Spectrum Asset Management

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Spectrum Insights

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Spreading your risk – the rules have changed

"It's not how much money you make, but how much money you keep" - Robert Kiyosaki

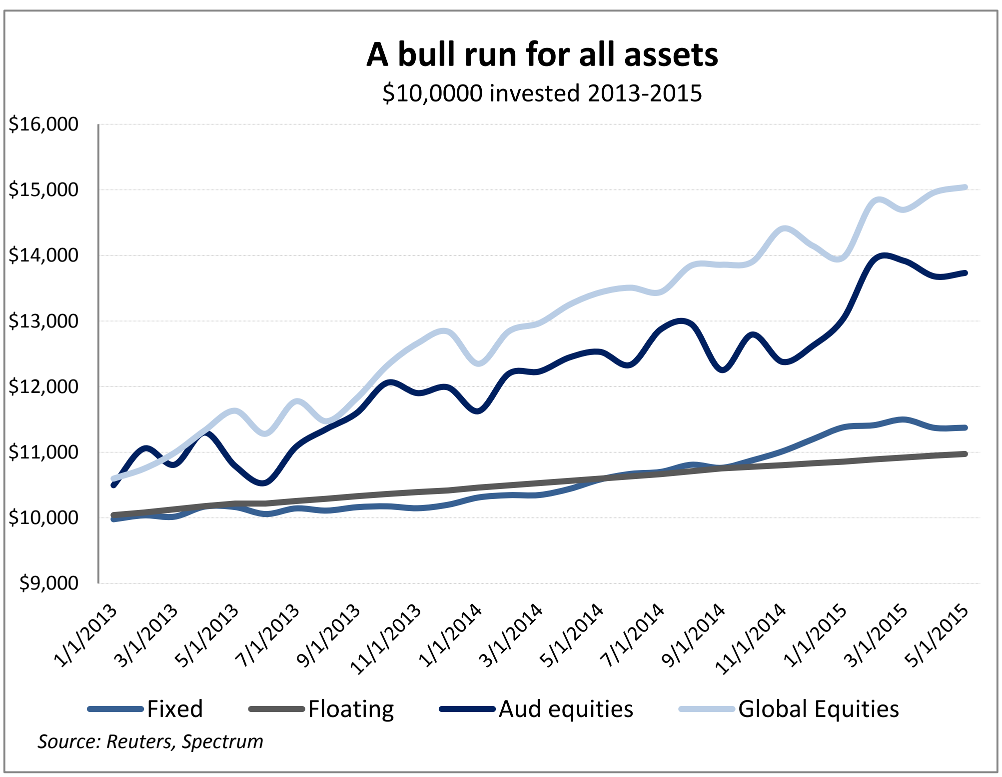
Spreading risk is generally seen as a prudent investment strategy. Financial textbooks and history suggest a mix of equities, bonds and offshore investments can improve the risk-return profile of an investment portfolio. Recent returns, however, have turned some of this theory on its head. The shift to a low bond yield environment has helped values in many asset classes rise in unison. The risk is the reverse may apply, that is, asset classes could fall at the same time should bond yields rise.

Recent times, however, have turned some of this theory on its head

Why invest in corporate bonds? – Diversification

Spectrum Asset Management sees allocating funds to corporate bonds with floating rate notes as a way to:

