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The performance may not be dinky di Aussie but a blend of local and international

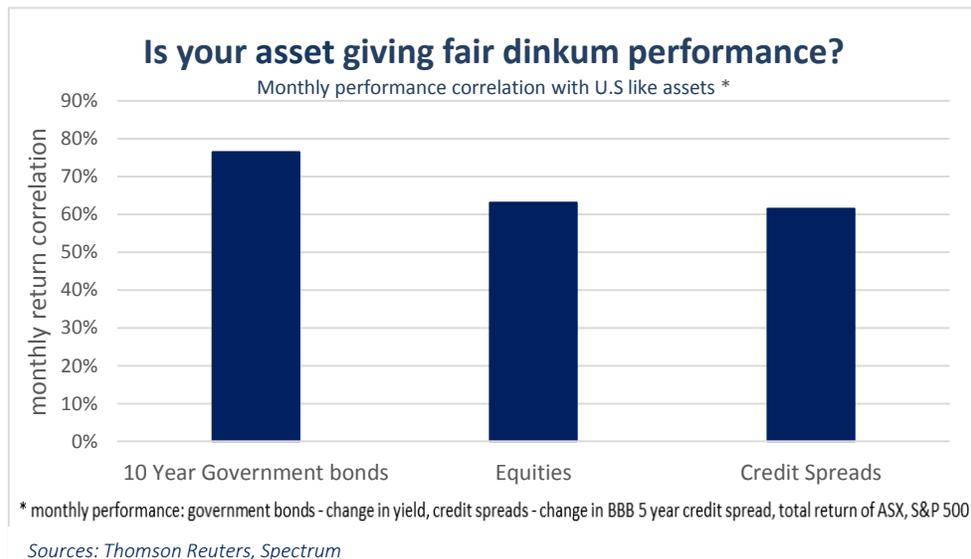
Buying Australian, Getting American

When buying Australian shares or bonds, investors could believe that the returns would largely be based on how well the company or Australian economy performs. What we have found, though, is that international factors have largely driven investment performance in recent times. In other words, the performance may not be dinky di Aussie but a blend of local and international factors.

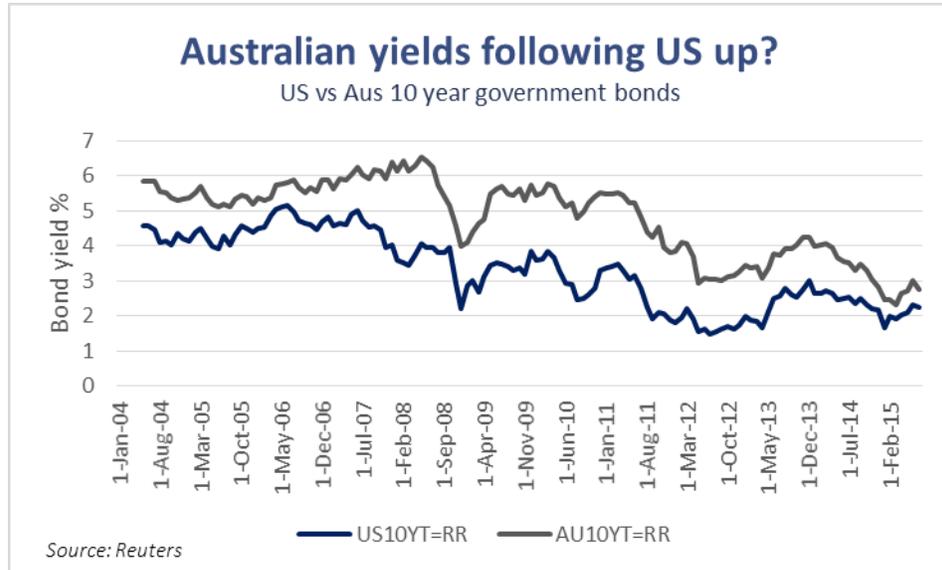
In recent years, strong investment performance in the US has helped buoy asset prices in Australia. A key concern for Spectrum is if US bond yields start to rise this could have a significant negative impact on many Australian investments. Hence, investors may want to consider increasing their weightings in Australian dollar assets that are likely to be resilient to rising US yields, such as floating rate corporate bonds.

Is your performance fair dinkum?

The graph below provides monthly correlations between the performance of like assets in the US and Australia since June 2010. We see there was a strong positive relationship between asset classes in both the US and the Australia. Spectrum believes this relationship was driven by the Australia markets following the performance of similar investments in the world's largest economy.



Of all the performance relationships, the longer dated government bond markets of both countries appear to be the closest as the graph below indicates.

