The changing face of fixed interest – from benchmark returns to absolute returns

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Why invest in bonds? As an investor saving for retirement or any other long-term goal, this remains a relevant question, especially given the recent environment of relatively low returns in the asset class. While there have been significant changes in the bond market in the past ten years, bonds still play an integral role in portfolio diversification and are a necessary element in any balanced investment strategy. However, the astute investor must acknowledge the changes in the market and tailor their strategy to best capitalise on these changes

Bill Nemerever, in his article "Bond Benchmark Baloney" published in September 2006, argues that bonds still have relevance in any portfolio by providing a diversifier when equity markets decline, for liability hedging, deflation/ inflation hedging and providing income streams to retirees. The investor should recognise, however, that allocation to fixed income as an asset class has more dimensions than pure interest rate risk. Exposure is increasing to countries, credit risk (default risk), volatility and or prepayment risks with the changing nature of benchmarks.

Changes in the Bond Market

There are at least six major areas of change in global bond markets:

1. Issuers
2. Instruments
3. Benchmark Composition
4. Performance Measurement
5. Globalisation
6. Economic Environment

Issuers: Traditionally, federal governments were the primary issuers of bonds, largely to finance budget deficits. Later, state and local governments also identified bond issuance as an important source of financing for investment projects. As the capital markets grew, corporations also looked to bonds to finance capital investments as an alternative to borrowing from their local banker. More recently, emerging markets have acquired increased access to bonds as a source of financing. This proliferation of issuers has increased opportunities for the investor, but also introduces additional risk factors.

Instruments: The fixed income universe has also evolved in terms of the instruments used to achieve alpha, or returns, in a portfolio. While the "plain vanilla" instruments of past decades, such as government, corporate and mortgage bonds are still important, more complex instruments such as derivatives and emerging market debt have become more commonplace as the markets in such instruments have become more liquid and stable. Some of the newer instruments include subprime loans (currently suffering in the U.S.), collateralized debt obligations (CDOs), credit default swaps, constant proportion portfolio insurance, futures, and swaps.

