



Asset Allocation  
Investing in the new reality...



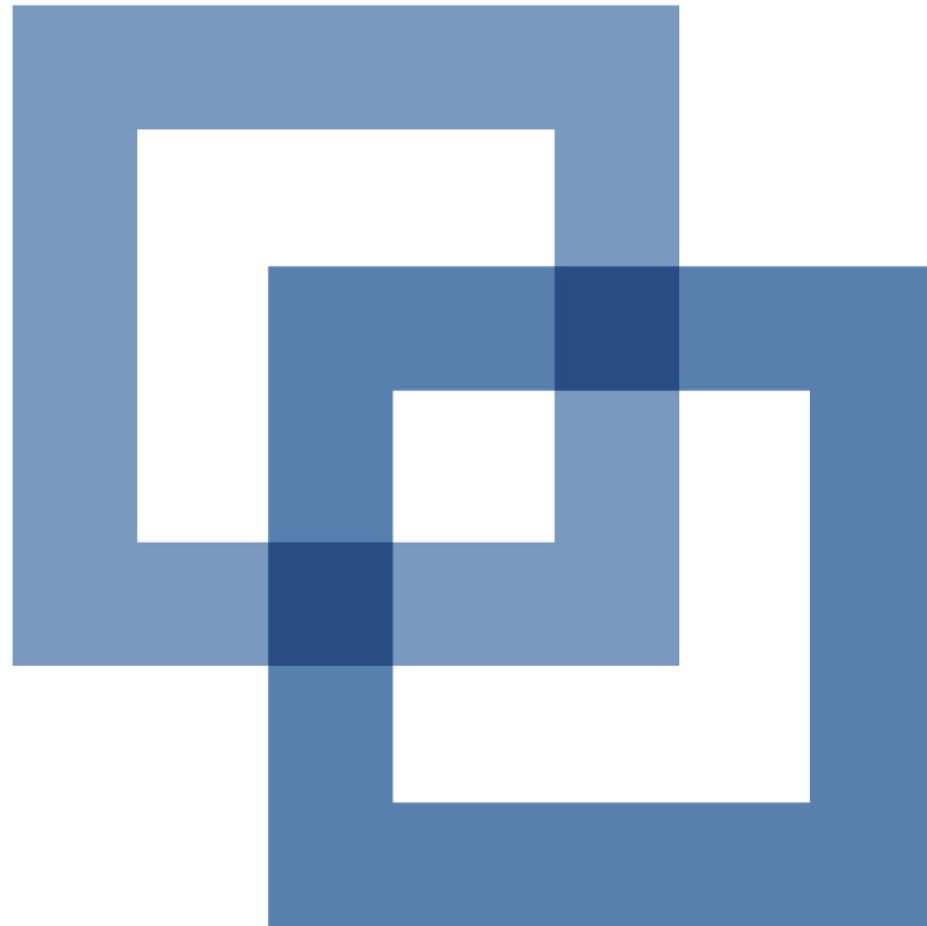
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# Opportunities and risks in credit

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August 2009



# Overview

- Fixed income assets, characteristics and risks
- Where the current opportunity is in fixed income markets
- How to access the credit opportunity