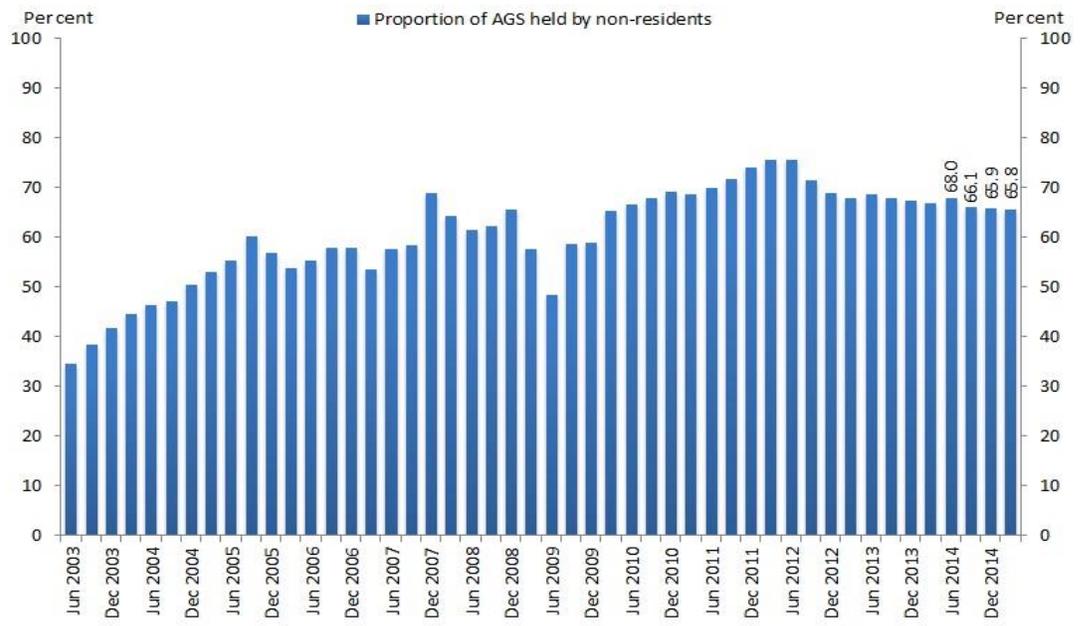


Why is it so?

Foreign investors have come to own around two thirds of Australia's government bonds. This is up from around a third in 2003. This group of investors in Australian government bonds, by their nature, take global factors into consideration when allocating funds. When other comparable countries' bond yields move, Australian government bond yields adjust to reflect the level at which international investors are willing to buy them.

Foreigners own the most

ownership Australia's government bonds



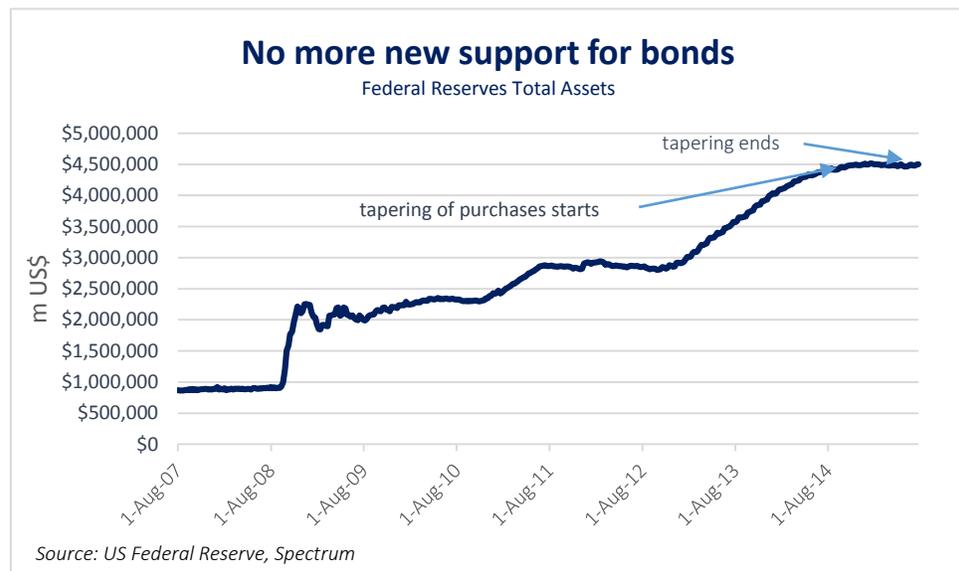
Source: AOFM

Is this a problem?

It could be for Australian investors. This is why.

Central banks, such as the Reserve Bank of Australia, are traditionally responsible for only very short term rates. As the length of the bond is extended, the greater the influence investors have on the market yield of the bond.