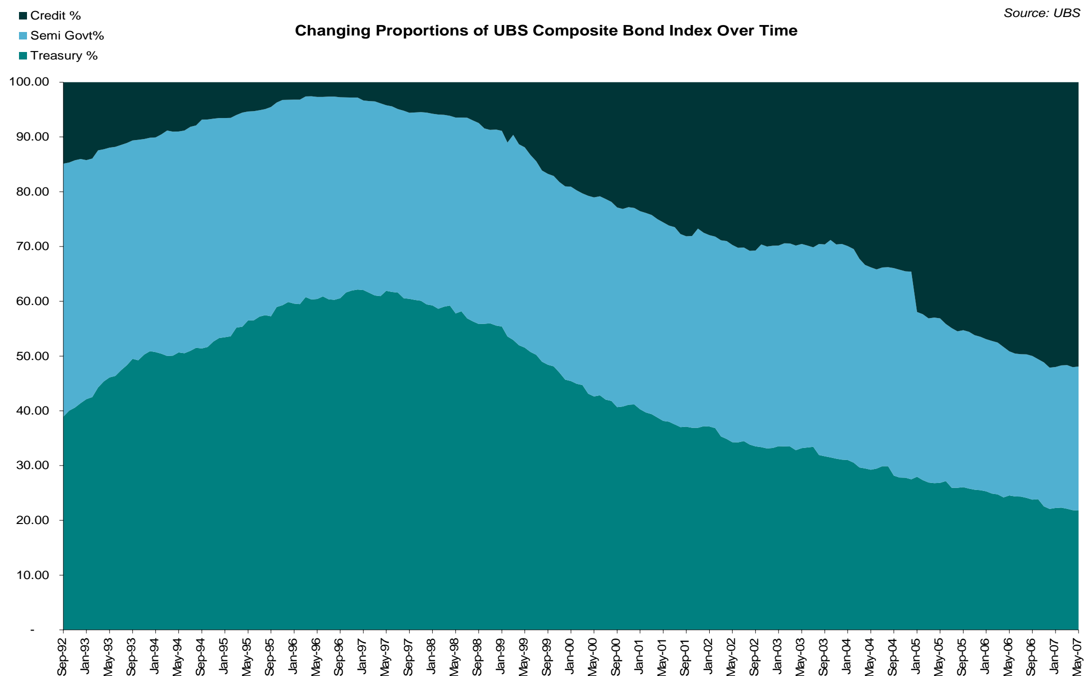
Table 1

Notional Outstanding in USD Trillion - Interest Swaps							
Currency	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
Euro	16.6	20.9	31.5	44.7	59.3	81.4	112.1
US $	13	18.9	23.7	33.4	44.8	74.4	97.6
Japanese Yen	11.1	10.1	12.8	17.4	21.5	25.6	38
Pound Sterling	4	5.0	6.2	7.9	11.6	15.1	22.3
Swiss Franc	1.1	1.2	1.5	2.0	2.7	3.3	3.5
Total	**45.8**	**56.1**	**75.7**	**105.4**	**139.9**	**199.8**	**273.5**
Source: "The Global OTC Derivatives Market Activity in the Second Half of 2006" BIS							

There has been an explosion in credit and credit derivative markets (see Table 1 above). As of 2006 the interest rate swap market was more than 5 times the outstanding size of the physical debt markets (which were around $40 trillion in 2006 according to Merrill Lynch). This leveraging has forced fund managers and investors alike to change the way in which they manage risks in a bond portfolio.

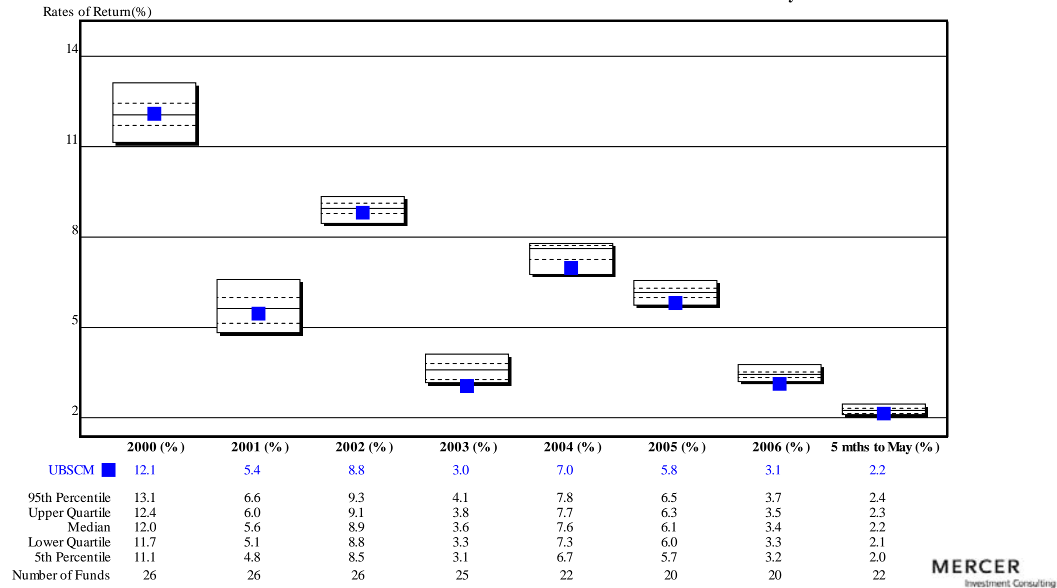
Benchmark Composition: Largely reflecting the changing face of issuers and instruments in the bond market, the composition of the most widely used investment benchmarks has also dramatically changed. According to a Lehman Brothers publication in 2003, treasuries as a portion of the Lehman Aggregate Index declined from 32% in 1976 to 21% in 2002. Credit also declined significantly during this period, while mortgage and asset-backed securities leaped from 11% to 40%. Locally, the benchmark UBS Composite has seen credit become the dominant sector to over 50% weighting, usurping the traditional government and semi-government sectors, which accounted for over 95% of the benchmark some 10 yrs ago. This is highlighted in Chart 1 below.