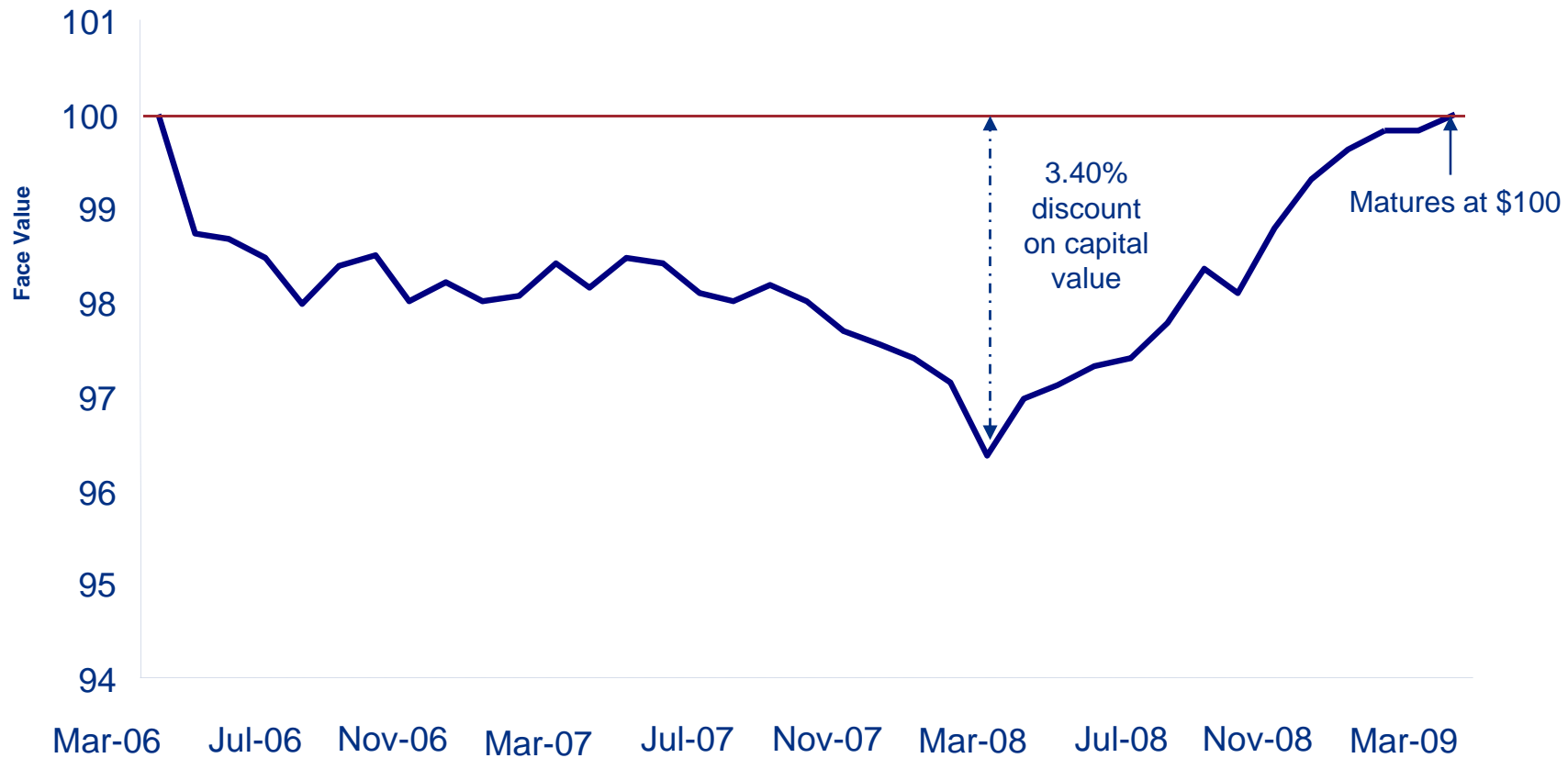
# Key characteristics of fixed income assets

- **Bonds represent borrowing** eg Governments (Govt bonds), corporates (corporate bonds) and mums and dads (RMBS)
- **Face value is the amount borrowed**
- **Investors receive a known return** (principal + coupon) – if they hold to maturity and the security does not default
- **The coupon can be floating or fixed.** The value of fixed coupon bonds are highly dependent on interest rates
- **Bonds are tradable** meaning although the return is known, the path can be volatile
- **The ‘spread’ or return above the risk free rate is dependant on the level of risk**
  - strength of the borrower
  - the tenor
  - secured or unsecured
  - where the debt ranks in the capital structure of the borrower



# Bond returns are highly certain

Coupon @ 6.00%pa and 3.40% pull to par = 9.40% yield in final year



Source: Bloomberg

# What this means for investors

- These characteristics of fixed income assets means:
  - Fixed income assets are generally less volatile than equities
  - They provide a regular and know income stream
  - They are liquid
  - They can be useful for preserving capital



# Drivers of returns in fixed income

- There are two key drivers of returns in fixed income:
  1. **Interest rate duration** - how much the value of the bond changes with interest rates. This is higher for fixed coupon bonds and longer dated bonds
  2. **Credit duration** - how high the perceived risk of the borrower is compared with risk free assets



# Key risks in fixed income

- Default risk
- Spread risk
- Liquidity risk
- Interest rate risk



# In a portfolio context investors can benefit from exposure to defensive assets

## Historic returns

Data from 31 December 1979 to 31 December 2008

	100% Australian equities	50/50 Australian and international equities	Balanced (70% growth)
Return (%pa)	11.7	12.0	11.6
Volatility (%pa)	17.8	13.8	10.1
Worst 1 year return (%)	-40.5	-31.9	-23.4
Worst cumulative 3 year return (%)	-28.0	-30.6	-15.2

Balanced fund asset allocation: 40% Australian equities, 25% international equities, 5% property, 20% fixed interest, 10% cash. Buy/sell spreads for rebalancing assumed to be 0.30% each way on Australian equities, international equities and property and 0.1% each way on Australian fixed interest.

