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Fixed income

Old lessons re-learned for income investors

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Role of fixed income in a portfolio

- The role of fixed income in a portfolio
  - a fixed or floating rate of interest (coupon)
  - a fixed maturity date
  - a return of capital (at par) upon maturity
  - tradeable on the secondary market
- These characteristics assist investors in three main ways:
  - they make fixed interest a less volatile asset class than equities
  - the provide a regular income stream
  - preservation of capital

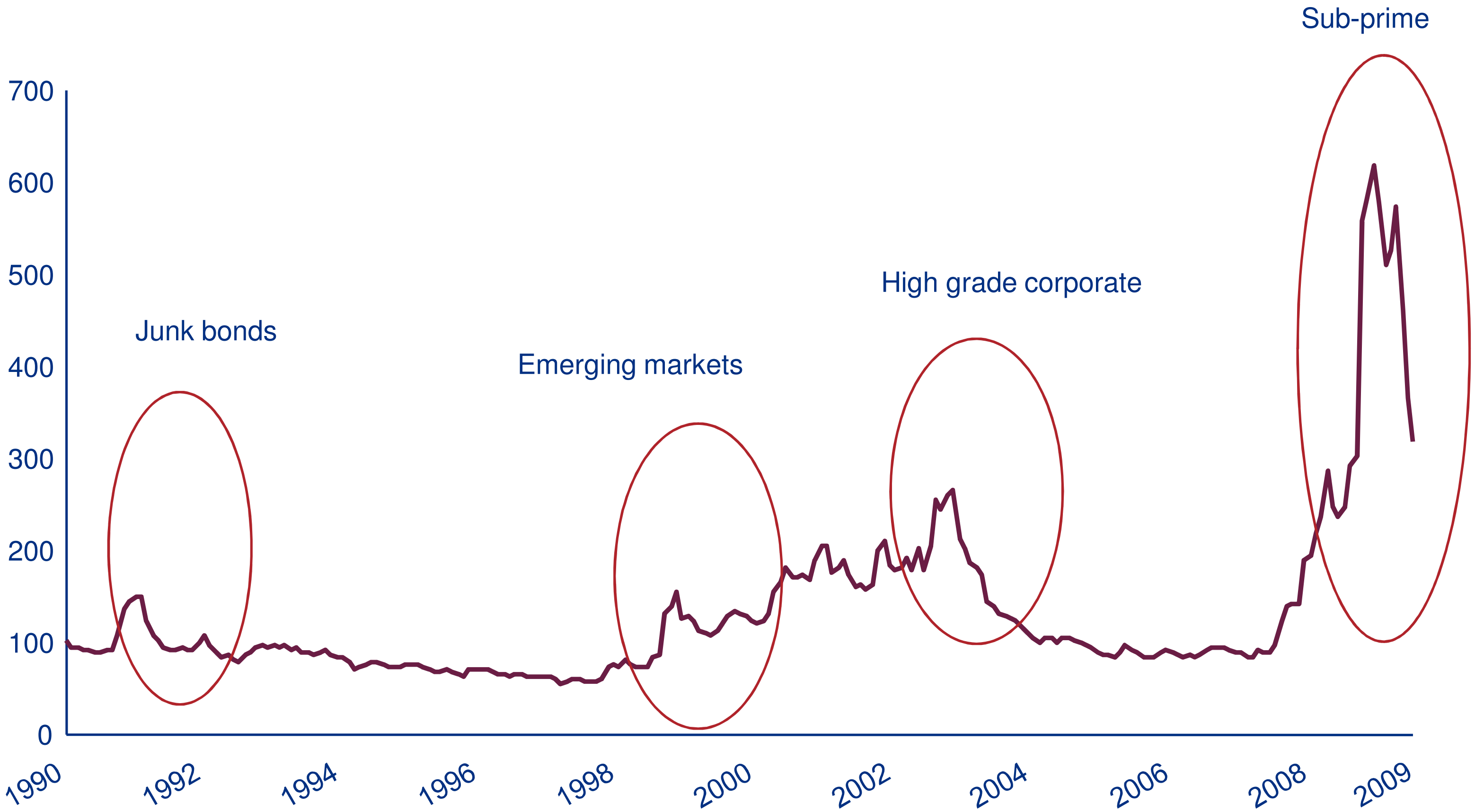
Fixed income lessons investors forgot

Some fixed income funds performed like equities

- Investor sentiment was opportunistic, risk seemed a historical concept
- Product development primarily completed at historical low credit margins
- Credit ratings used benign, historical default rates and inadequate methodology
- A lack of understanding by investors (and arguably other parties) fuelled this
- Illiquidity was not properly factored in

Credit markets are cyclical

Credit market cycles – Investment grade credit spreads 1990-2009



Source: Bloomberg, Perpetual – July 2009

Is it time to re-think risk management in fixed income?

