrated by investors around the world.

Given these dynamics, there is temptation for investors to take on uncompensated portfolio risks. For example, according to flows observed in Morningstar (2016), there has been a trend to over-concentrate portfolios in assets with observable higher yields and hence lower credit quality – in effect, without reference to overall investment characteristics. Assets with higher headline yield such as hybrids (mixed or poor secondary liquidity), corporates (credit risk), equity (not a like-for-like substitute for true defensives) or property (as for equities) have been commonly held out as ways to deliver income. This preference for higher observable yield leads many portfolios toward poor risk-adjusted profiles and sacrifices critical liquidity, particularly in times of stress.

WHAT WILL IT TAKE TO PERFORM IN THIS BRAVE NEW WORLD?

In a world characterised by uncertainty combined with moderated longer-term asset class return expectations, two things become apparent – especially in the defensive portion of portfolios:

1. consistent, incremental returns matter in a low-return environment; and,
2. applying exposures that are true-to-label and perform as expected are key.

In managing these truly defensive exposures, what are some areas where managers can proactively navigate markets without taking on undue risk?

Right-sizing portfolios – do not forget the value of high quality bonds

Australian investors are amongst the lowest users in the developed world of bonds in their portfolios as found in numerous studies, such as shown in Figure 2a. Within superannuation funds, investors have tended to overwhelmingly prefer shares, property and cash forms (e.g. term deposits). Figure 2b supports the notion of bonds being generally underutilised due to favourable tax treatments associated with shares (e.g. dividend imputation) and property

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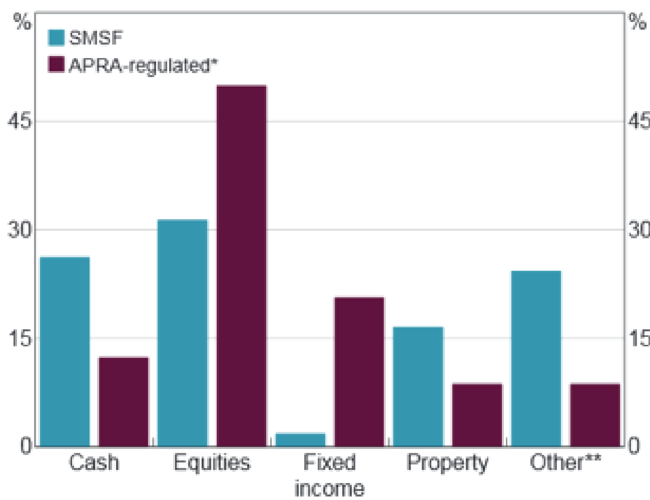
(e.g. negative gearing), along with a lack of understanding or familiarity of these instruments. The opportunity to better weight portfolios remains.

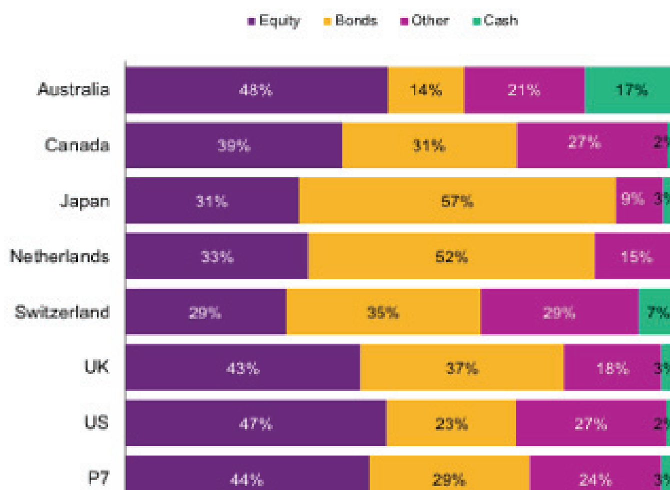
Figure 2: Australian investors are materially underweight bond exposures.

A. Superannuation funds' asset allocation (Dec 2015)



Source: Reserve Bank of Australia, using data sourced from APRA and the ATO, as at December 2015. * APRA-regulated includes exempt public sector superannuation schemes. Other includes investments in managed funds, listed trusts and unlisted trusts which invest in a variety of asset classes.

B. Average asset allocation in pension assets in selected developed markets. (Dec 2015)



Source: Towers Watson Willis Global Pension Assets Study 2016 (for data to December 2015). P7 = the abovementioned countries – Australia, Canada, Japan, Netherlands, Switzerland, UK and US.