Source: Datastream, Mercer, IRESS.



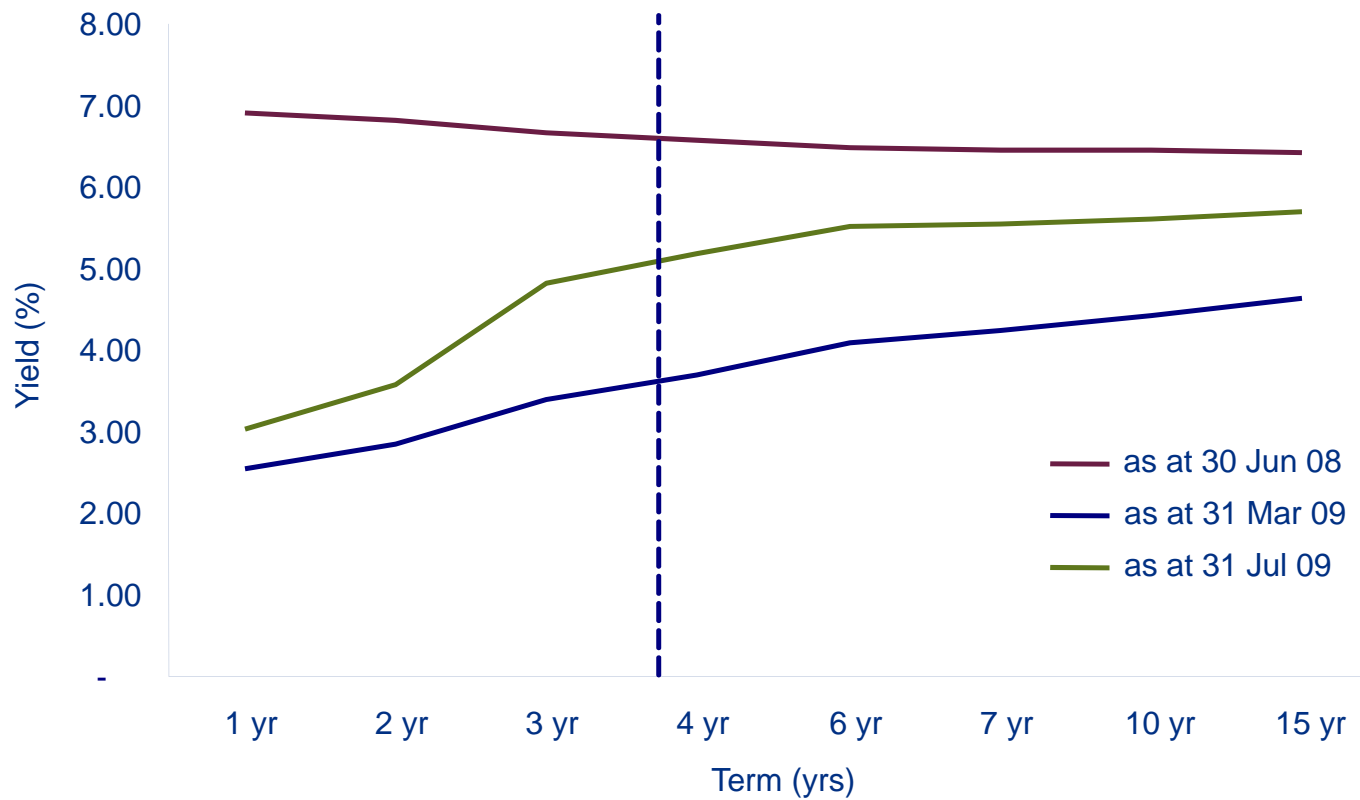
# So where is the opportunity right now?