Chart 1 – Changing proportions of UBS Composite Bond Index over time



Performance Measurement: Traditional bond fund managers managed assets against an established benchmark, such as the Lehman Aggregate Index. What this has meant in recent years as yields have risen from their 2003 lows is that many of these funds returned less than the cash rate, while still outperforming the benchmark. As a result, there has been a gradual move by investors away from the traditional benchmark in favour of absolute return strategies. Indeed, the case for a traditional bond manager has been declining for a number of years, given the marked convergence of managers over time to median. Absolute levels of returns have decreased over time, and the maturation of investment universes whereby managers are defined along investment parameters into client-friendly buckets have been the primary drivers. This has resulted in a greater correlation between so-called active managers and to the benchmark. Chart 2 demonstrates this tendency, with the band of performance differentials between fund managers narrowing significantly in recent years.

Chart 2

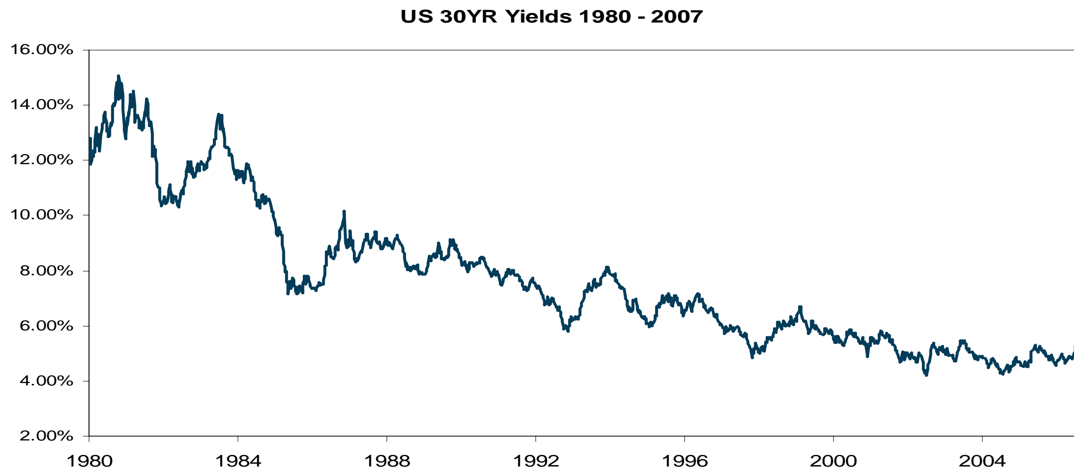


	2000 (%)	2001 (%)	2002 (%)	2003 (%)	2004 (%)	2005 (%)	2006 (%)	5 mths to May (%)
UBSCM	12.1	5.4	8.8	3.0	7.0	5.8	3.1	2.2
95th Percentile	13.1	6.6	9.3	4.1	7.8	6.5	3.7	2.4
Upper Quartile	12.4	6.0	9.1	3.8	7.7	6.3	3.5	2.3
Median	12.0	5.6	8.9	3.6	7.6	6.1	3.4	2.2
Lower Quartile	11.7	5.1	8.8	3.3	7.3	6.0	3.3	2.1
5th Percentile	11.1	4.8	8.5	3.1	6.7	5.7	3.2	2.0
Number of Funds	26	26	26	25	22	20	20	22

Globalisation: The world is becoming ever more interconnected. Technological advances have facilitated communication and transfer of information allowing investors access to a greater range of opportunities than those available in their home countries. The depth and stability of new markets is developing rapidly offering investors additional options for value added.

Economic Environment: Thirty years ago, in the high inflation/high interest rate environment of the 1970s, it was easy to place your funds in a 30 year bond and feel confident of its long-term returns. In fact, it has been a bull market in bonds for the better part of the past 25 years, as shown in chart 3 below. But, the past three years have seen a shift to more bearish prospects, with low returns, inverted yield curves, and more stable economic fundamentals. So in this new environment, bond investors must find creative and innovative strategies to generate returns.

Chart 3



Source: Bloomberg

What does all this mean for investors?

So, what do these changes mean to an investor in terms of portfolio composition? There are several things an investor can do to optimise returns and capitalise on recent changes in the bond market.

First, investors should ***rethink their asset class allocations***. Historically, stocks and bonds have been somewhat positively correlated (about 30% by our calculations). Since 2001, however, the correlation has been significantly negative, offering increased diversification benefits to investors. That is to say, bond returns in recent years do not move in the same direction as equities, therefore the bond element of a portfolio provides positive returns when equities are bearish.