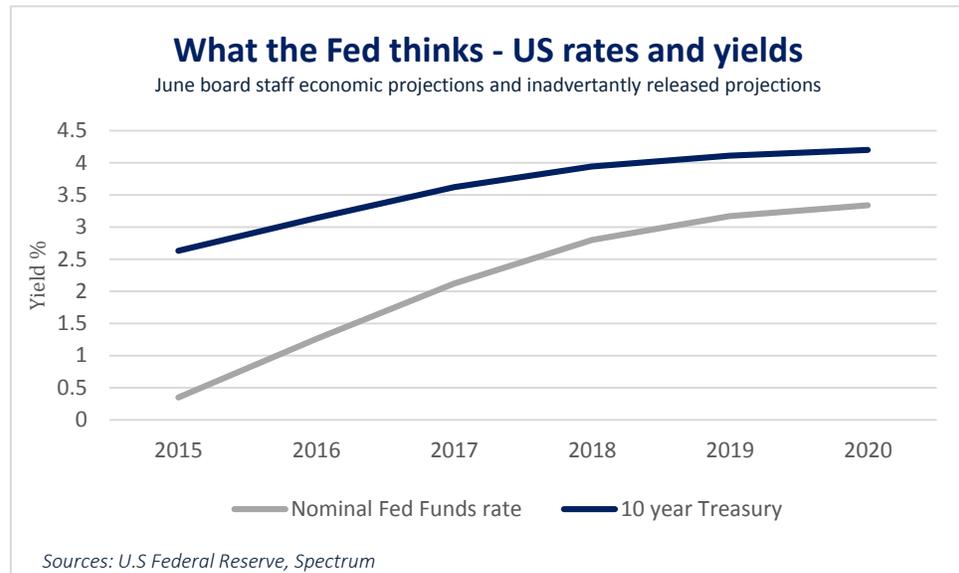
This changed in recent years. Post the GFC, the US Federal Reserve took the unusual step of intervening in the market and buying various US\$ investments, primarily US treasuries and mortgage backed securities. This helped keep market yields on longer dated US government bonds low. Then, the US Federal Reserve began to taper its purchases of the assets in December 2013 and ceased intervening in longer dated securities in October 2014.



Not surprisingly, some market commentators are now expecting the absence of Fed intervention and some improving macro-economic indicators in the US to cause US bond yields to rise.

Want to bet against the Fed?

Perhaps, the most telling factor is seen in the following graph. Recently released information shows staff at the Federal Reserve are expecting both the Fed Funds rate – the rate which they set - and the bond yields to rise.



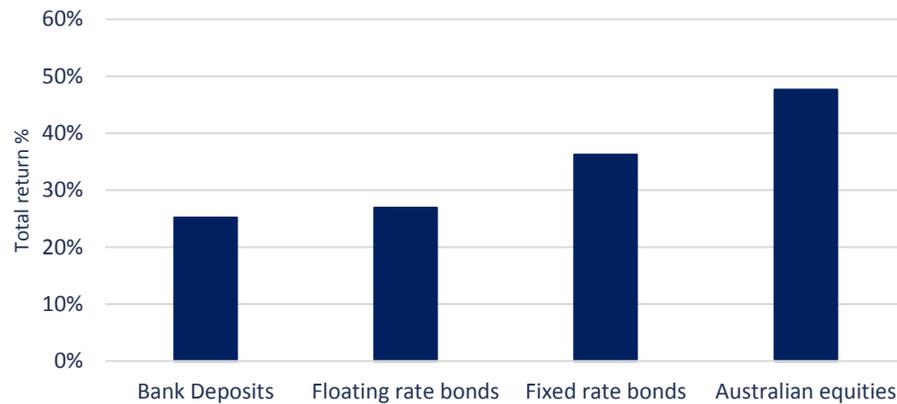
The implication is that if the collective wisdom of the Federal Reserve is correct and that previous correlations between US and Australian government bonds hold then some Australian investment returns will come under pressure. Specifically, longer dated bonds with fixed rate notes and other investments whose key attraction is steady income are at risk of price falls.

What to do?

Many investments in Australia have had great returns over the last five years. Key drivers of these returns were attractive valuations as a starting point and a sharp fall in bond yields. Now that one driver, yields, are at risk of reversing this trend, investors may want to consider turning their investment risk dial from price growth towards capital preservation.

Healthy returns - will these last?

July 2010 to June 2015



Sources: Reuters, RBA, Spectrum

Specifically, investors may consider increasing exposure to investments which are not sensitive to bond yield rises. These include floating rate notes and even bank deposits. For corporate floating rate notes or bonds in Australia, most look around fair value from a historical perspective¹. In addition, corporate default rates in Australia are very low and look set to remain low in this interest rate, low leverage environment. These factors combine to give investors a reasonable return outlook for the risk taken. After the great returns other asset classes have given in recent years and the growing headwinds from abroad, perhaps it is time for investors to lock in some of their gains.

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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¹ Please refer to our publication "Is Australia Turning Japanese?" <http://www.spectruminvest.com.au/wp-content/uploads/2015/05/150501-Spectrum-Reports-Australian-Credit-Are-We-Turning-Japanese....pdf>

