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Spectrum Insights

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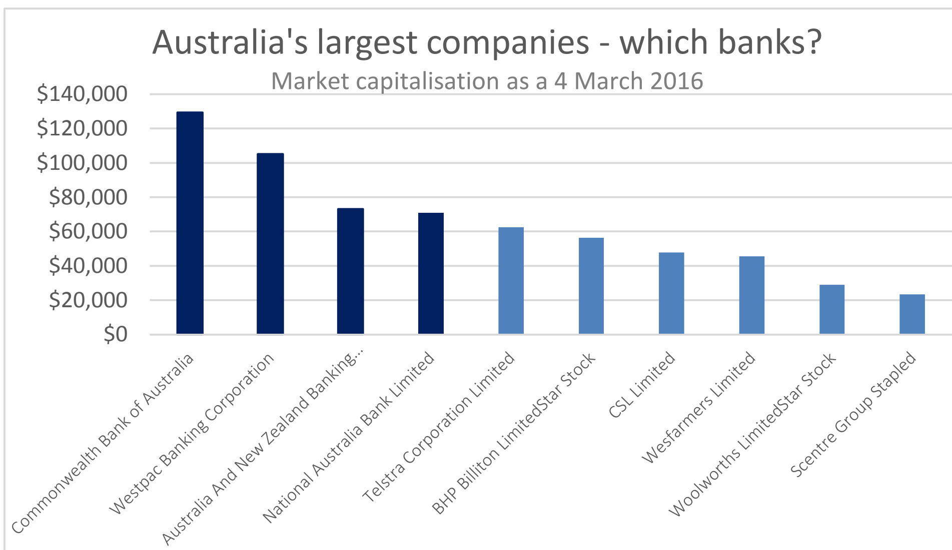
Banks, banks and more banks

Australian banks dominate the domestic investment landscape. They are the four largest stocks on the Australian stock exchange, the biggest part of the hybrid market and make up a large chunk of the corporate bond market. Even when investors take cover in cash, they are mostly deposited at - guess where? - banks. For most investors, this concentration risk has not caused large sustained problems over the last twenty or so years. Australian banks have generated strong financial performance. Should this change, however, a Plan “B” may be highly useful in protecting nest eggs. Corporate bond funds can help but investors should check how much these have in Australian bank risk.



Sources: Market Index

Nowhere to go but banks

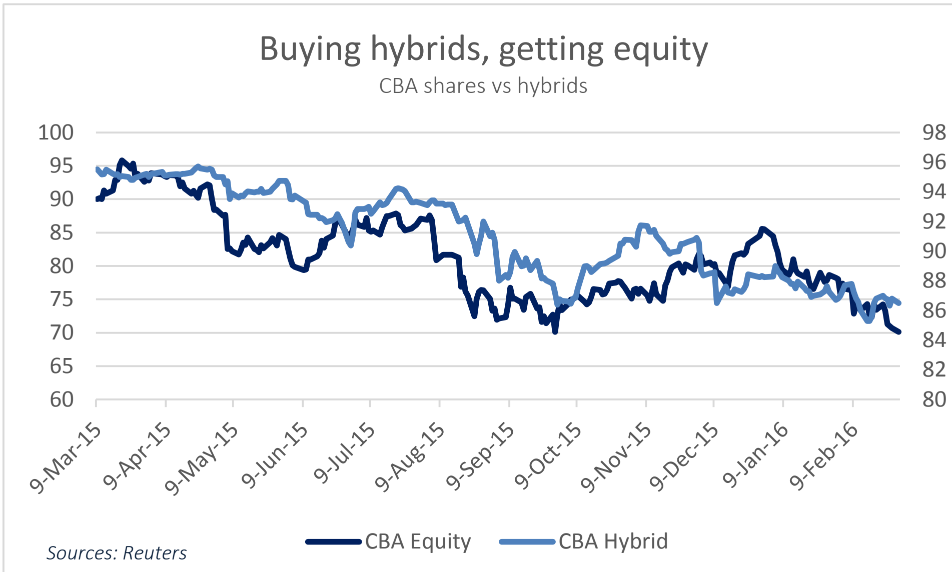
	ASX50 (MCAP)	Listed Hybrids	Listed FRNs	Listed Corporate Bonds	Floating rate Index *	Fixed Index*
Concentration of Australian Banks %	54%	63%	36%	33%	48%	3%