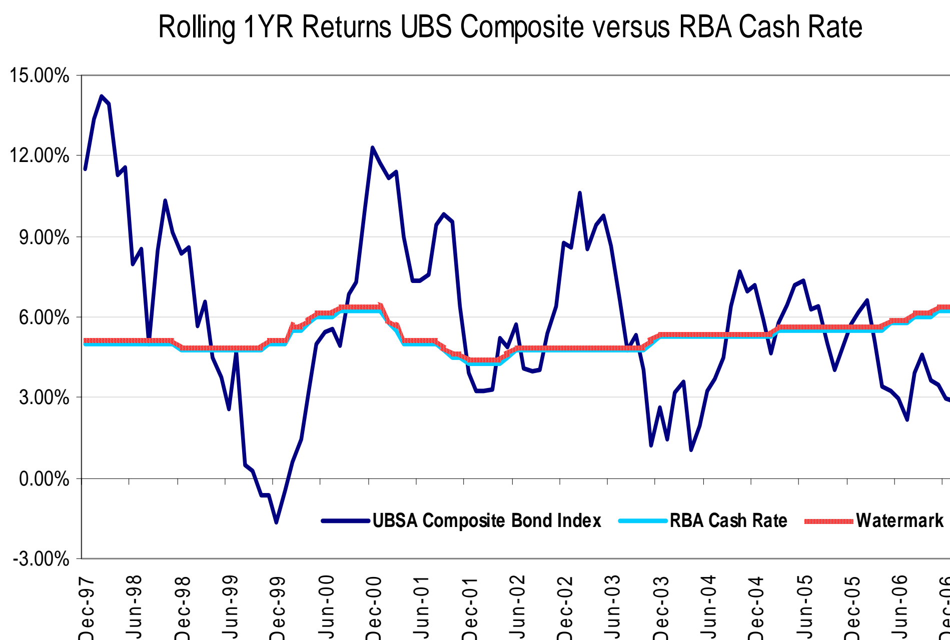
Additionally, while bonds still play a key role as diversifiers in a balanced portfolio, there are more options within the asset class for investors to consider. Within fixed income, investors can now complement their core portfolio not only with hedge fund strategies, but also with an allocation to absolute return strategies. The precise blend depends on an investor's risk appetite. The rationale for including an absolute return strategy is to provide diversification benefits based on the potentially lower correlation with vanilla bond managers, as well as potentially higher returns.

Second, investors must be willing to ***expand their investment guidelines***. Rather than restricting a manager in terms of the instruments used, broader guidelines will allow a manager to use the whole range of instruments available to maximise returns for the client. To use a common analogy, a golfer must be able to use all the clubs in his bag to play his best game—you wouldn't want to use a putter for a long drive. Likewise, a manager should be able to use all available instruments to maximise returns. This does not mean that all the instruments will be used at any one time. Just as a golfer adjusts his game according to the terrain and conditions, so too does a manager use the appropriate tool for the prevailing economic and market conditions.

Third, investors should ***shed their benchmark bias.*** In today's environment, where cash has often outperformed traditional bond benchmarks, an investor should demand returns at least equalling the cash rate, or the so-called "risk-free rate". Right now, this translates to 5.25% in the US and 6.25% in Australia as at 30th July 2007. This argues for a more proactive absolute return strategy, identifying high conviction

relative value trades, while ensuring a "high water mark" of at least the cash rate. Chart 4 shows the rolling 1 year returns for the UBS Composite vs. the RBA cash rate, demonstrating that in the past four years, cash has generally outperformed the UBS benchmark.

Chart 4



Source Bloomberg

Nemerever's paper also questions whether benchmarks are relevant in bond portfolios. He argues that benchmarks are capitalization-weighted, and all are meant to be replicable. In a capitalization-weighted benchmark, the benchmark is biased towards issuers of bonds rather than providing a hedging mechanism to the liability stream of the investor. The larger the debtor, the bigger portion of the benchmark they become. This brings into question what the investor is trying to achieve by picking a benchmark and whether it is a meaningful hedge to the investor's risk reward profile. This argument also supports a move to an absolute return strategy.