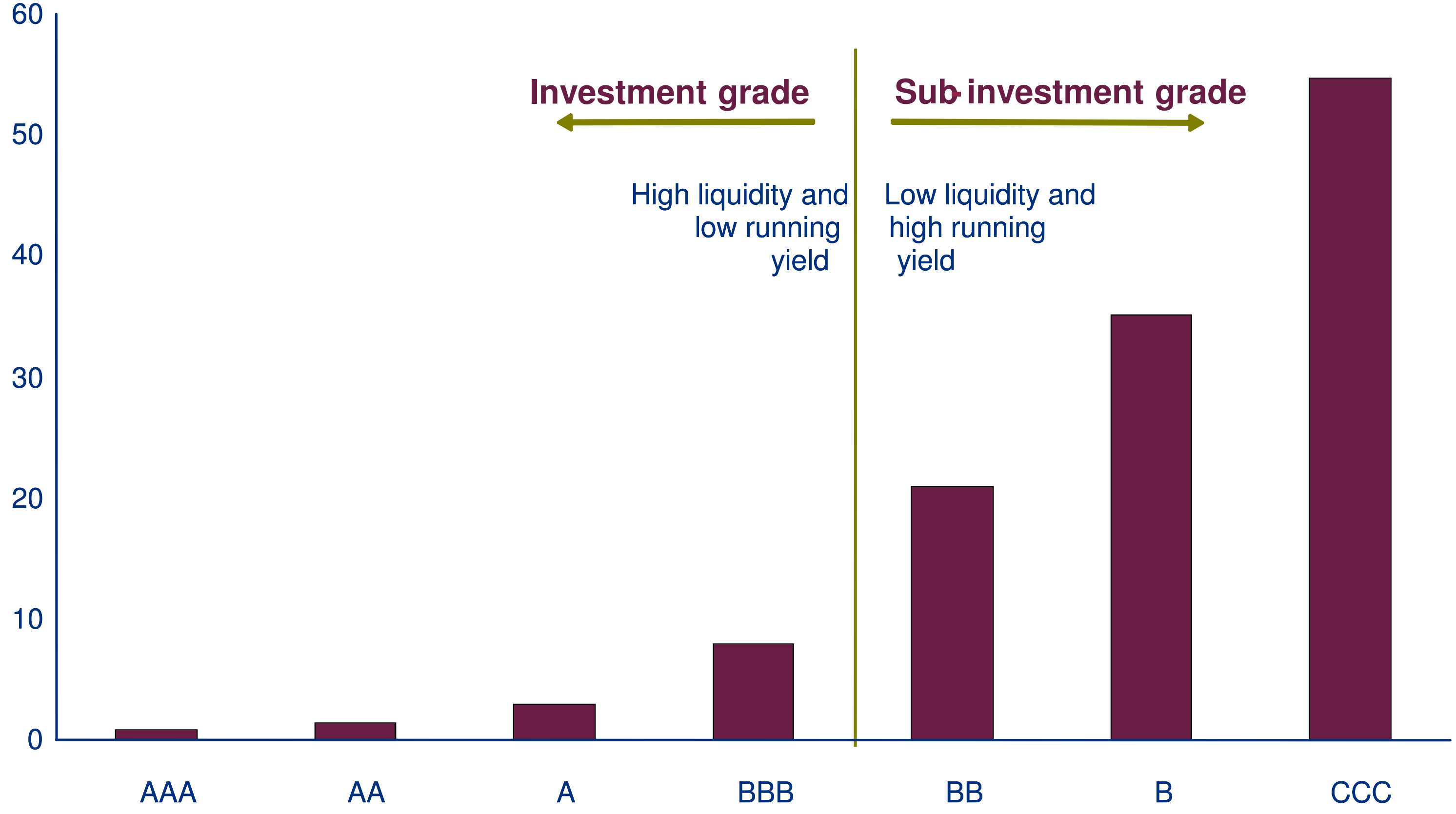
- Not necessarily, in fact one could argue it's **back to basics**
  - focus on downside risk (default)
  - investing in quality assets that are transparent and understandable
  - properly valuing liquidity
  - achieving appropriate diversification (not just issuer, but also sector and type)
  - actively manage credit spreads and interest rate duration

These are not new lessons, in fact they've always been key principles of Perpetual's approach to fixed income. However in periods of sustained bull markets, across practically all investment types and asset classes, it is easy to forget the fundamentals.

