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Spectrum Insights

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Investing in floating rate bonds as opposed to fixed rate bonds helps protect bond investors from price slumps.

Time to float

Spectrum expects that the excess yield corporate bonds generate above government bonds to fall by around 15% over the coming year in Australia. Lower yields boost bond prices. Not all types of bonds, though, have the same price stability. Specifically, investing in floating rate bonds as opposed to fixed rate bonds helps protect bond investors from price slumps. A key risk is a rise in Australian government bond yields. Currently, they are near their all-time lows. Should these yields move back towards historical norms, fixed rate corporate bond prices will be hit. Given this scenario, Spectrum currently has a preference for floating rates over fixed rate for Australian dollar (AUD) corporate bonds. We foresee the overall floating rate note index delivering low volatility total returns of around 4.5% over the coming year. Well-managed bond funds should generate more. This compares with one year deposit rates of around 2.5% to 3%.

This report is the second in the series on the AUD corporate bond sector. It follows – Corporate bonds – the new frontier for retail investors – which focused on the safety of corporate bonds.

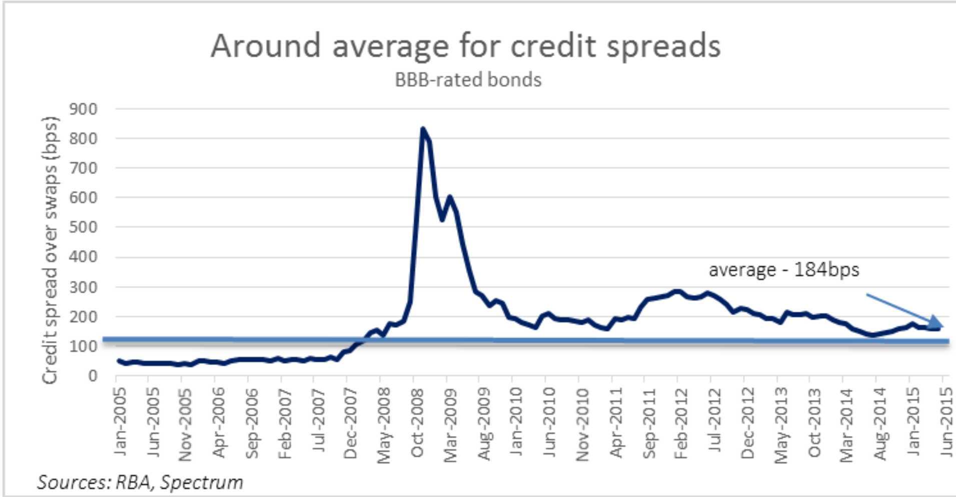
Why invest in corporate bonds? - Value

Our positive view on Australian corporate credit spreads is due to the following:

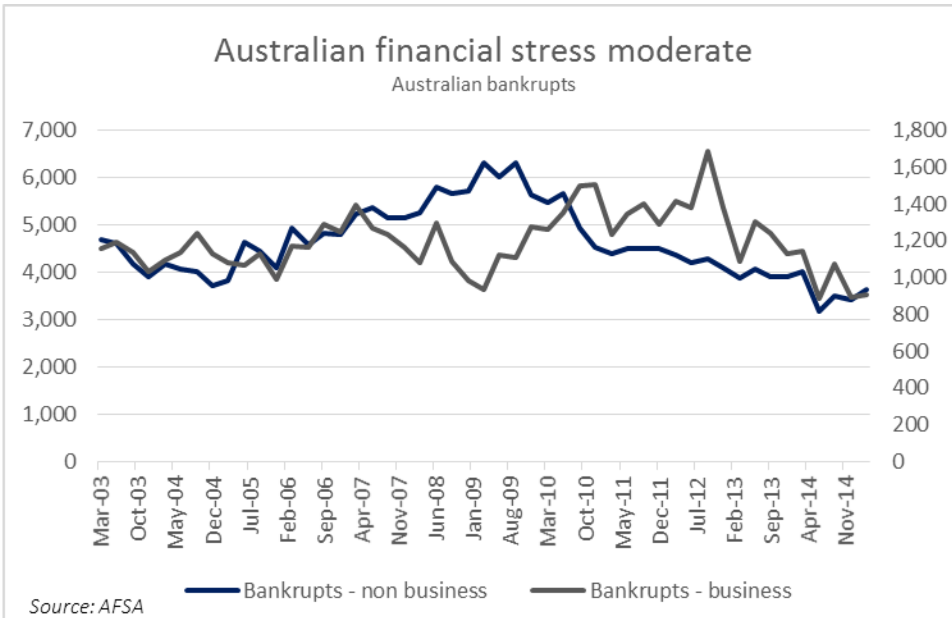
- the low interest rate environment encourages investors to seek yield;
- the low default rate environment in Australia provides investors with confidence to take credit risk; and,
- AUD credit spreads look cheap compared to like-risk bonds in other countries. We expect this gap to narrow.