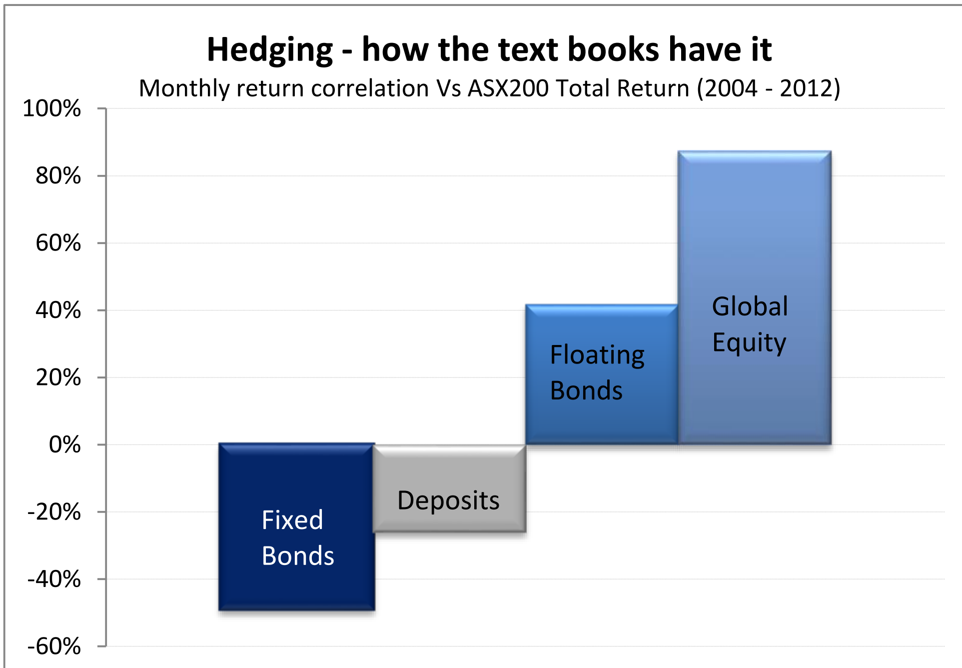
- Help lock in gains;
- Help shield against the impact of a jump in bond yields; and,
- Generate a healthy income stream.



Looking back - 2004 to 2012

Bonds are supposed to be a good hedge for equities and several other asset classes. Typically, when the economy sours, profit outlooks fall which, in turn, puts pressure on stock prices. At the same time, lower growth outlooks dim inflation expectations, causing bond yields to fall and fixed coupon bond prices to rise in value.

From 2004 to 2012, this textbook relationship was largely in play. The graph below illustrates that return correlations with the Australian stock market were what the theory suggests, that is, fixed rate bonds were negatively correlated with the performance of equities.



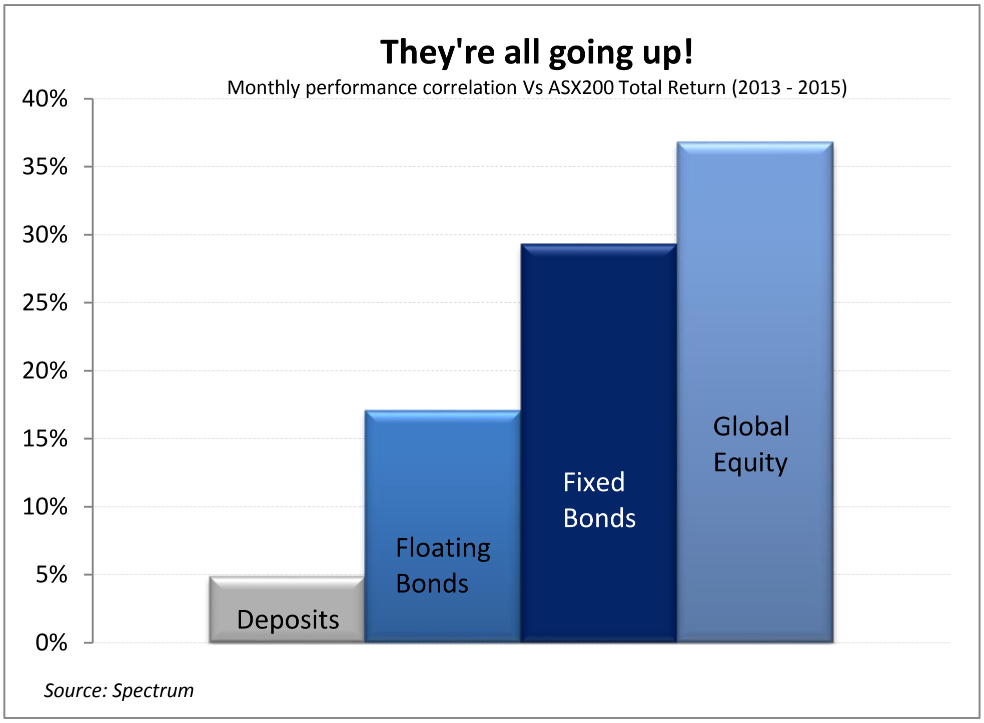
Source: Spectrum

In this report, we look at the historical correlations of monthly total returns of various key asset classes Australian investors may consider: Australian equity, Global Equity in Australian dollars, Australian fixed income bonds, Australian floating rate bonds and bank deposits.