Evaluating risk – credit risk

15 year cumulative average default rates (%)

Standard & Poor's survey of rated corporate obligations (1981 – 2008)



Source: Standard & Poors – Apr 2009

Perpetual risk score:	0.1	0.35	0.80	1.80	3.80	5.00	5.00
S&P	7	20	50	250	1,000	4,000	8,000

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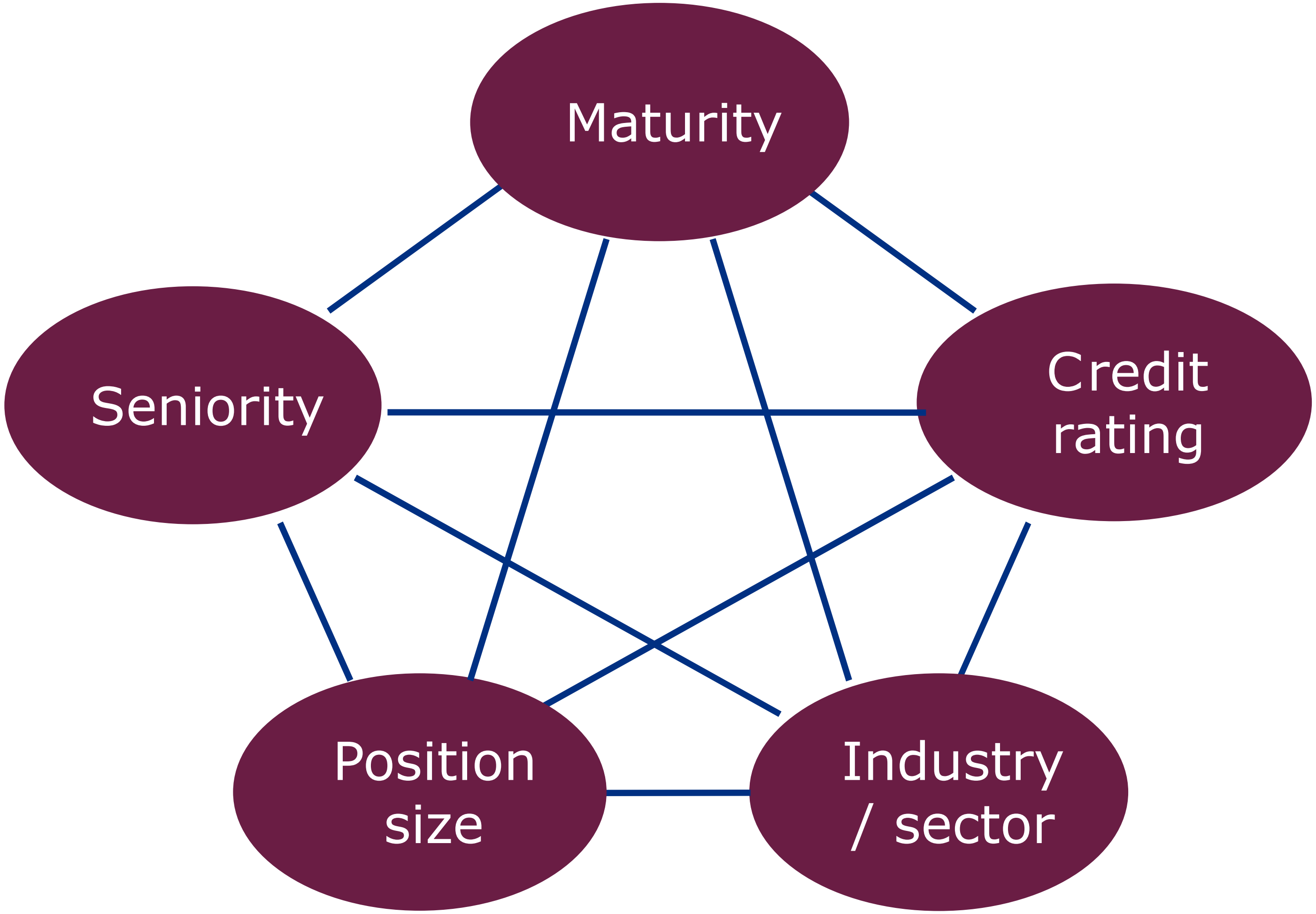
Evaluating risk – security related risks