Spectrum sees the extra yield that AUD corporate bonds currently give over government bonds, known as credit spreads, provides investors with an attractive return for the extra default risk over the Australian government.

For example, 5 year BBB rated bonds in Australia yield 1.7% more than government bonds. This credit spread of 1.7% or 170 basis points compensates investors for the risk of default. At current levels, it implies a cumulative default rate of around 8%. Or, that 1 in 12 of the likes of Lend Lease, Coca Cola Amatil and Brisbane Airport will go broke by 2020. We see the likelihood of this occurring to be low.



Sources: RBA, Spectrum



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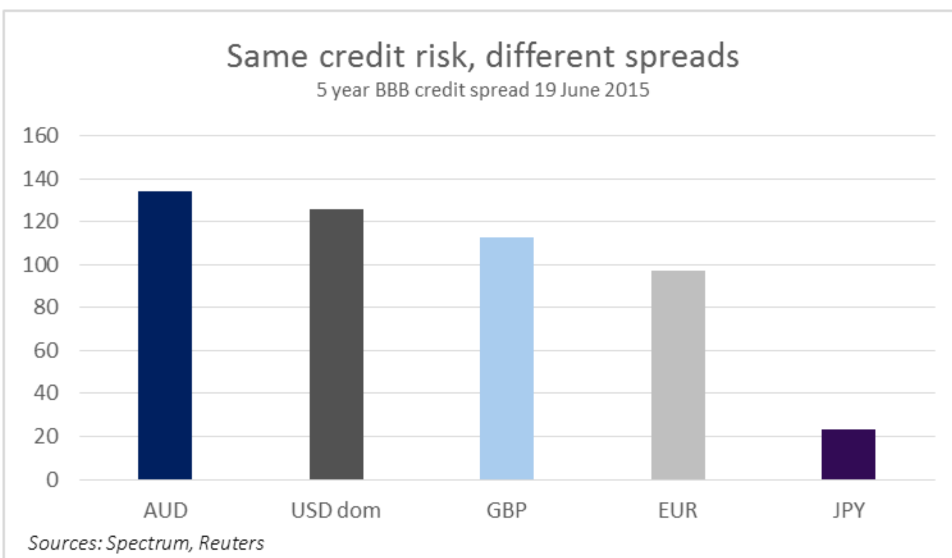