2. Are bond portfolio offerings well weighted and truly defensive?

The average Australian bond portfolio product is skewed towards non-Government exposures. The typical fund tilts around half of its portfolio in non-Government/non semi-Government exposures, compared to the market cap weighting of Government bonds outstanding being closer to 90%.[1] While, of course, return and yield can be potentially higher for these non-Government securities, credit (default) risk also rises.

The reasons for this phenomenon are many, but centre on legacy configurations which are oftentimes sub-optimal. Broad Australian bond funds launched before the global financial crisis are beholden to the dynamics of the day - from a fiscal standpoint, Australia's budget enjoyed a period of structural surplus in line with a robust economy. The Howard Government (1996-2007) took this opportunity to repay much of the outstanding debt of previous governments which, in turn, saw the domestic government bond market lessen. The paucity of local debt in terms of outstanding and liquidity measures encouraged more generic bond solutions combining Government debt with corporate debt, along with instruments including high yield and hybrids. In having scope to invest through along the credit spectrum, fund managers collectively have tended to favour lower quality high yield securities versus their high quality Government alternatives.

Ultimately, major financial market dislocations including the Global Financial Crisis have underlined the danger of taking on too much credit risk. In short, as one ventures into non-investment grade quality credit assets, there is the tendency to perform poorly during recessions and also during poor equity downturns. Equally, it shows which exposures are the ultimate sources of liquidity - namely developed market sovereign bonds.

3. Australian Bond Market evolution - a time to specialise (as has been the case in offshore markets)

Large, mature bond centres such as the US and Europe/UK have deep bond sub-sector physical and derivative instrument turnover.[2] In the US, treasury instruments dominate average daily trading volumes, however, municipal bonds, agency- and non-agency MBS, corporate debt and federal agency securities all boast multi billion dollars of daily trade. Figures 3 and 4 also highlight the evolution of the US bond market, encouraging the emergence of specialist managers in sectors to help navigate a sector's nuances.

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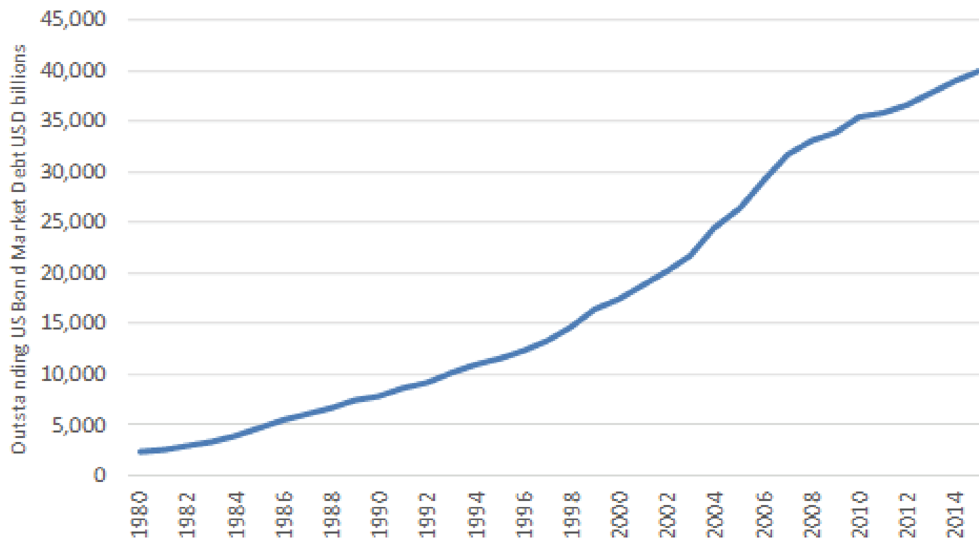
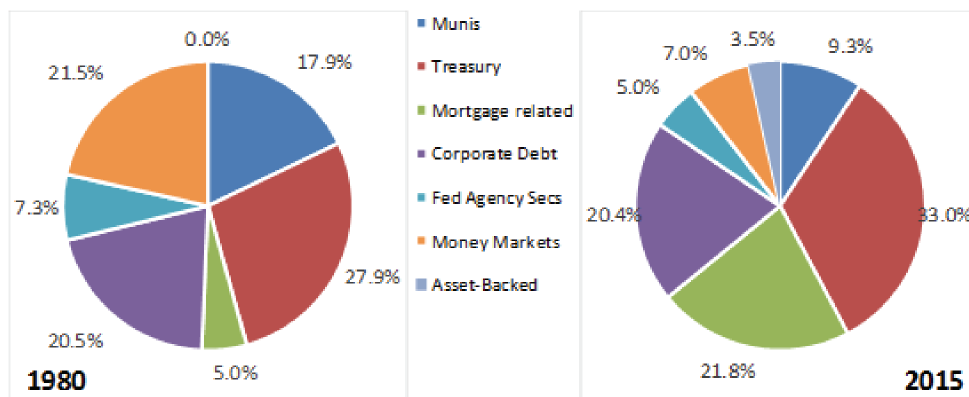
Figure 3: Outstanding US bond market debt (USD billions)
(Dec 2015)