Sources: Reuters, ASX, S&P. Floating Rate Note and Fixed Rate Indices are from Bloomberg – As at 3 March 2016

* When taking out government and supranationals from the indices, banks make up 56% of the Floating Rate Note Index, and 22% of the Fixed Rate Composite Index.

Diversification not working with hybrids

Some investors have taken their corporate credit exposure via the hybrid market. If the purpose was to diversify away from their heavy bank equity exposure, they may be disappointed of late. As noted in the graph below, the recent weakness in CBA stock price was accompanied by weakening in CBA hybrid notes. Since May 2015, daily price movements of the CBA shares and the hybrid CBAPD have a whopping correlation of 80%.



When investors seek diversification, they look for an investment that will either hold or increase in value while other investments are falling. Investing in hybrids as well as Australian bank equity, however, has not diversified one's risk but compounded it.

This makes sense. Should an Australian bank come under financial stress, then it is highly likely that its ability to pay dividends both on its equity and hybrids both come under pressure.

The struggle to diversify

The challenge for many Australian investors is to diversify away from their domestic equity exposures but not give up too much income.

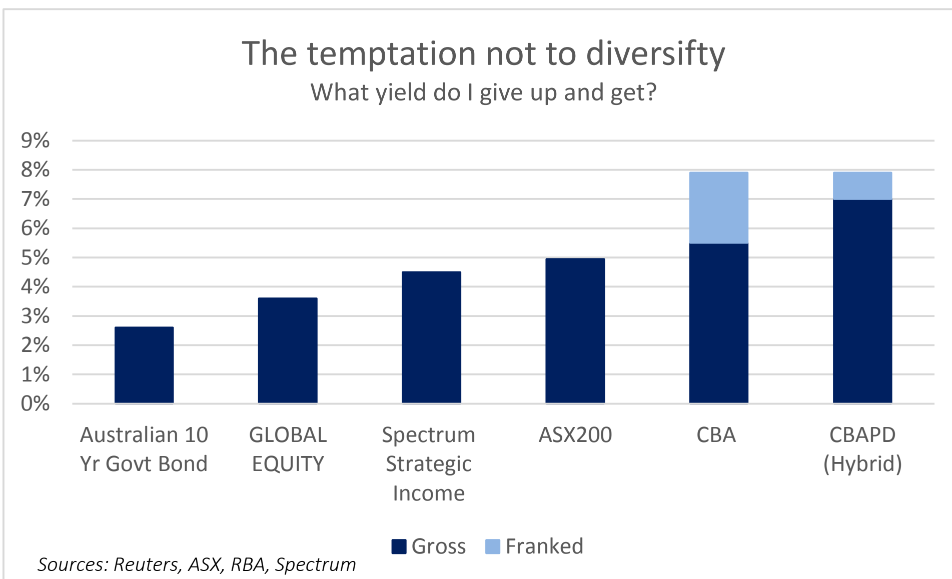
Below, we look at the correlations of monthly returns for some asset classes and our fund. The lower the number – up to -100%, the more diversification an investor gets. The higher – up to 100%, the more the asset classes move in the same direction.