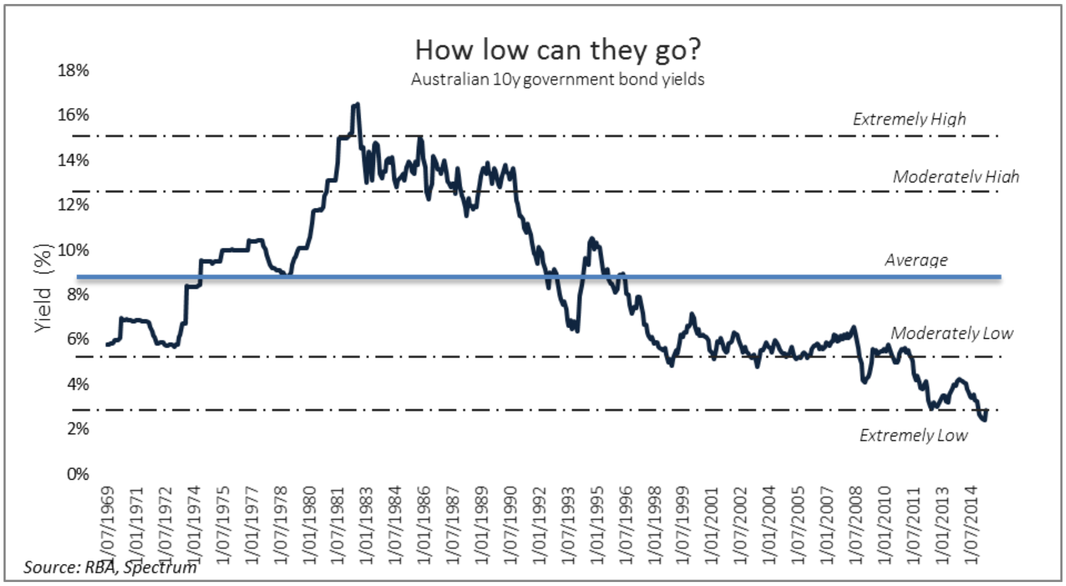
Sources: Spectrum, Reuters

history shows that when valuations are stretched far from their averages they have a habit of snapping back towards the mean.

Same value but different risks

That's the positive. A concern we have is that fixed rate corporate bond performance is linked to changes in government bonds yields. And Australian government bonds yields are currently at near all-time lows.

We note that bond yields may fall further, pushing fixed rate bond prices higher. This positive could come from further declines in Australian inflation expectations or the flow on effects from global quantitative easing. Despite this, history shows that when valuations are stretched far from their averages they have a habit of snapping back towards the mean.



So, if credit spreads are reasonable value and government bonds yields near historic low, what can an investor do? Spectrum takes the view that floating rate notes provide a better risk-return outlook compared to fixed rate notes from similar credit risk issuers.

Below, we discuss some basic differences in the performance characteristics of fixed and floating rate notes.

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Fixed vs. Floating – the basics

Fixed and floating rates notes from the same company and the same maturity will perform differently. This is despite them starting with similar yields. The key drivers of this variance are changes in government bond yields and the shape of the yield curve.

In essence, a fixed rate note investor is buying a government bond plus a premium (credit spread) for taking the risk that the issuing company may default. A fixed coupon will provide a set amount every year, say 5% of the face value of the bond.

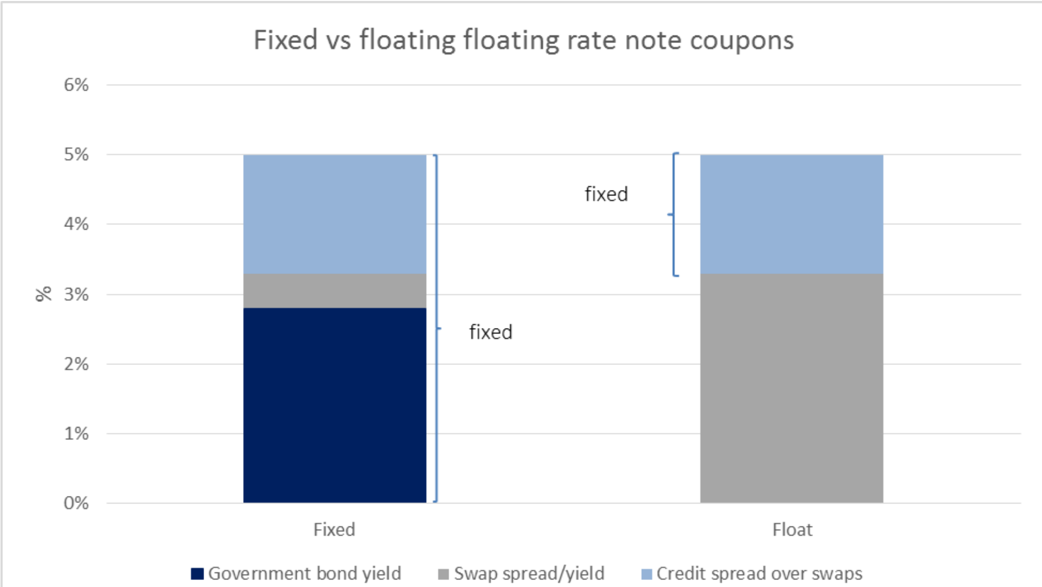
The price performance of the fixed rate bond, therefore, will be linked to the performance of the government bond market. If government bonds fall in price, so too will the corporate fixed rate bond – assuming its credit spread is constant.