- In our view exposure to interest rate duration (fixed coupon bonds) is less appealing at present due to the risk of interest rates rising
- Credit on the other hand offers a compelling opportunity if:
  - Investors are being compensated for any perceived increase in default risk
  - The running yield is high enough to absorb future spread widening
  - Investors time horizon is similar to the weighted average life of the portfolio
- The best risk / reward profile is investment grade securities



# Fixed coupon bonds are relatively less attractive

Australian treasury yield curve

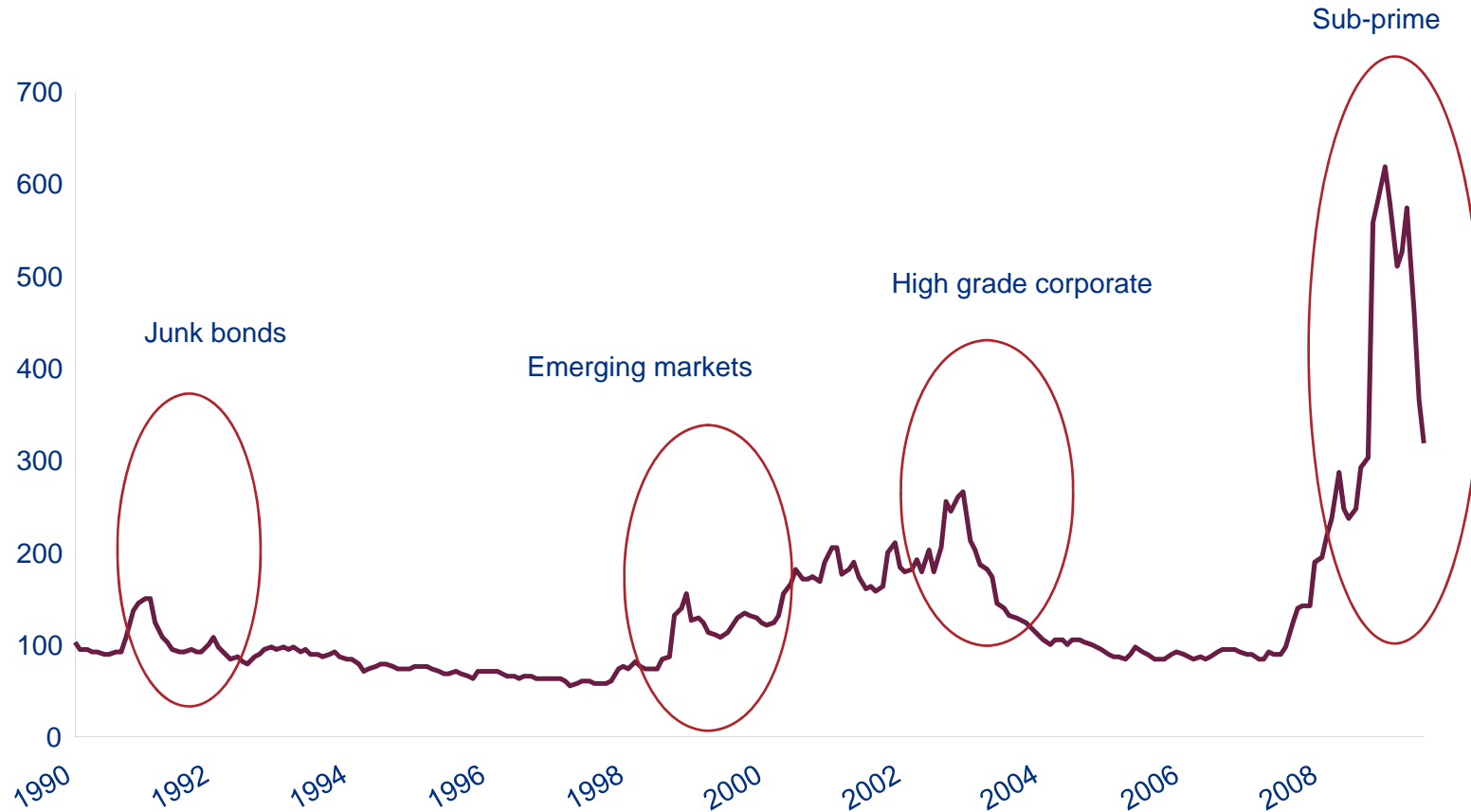


Source: Bloomberg, RBA – Aug 2009



# Credit spreads are still at all time highs

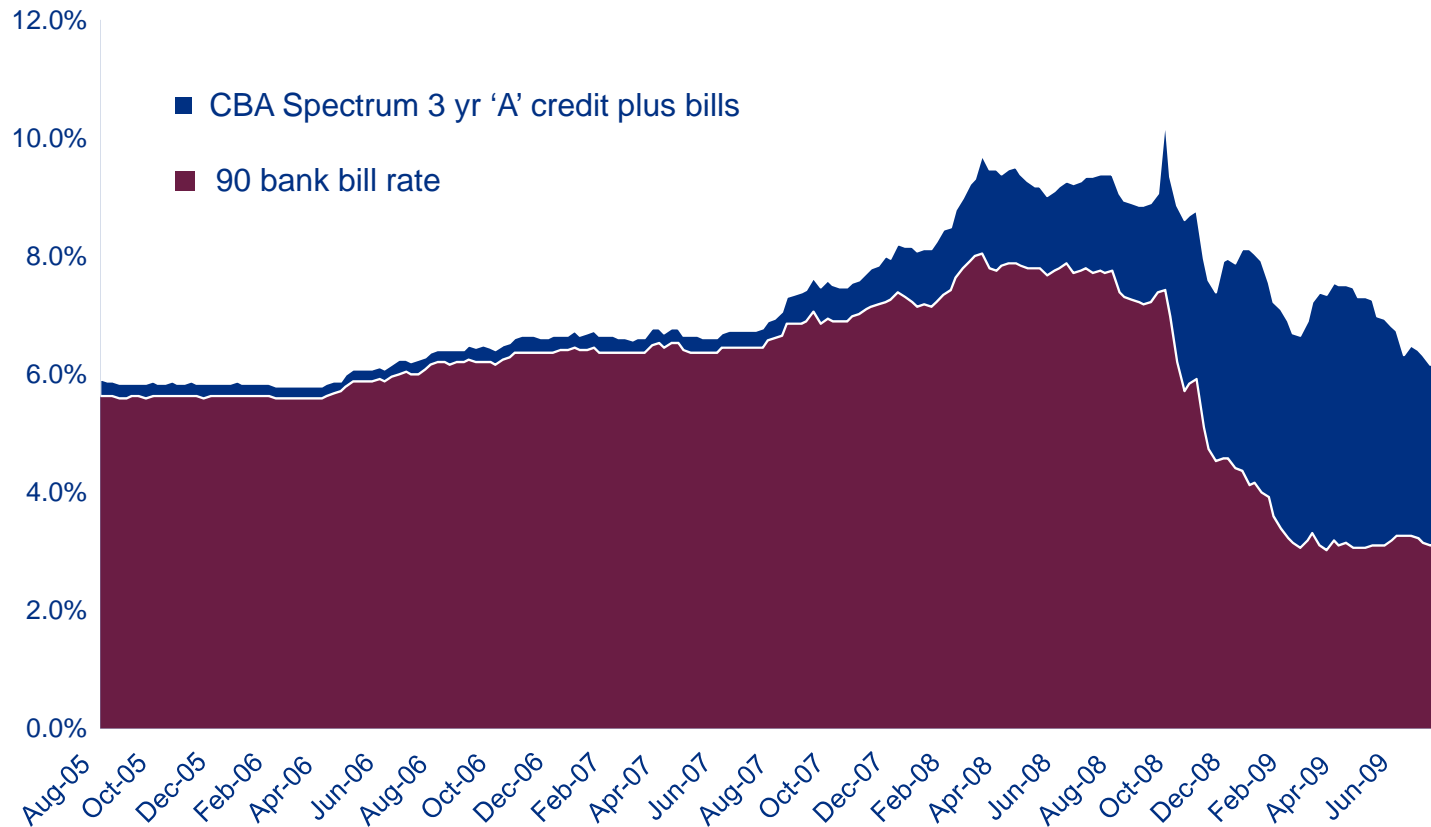
Credit market cycles – Investment grade credit spreads 1990-2009