Feb 2011 - Feb 2016	Spectrum Strategic Income	FIXED RATE BOND INDEX	FLOATING RATE NOTE INDEX	ASX 200 Total Return Index	GLOBAL EQUITY
Spectrum Strategic Income	-	-4%	46%	35%	36%
FIXED RATE BOND INDEX	-4%	-	-1%	-18%	-37%
FLOATING RATE NOTE INDEX	46%	-1%	-	30%	37%
ASX Total Return Index	35%	-18%	30%	-	65%
GLOBAL EQUITY	36%	-37%	37%	65%	-

Sources: Reuters, ASX, S&P, Spectrum

Notes: Floating Rate Note and Fixed Rate Indices are from Bloomberg. The ASX 200 is the total return index. Global Equity is the S&P Global 100 Total Return AUD Hedged.

The problem for many investors is that the cost of diversification is the sacrifice of yield.The graph below illustrates the indicative yields of various securities and indices.



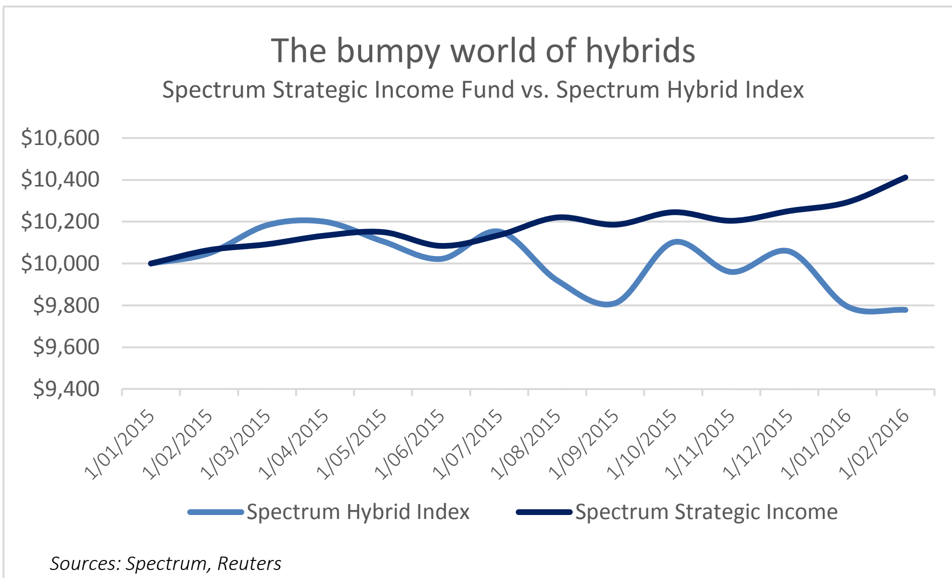
When investing in an Australian bond fund, an investor is likely to give up yield on bank equity or hybrid investments. In return, they should get both diversification benefits and better protection against loss of capital. Or, in other words, get steadier income over their investment portfolio.

Different bank, similar risk

Buying one of each of the major Australian banks will probably not help much as well. Their businesses are similar and carry comparable risks. That is, financial problems in one are likely to appear in another. In sum, owning various bank issued securities can simply add to one's concentration risk – despite being at different levels of a bank's capital structure.

A corporate bond fund – but not as you know it

Like many investors, Spectrum too sees merit in the strength and valuation of Australian bank securities. We, however, seek to limit the exposure of our bond fund to Australian banks. Our exposure is around 30% of the fund in Australian banks – well below the floating rate note sector concentration of around 50%. Moreover, our concentration in floating rate notes helps de-sensitise the fund from interest rate volatility – an additional risk to share price performance.



Australian investors are blessed with many high yielding investment opportunities. This, however, can lead to concentration risk as many come from its banking industry. Broadening the investment spectrum into a corporate bond fund can help reduce this concentration of risk without giving up much yield.

Spectrum Asset Management manages the Spectrum Strategic Income 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 and how to invest please go to our website http://spectruminvest.com.auor contact your mFund brokerhttp://www.asx.com.au/mfund/foundation-members.htm#tabs-218. Spectrum and the author have investments in either securities mentioned in this report or comparable securities