In contrast, a floating rate note coupon will vary each payment. That is, it will pay the prevailing reference point, often a 3 month bank bill swap rate, plus a fixed margin to compensate the investor for the credit risk of the issuer. Similar to the fixed rate bond, the margin or credit spread is the market's assessment of default risk at the time of issue.

For a floating rate bond, the price change will largely be linked to the perceived change in default risk of the company. This could be driven by a credit rating upgrade or downgrade. Note that this change in perception will likely impact on the fixed rate note by a similar amount.

The floating rate component of the coupon moves up and down to reflect the prevailing interest rate in the market. Hence, there is next to no impact on the bond's price from a change in the government bond or swap yield curve. This is why floating rate notes tend to have far more stable prices than fixed rate notes.

Below are the indicative building blocks of fixed and floating rate notes' coupons.

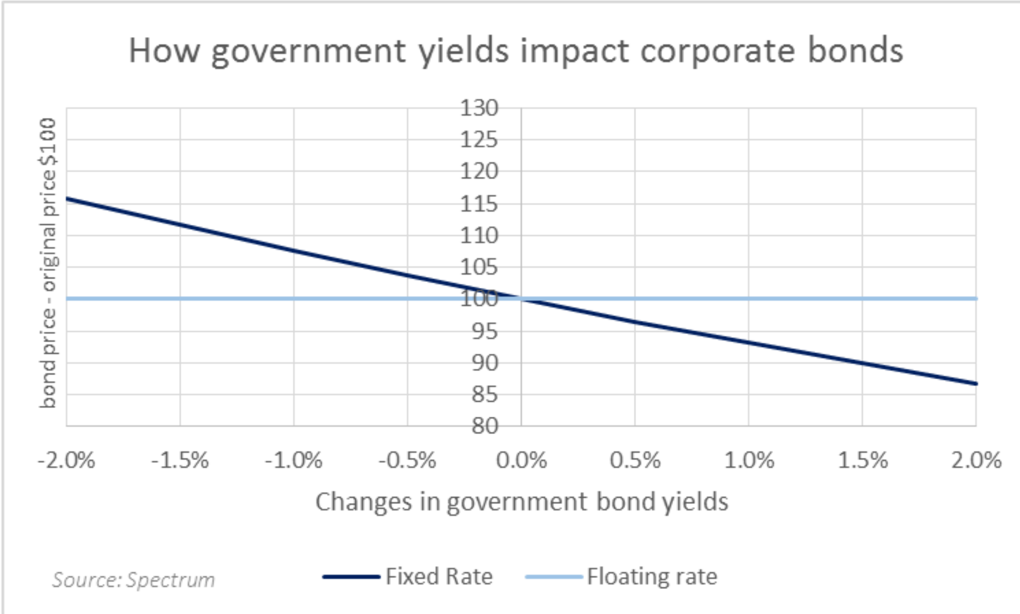


Source: Spectrum

At launch and over the period of the bonds' lives, the prevailing yields of both the fixed and floating rate note will tend to be around the same level.