Source: Bloomberg, Citigroup, Merrill Lynch



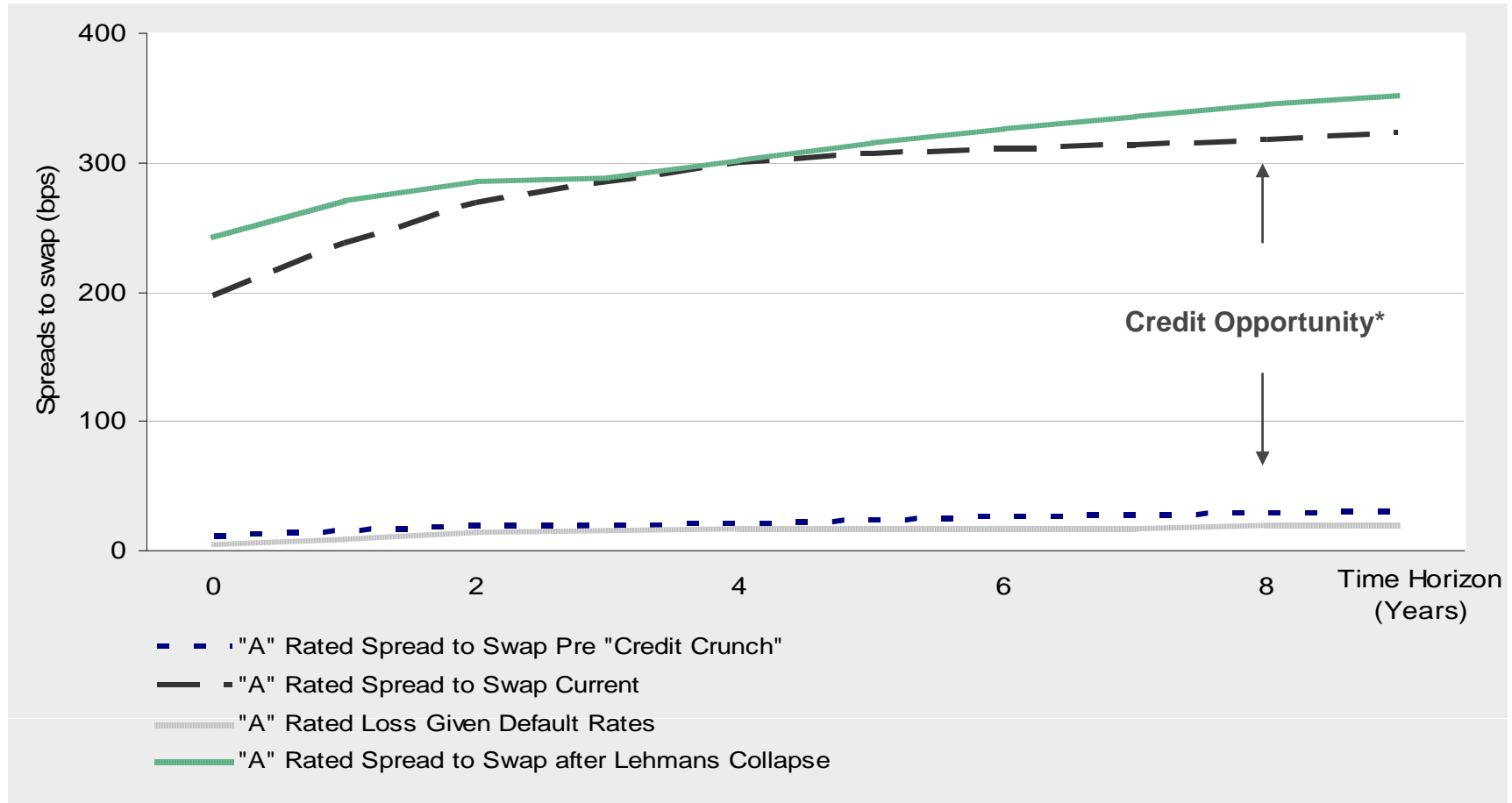
# The reward for taking credit risk is also high



Source: Bloomberg, CBA. Pre fees, pre tax.



