Damien Wood, Principal

Spectrum Insights

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A bond analyst's theoretical take on valuing different investments

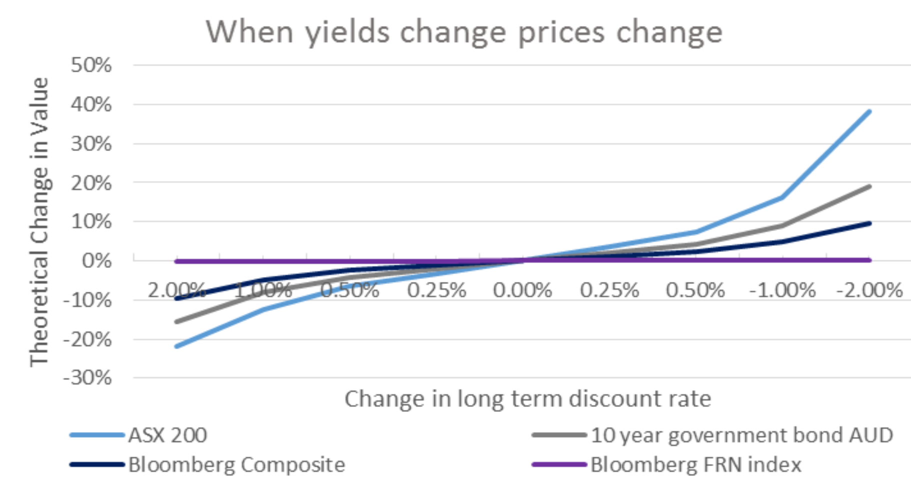
Yield Jumps, Price Slumps

Global bond yields jumped in recent weeks. Neither Australian bonds nor equities were immune. Both fell sharply in just a few trading sessions. Despite this, global bond yields remain near at historically low levels. Should they again regress towards historical norms, both equities and bond will once more be vulnerable to sharp falls. Investors wanting to shield themselves from these falls should consider putting part of their portfolios in floating rate notes. Not only should rising bond curves have little impact on their prices, it should also push up the future income stream from these investments.

Theory

Bond analysts often have a simple view on valuations. Assets can be valued using net present valuations. This is done by mapping out future cash flows and applying an appropriate discount on their future value. The value of an asset moves up or down by adjusting either the expected cash flows or discount rates [(1).]

Below we graph what a 2% change in current Australian government bond yields would theoretically do to the net present or current values of the ASX 200, a 10 year government bond, the Bloomberg Australian composite bond index and the Bloomberg floating rate note index.



Source: Spectrum

(1) The discount rate is the combination of the government bond yield and a premium to reflect the relative riskiness of the asset. The risk premium for debt is the credit spread and the risk premium for equity is the implied cost of equity less a risk free rate. In this process, we use the 10 year Australian government bond yield.

As the graph above shows, a 2% jump in the bond yields would theoretically result in a:

- 22% fall in the fair value of Australian equities,
- 15% fall in 10 year government bond prices,
- 10% fall in Bloomberg Australian composite bond index,
- 0.2% fall in the Bloomberg Australian credit FRN index.

Theory vs Reality

Global bond yields jumped in early May 2015. This yield spike appeared to be independent of any notable changes in the outlook for corporate profits, economic growth or inflation expectations. Hence, with just one key variable changing, it provided an insight to how asset prices actually behave when just the bond yield moves.

But as baseball great Yogi Berra is quoted as saying, “In theory, there is no difference between theory and practice. But in practice, there is.” We, too, found a notable difference in theory and reality for Australian equities. For other assets, it was close to expectations.

Comparison of theory versus reality

Australian 10 year bond yields rose 71bps from 15 April to 7 May 2015	10 year Australian government bond	ASX 200 [2]	Australian composite bond Index	Australian FRN index
Theoretical change in price	-6%	-9%	-3%	-0.1%
Actual change in price	-6%	-5%	-3%	0.2%

Source: Spectrum

One reason behind this discrepancy in Australian equities is that equity investors may not care about how a bond analyst theoretically values assets. They may have their preferred methods or also see changes in bond yields as temporary and choose to ignore the short term theoretical impact. Hence, there was, and will almost always be, a gap between theoretical and actual changes in some asset price changes which are driven by yield changes.

Despite these differences, the actual outcomes support our view that changing bond yields can have a large impact on some asset valuations, including equities.