Source: SIFMA.

Figure 4: Change in composition over time
(1980 vs 2015)

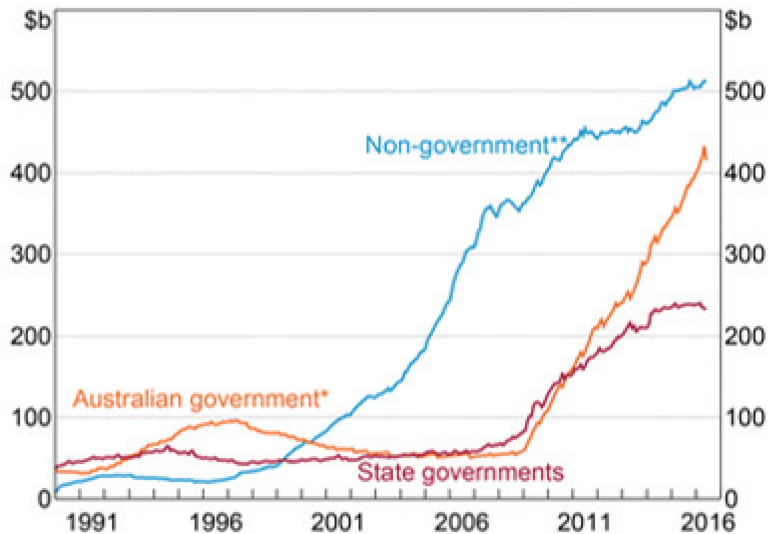


Source: SIFMA.

The expansion of the Australian Bond Market has mimicked these overseas experiences. Figure 5 shows the dramatic expansion of bonds on issue in Australia, effectively deepening the liquidity and trading profiles. Again, the US (and UK) experiences suggest the emergence of opportunity for fund managers to design specific products to meet investor needs at a sub sector level, helping allocators control asset allocation with increased precision. The disaggregation of traditional fixed income silos will see intra product specialists emerge focused on filling these gaps within the large sphere of fixed income. This should help

investors find products that offer ''true to label'' solutions to better meet the needs of investors to balance risk and return.

Figure 5: The Australian bond market enjoyed significant growth since the Global Financial Crisis
(Bonds on issue in Australia)



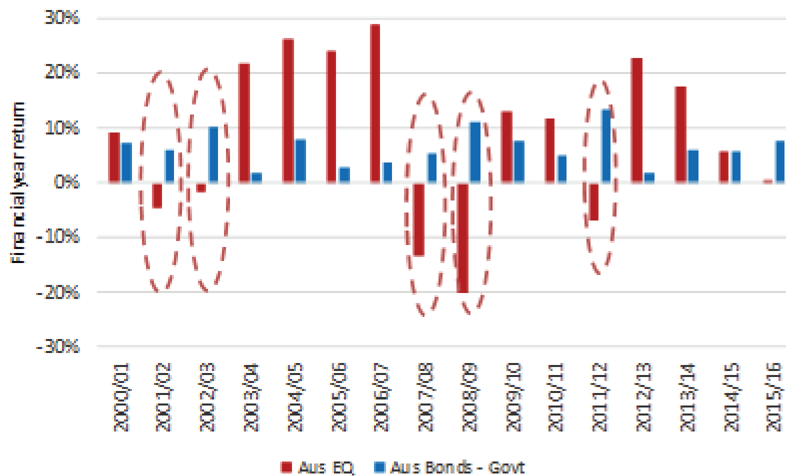
Sources: ABS, AOFM, RBA, State Treasury Corporations. Notes: * Australian government excludes bonds purchased by the Australian Government. ** Non-government excludes ADIs' self-securitisations, includes government-guaranteed bonds.