# Current credit spreads more than compensate for historical default rates



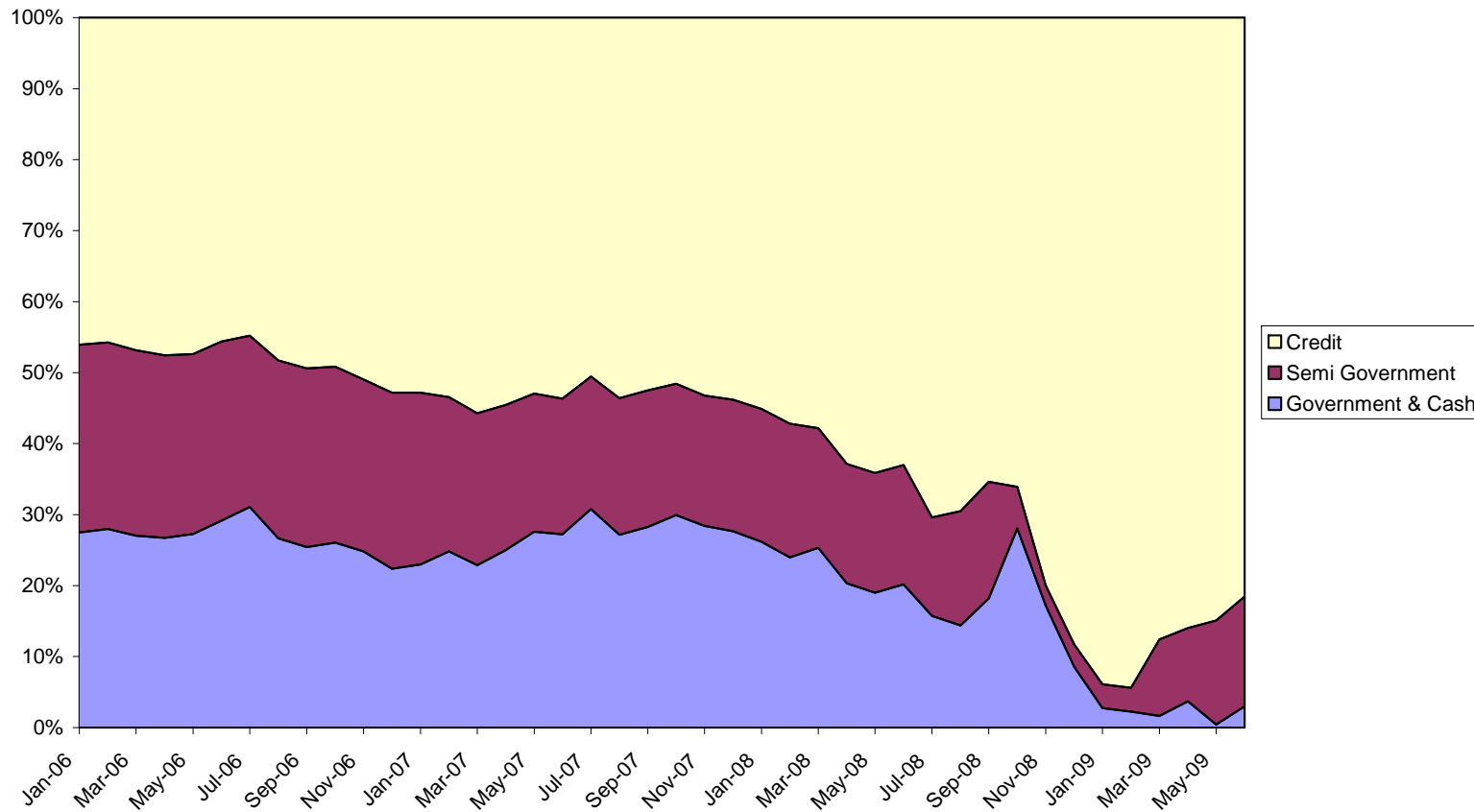
Source: Moody's Corporate Study for 1970-2006, Feb 07, CBA Spectrum