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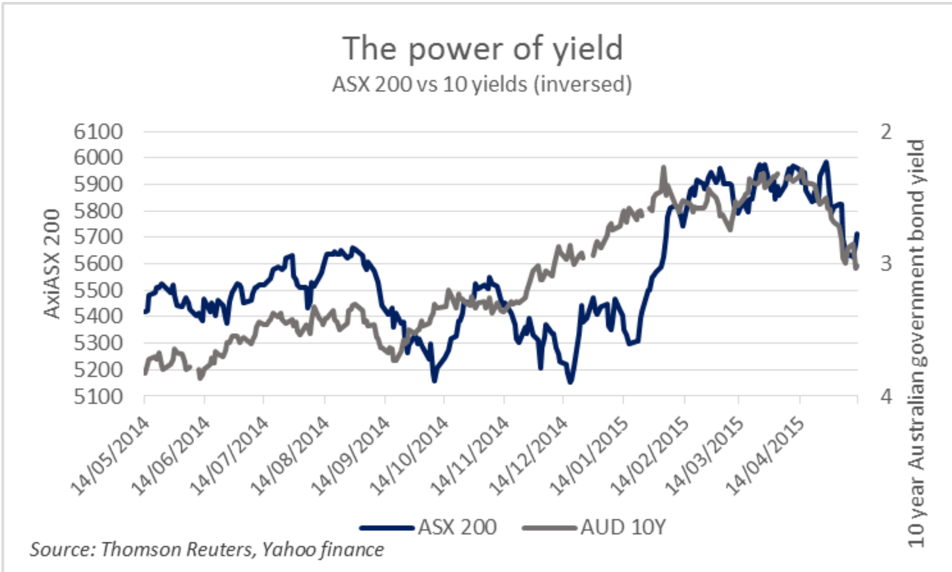
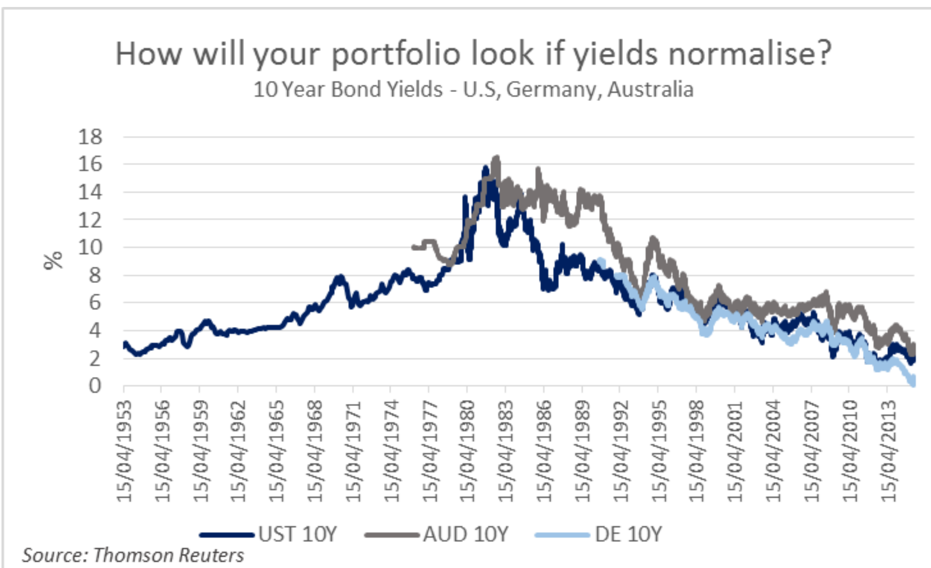
(2) Equity model: P/E 14x, earnings growth 3% p.a.

most asset prices benefit from falling government bond yields

Protection from rising yields

Global and Australian asset values have risen sharply in value over the last year. During this period bond yields globally have fallen to historic low levels. Spectrum does not believe these two factors are independent. We view that most asset prices in Australia have benefitted from falling government bond yields.





If investors think that bond yields, in particular in Australia, are at risk of regressing towards historical norms, they may want to consider protecting themselves from their potential negative impact. As seen in theory and reality, floating rate note prices tend to be stable in volatile yield environments. Exposure to this asset class potentially reduces the volatility of a diversified investment portfolio.

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.

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