4. Government bonds have an enduring role to play in portfolios

Despite the falling and historically low interest rates, bonds over market cycles have a real role to play given their demonstrated ability to:
- diversify against risk assets;
- protect against cyclical downturns; and,
- deliver a predictable income stream.

The defensive element is shown in Figure 6 where financial year outcomes for Australian equities and Government bonds are highlighted. Importantly, in times of market stress (e.g. dot.com bubble, global financial crisis), local Government bonds have provided a true defence. The exposure is plain vanilla in form without any foreign exchange risk, backed by a fiscal and monetary policy which remains the envy of the world in relative terms and which offers risk-free yields of around 2% to 3% invested wisely. While additional debt issuance as a result of Government policy can prima facie raise eyebrows, Australian Government debt remains one of twelve issuers to retain a AAA rating.[3]

Figure 6: The protection benefits offered by government bonds during equity market downturns



Source: JCB team analysis, based on data sourced from Bloomberg for each financial year

5. New (perhaps under-used) tools and skills are required in managing portfolios.

The secular decline in interest rates as highlighted in figure 7 has represented a bull run for many asset markets – over the last 30+ years falling long dated global interest rates have strongly supported asset owners (particularly leveraged participants) and long skewed risk takers. With rates where they are now, new rules are now in play.

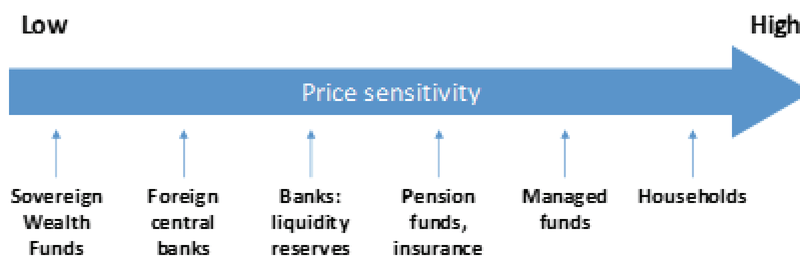
Figure 7: Secular decline in Australian RBA cash rates over the last 30 years (to July 2016)

Source: Reserve Bank of Australia.

The most successful (and unadjusted) investors during this previous 'easy' phase have potentially assumed higher risks should the market thematic shift. Looking ahead, investors will not likely have this positive rate momentum – credit quality fund managers across all asset classes will need skillsets to play both sides of the trade going forward. Put another way, managers require skills in identifying changes and managing risk exposures for both sides of the market. Considering many participants have historical confirmation biases and been largely trained and rewarded for simply buying into dips in asset markets, consideration for the new world is key.

Another example of thinking and approaches relates to bond market participants, and how to benefit. When considering the many participants who transact bonds, it is clear that there is a spectrum of participants who trade (Figure 8) – each with different motivations who may tend to play in certain sectors. In a low return environment where basis points matter, navigating these markets with requisite knowledge becomes key.

Figure 8: Participants in the Australian Government bond market have different motivations (and consequent sensitivity) to transacting bonds



Source: JCB team analysis.

6. Contemporary approaches to bond investing – resource and align accordingly

Analysis of pooled bond offerings in Australia concludes that 87% of bond managers underperform the domestic bond benchmark.[4] At first glance, this is clearly an underwhelming statistic for purveyors of active. However, Joye (2016) noted that there is more to this headline result in explaining an apparent weak active result, which includes:

1. The allocation and/or resource investment made in bond management teams (which have tended to lag those comparatively made to equity teams); and,
2. The hold-to-maturity style that, after fees, means that most portfolios will guaranteed underperform.

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CONCLUSION

The prevailing financial market environment poses immense challenges for investors over extended time periods – how to navigate an uncertain investment market with low forward return expectations; how to position against the spectre of event risks and heightened market sensitivity; and, ultimately, how to generate a meaningful portfolio return.

By their very design, high quality Government bonds provide the ballast for portfolios across different environments. They provide genuine diversification against growth assets, and act an effective hedge against cyclical downturns in markets – all in a highly liquid form. Australia's Government bond market has grown and matured substantially in the past ten years, resulting in higher liquidity and the need for greater dedication and specialisation in managing such exposures.

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ENDNOTES

1. According to Morningstar, as at June 2016.

2. The US Securities Industry and Financial Markets Association (http://www.sifma.org), illustrating average daily turnover to be substantial across sectors

3. As at June 2016, according to Standard and Poor's.

4. e.g. Standard & Poor's Index Versus Active, Year End 2015 scorecard.

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