\* Loss Given Default Curve assumes 50% recovery rate



# What we have been doing in our balanced portfolios

Australian fixed interest - sector exposure over time



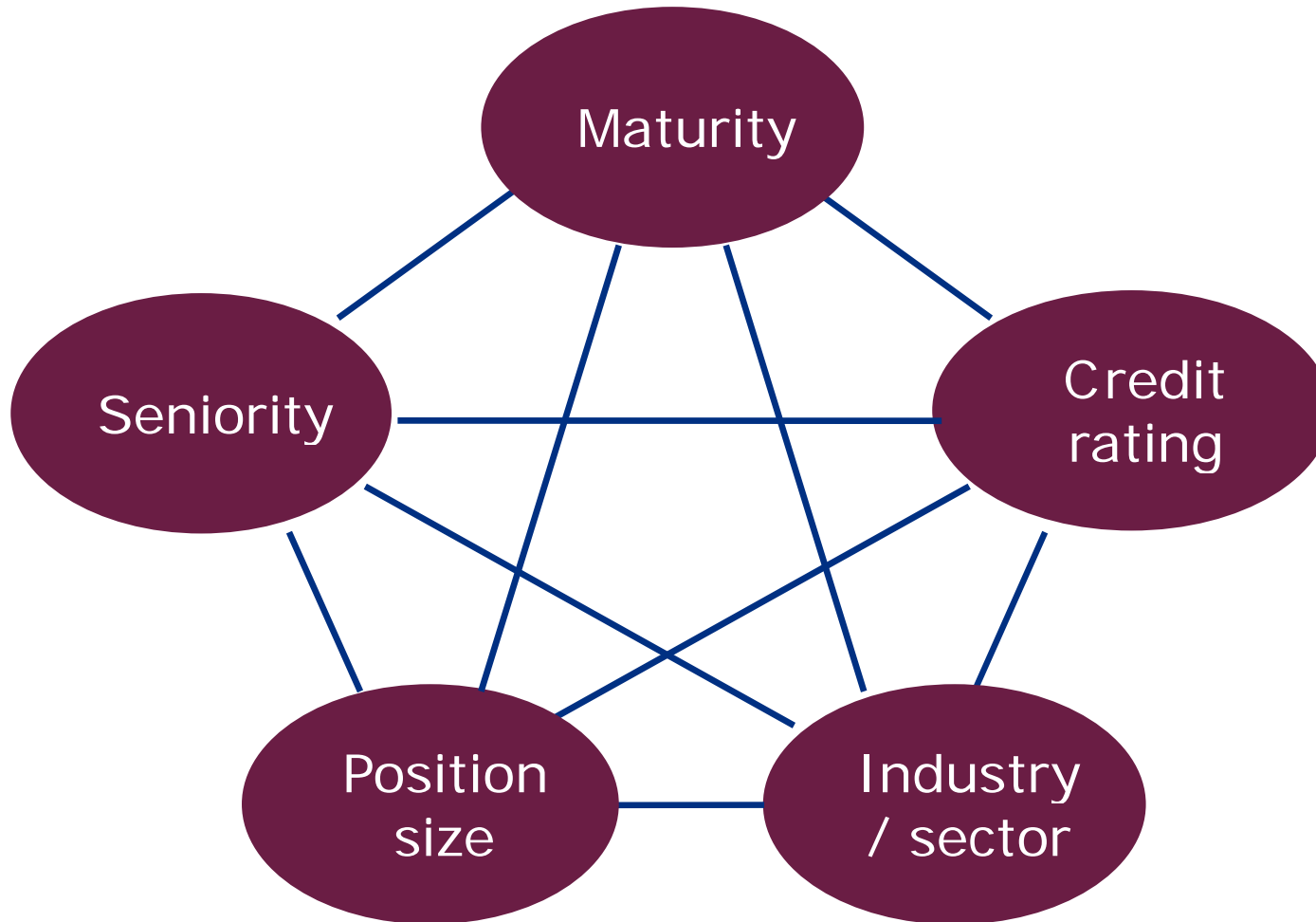
Source: Perpetual

# Why a managed fund is the best way to access this opportunity

- **Access** – Minimum parcel size for credit securities is \$500,000. Given a prudent investor would have at least 100 securities they would need at least \$50m!
- **Global assets** – a broader universe of securities is available globally
- **Diversification** – A well diversified credit portfolio should hold at least 100 names meaning at current spreads any one default would not affect capital values
- Hybrid securities are not an investment grade universe of securities
- **Relative value** – there are opportunities to buy less risky securities for higher spreads
- **Risk management** – Many factors affect the valuations of credit securities which are best monitored and managed by a professional manager



Risk in credit is multi-dimensional and requires expertise



# Recent credit investment opportunities

## Tabcorp

- Retail ASX listed bond issued on 30/4/09
  - 5yr Senior bond
  - BBB+ rated
  - Credit spread of 425bps
  - Our risk score is 1.84
- We purchased a Oct 2010 Tabcorp bond
  - 2.5yr Senior bond
  - BBB+ rated
  - Credit Spread of 385bps
  - Our risk score is 0.53

## Bank of Queensland originated RMBS

- Reds 2009-1 A1 issued on 9th April
  - Senior secured
  - WAL of 4.2yrs
  - AOFM purchased at 130bps
  - Our risk score is 0.04
- We purchased Reds 2006-1EA2 on 24<sup>th</sup> April
  - Senior Secured
  - WAL of 4yrs
  - Credit Spread of 350bps
  - Our risk score is 0.03

Source: Perpetual



# Summary

- There are definite portfolio benefits of holding quality fixed income assets
- Returns are highly predictable for fixed income assets
- On a relative basis, credit markets currently present compelling value
- A investment grade credit fund is the best way of accessing the current opportunity
- Want to learn more? Come to the “Old lessons re-learned for income investors” presentation at the PortfolioConstruction conference (“Of Interest” stream)



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