Fourth, investors should ***ditch their home country bias***. The world is changing, and with it comes changing opportunities. Australia represents only one half of one percent of all outstanding debt markets. By limiting exposure to Australia, investors are increasing concentration risk while forgoing opportunities available in other developed and developing markets.

An increasingly deep and liquid Australasian debt market is developing and will continue to grow in the next 3-5 years. China and India have burgeoning middle classes, adding to the global consumer base on the order of 3 billion people. As Asian markets develop, the traditional asset classes that the West has enjoyed for a long period of time will become available in the East; beginning with sovereign debt, followed by issuance by corporations, eventually providing opportunities in asset backed and infrastructure issues. This provides further diversification for an investor. Opportunities like those anticipated in Asia will

continue to arise around the world, and investors should be willing to take advantage of the benefits deriving from increased globalisation.

Table 2 below shows the current composition of the world debt markets by country. While the US, Euroland and Japan currently dominate the market, the emerging markets, including Asia and Latin America, are starting to play a more significant role in the market, together comprising a greater percentage of the market than the United Kingdom.

Table 2 – Current composition of the world debt markets

Country	Total Outstand.	% World Bond Mkt
United States	17090.9	51.9
Euroland	6466.9	19.7
Japan	5305.2	16.1
United Kingdom	1081.6	3.3
Canada	514.4	1.6
Switzerland	261.6	0.8
Denmark	252.3	0.8
Australia	182.7	0.6
Sweden	128.6	0.4
Norway	47.7	0.1
New Zealand	16.6	0.1
Sub-Total	31348.5	95.4
Emerging/Converging Markets		
Asia	1000.7	2.8
Latin America	391.6	1.2
Eastern Europe, Middle East, Africa	231.3	0.6
Total	32972.1	100.0

Source: Merrill Lynch

Lastly, investors should be aware of the growing ***complexities in performance measurement***. While the calculation of returns in traditional bond instruments can be relatively straightforward, additional levels of complexity are introduced when derivatives and other more exotic instruments are used.

With the introduction of new products and issuers, performance measurement and attribution are the holy grail of fixed income investing, meaning that it is increasingly difficult to calculate. Complicated models and systems are required to manage risks in fixed income portfolios. Just pricing of physical assets and accounting the accrual of coupon alone is insufficient. Fund managers have had to learn to price and value a variety of structured credits and products with embedded optionality. The components of leverage have changed as well with the gray area between what is considered accounting leverage vs. economic leverage (arguably the more relevant figure). With absolute return funds, the attribution becomes more intuitive as the profit / loss to the portfolio is pure profit / loss to the investor, as opposed to traditional fixed income attribution. The end question for the investor is, how much did I make / lose, and this is also what the absolute return manager also asks.

What risks should investors be aware of in this brave new world?

1. High commodity/oil prices remain as Asia transitions from producers to consumers and a middle class is formed.
2. China and rest of the countries that have accumulated USD$ reserves slow down the purchase of US Treasuries.
3. Historically low unemployment rates around major developed worlds leads to wage inflation, in turn forcing central banks to tighten monetary policy.
4. Excess leverage in the system with the introduction of new instruments such as synthetic credit default swap markets, sub prime loans.
5. Unfunded pension liabilities place a bigger burden on governments thereby extending retirement age for most workers or reducing their pension payments
6. Lack of skills in the investment management community to deal with the introduction of new products to price value and measure risk characteristics.

Considerations for financial advisers

The changes in the bond market over the past ten years have been deep and profound. Adjusting to the new paradigm will require investors to shed some biases and preconceptions, but ultimately will offer an increased range of opportunities within the asset class. Far from dead, the bond market is more exciting and more complex than ever.

In an environment where the end of the 25 year bull market in bonds is possibly approaching, investors should prepare for short term volatility. With that comes an extended period where fixed income significantly underperforms its peers (i.e. equities, property and alternatives). During this transition, it is prudent to look for opportunities to maximise returns and minimise risks. This entails tapping into new instruments and markets. Individual investors can gain access through direct offerings from fund managers, or through retail platforms offered by numerous investment houses.

The “new new” generation to manage fixed income has arrived.

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