Correlations can vary between 100% and – 100%. For example, those with 100% correlation results have moved in lock step with each other while -100% will move in equal proportions in opposite directions and those close to 0% have little or no relationship in past performance.

Looking back - 2013 to now

In recent times, correlations between asset classes look different and, in some cases, these have been flipped. Note that all are positive from 2013 to 2015. What gives?



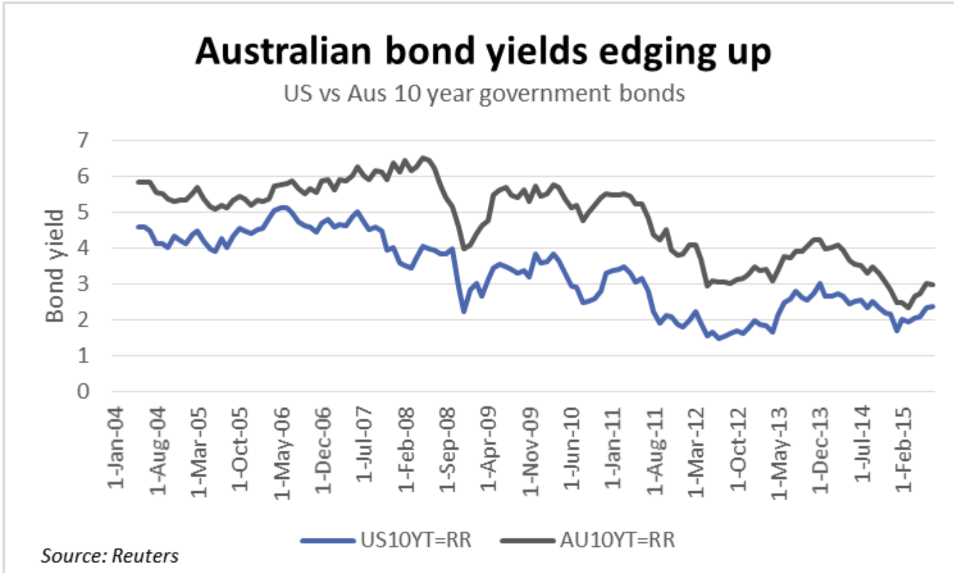
We believe that the collapse in global bond yields has helped a broad based rally in almost all asset classes in Australia. Lower bond yields mean lower discount rates for assets. And, as income outlooks have not fallen, this results in higher asset prices.   In equities, this is reflected in higher price to earnings ratios and in corporate bonds, it is seen in lower credit spreads.

Positive correlations - great in a bull market

In a perfect world, investments are positively correlated when they are going up in price and are negatively correlated when some assets are falling in value. The first part of this wishful equation has broadly worked since 2013. Asset prices have generally risen together. The risk for investors is this relationship continues in a price decline environment.

What if yields normalise?

The problem occurs when bond yields start to rise. Not only will fixed rate bonds be vulnerable to price falls; equities prices, too, could be hit if the yield climb is not accompanied with a compensating upswing in earnings expectations.



What to do?

If you are worried that Australian bond yields are at risk at moving back towards historical norms, it is worth considering reducing exposures to yield sensitive assets.

One option is to stuff some money in your mattress. In technical terms, this means increase your exposure to bank deposits. The returns are not great but capital is preserved.

Corporate bonds with floating rate notes are another way to diversify. They do not suffer losses like fixed rate notes if government bond yield rise. Investors also typically get extra yield over deposits. Capital gains can occur if investors push lower the yield margin or credit spread over the floating rate benchmarks.

As with most investments the extra income comes with additional risk. The key risk with corporate bonds with floating rate notes is the company that issues the bond defaults. While Spectrum sees this as a modest risk for most Australian issuers in the next year diversification into a fund with floating rate notes may be the preferred option to spread this credit risk.

*This is the third in our series of reports on the benefits of investing in A$ corporate bonds. The first was on **safety**, the second was on **value** and this is on its merit in diversification.*

Spectrum Asset Management manages the EQT Spectrum Credit Opportunities Fund. This fund invests in AUD corporate securities of which the majority are floating rate notes. The intention is to make this portfolio relatively immune from the bond yield volatility which can, in turn, hit equity and fixed income markets. The fund is also designed to deliver an income stream while generating capital gains from time to time. For more information please go to our website http://spectruminvest.com.au

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