The prices of the bonds, however, will vary over the life of the bond as government bond yields move.

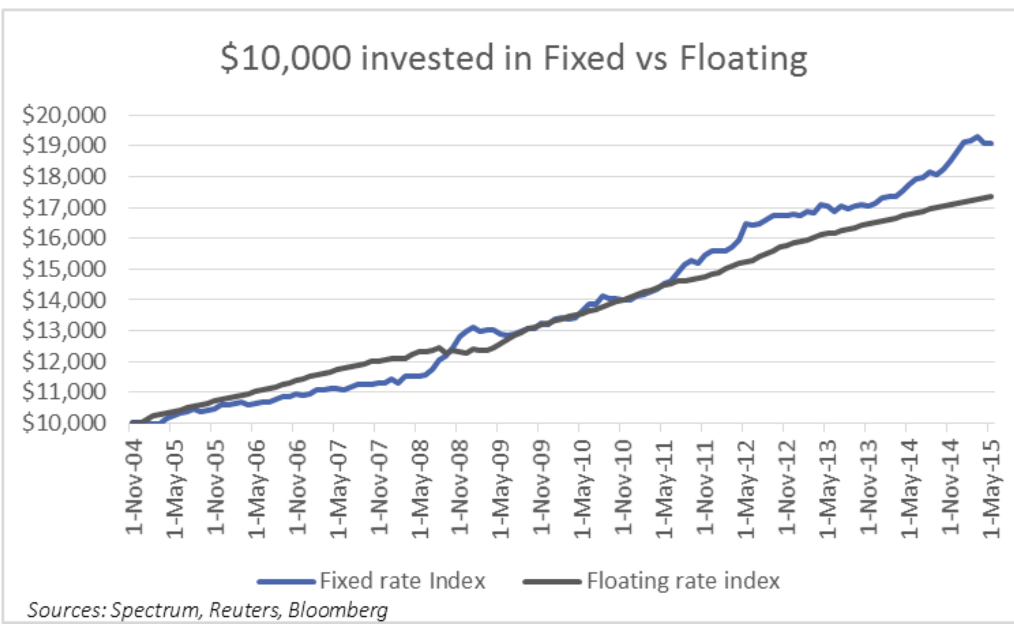
For example, if government bond yields fall, it makes the fixed rate note more attractive and pushes the corporate bond price. The same happens in reverse. Below is a scenario of how a fixed and floating rate note change in price when bond yields change. Note that the floating rate note stays at around the launch price.



Note: The above graph assumes 10 year bonds with starting yields of 5%, credit spread of 2.2% and launch price of $100. It assumes that the credit spread is static.

Fixed vs Floating – looking back, fixed outperforms

Fixed rate corporate notes have been the place to get your corporate bond performance recently. The Australian fixed rated index has outperformed the floating rate index over the last five years. Since November 2004, the annualized total return was for the floating rate index was 5.5% and the fixed rate index was 6.4%. This outperformance has mainly come from a fall in Australian government bonds yields.



The graph above also shows the fixed rate index has also been far more volatile than the floating rate index. This is despite credit spreads on both indices moving fairly much in tandem.

As the ads say, past performance is no indicator of future performance. The concern Spectrum has is that Australian government bond yields are now near historical lows. Valuations are at extremes when compared to history. When looking at medium to long term investments, it matters where the starting valuation point is. And unless *this time is different* there is likely to be a pull towards the average over the medium to long term for government bond yields in Australia. If bond yields rise, fixed rate bonds fall in price.

Looking forward – floating looks safer

Spectrum has a preference for floating rate corporate notes over fixed rate notes for Australian dollar exposures. An investor can still get performance from credit spreads but with less price risk. Accordingly, we have tailored our portfolios towards a greater proportion of floating rate notes. We believe this will help keep our volatility moderate while improving the total return performance over the medium term.

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