Evaluating risk – example of security decision

New issuance – April 2009

Tabcorp Retail ASX listed bond

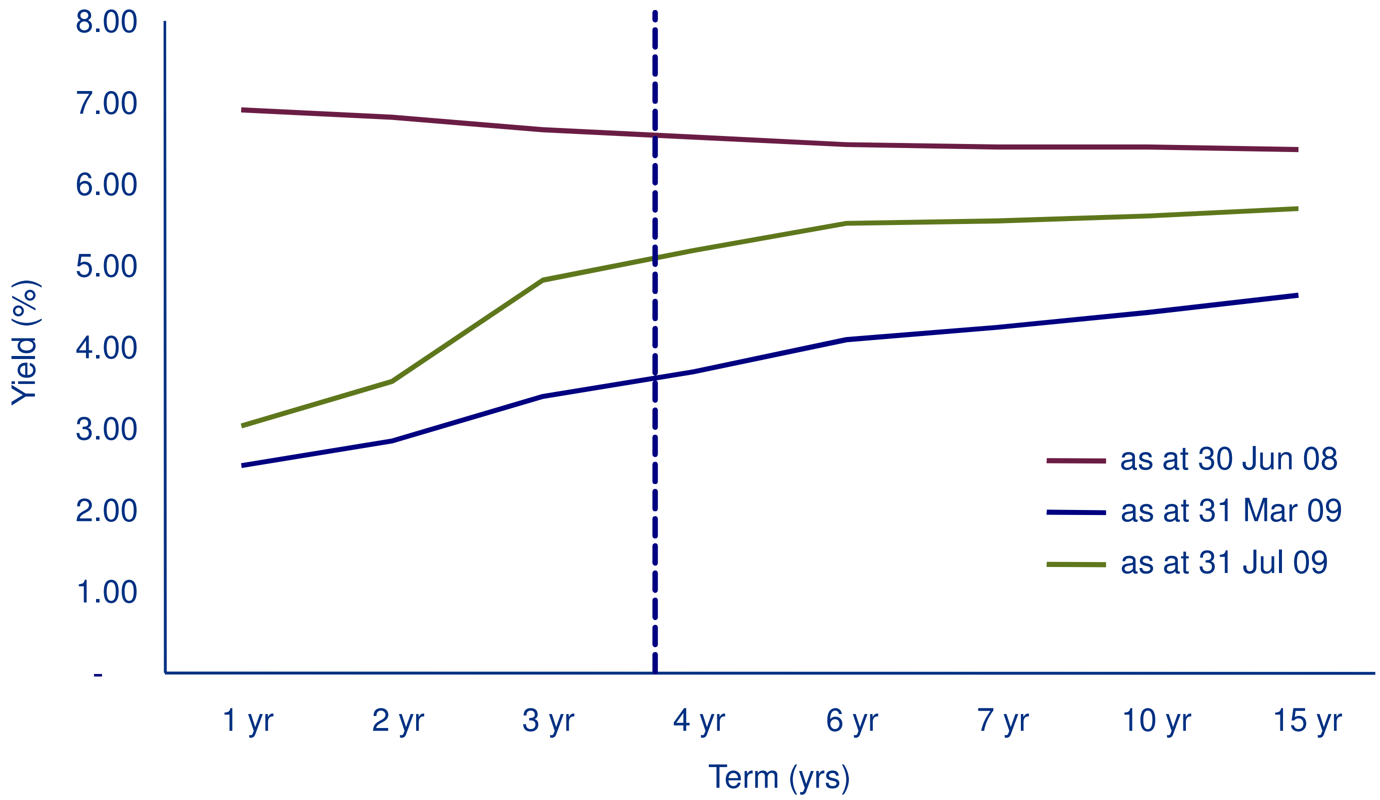
- 5yr senior bond
- BBB+ rated
- Credit spread of 425bps
- Perpetual risk score was 1.84

Preferred secondary market offer

Tabcorp bond – Oct 2010 Maturity

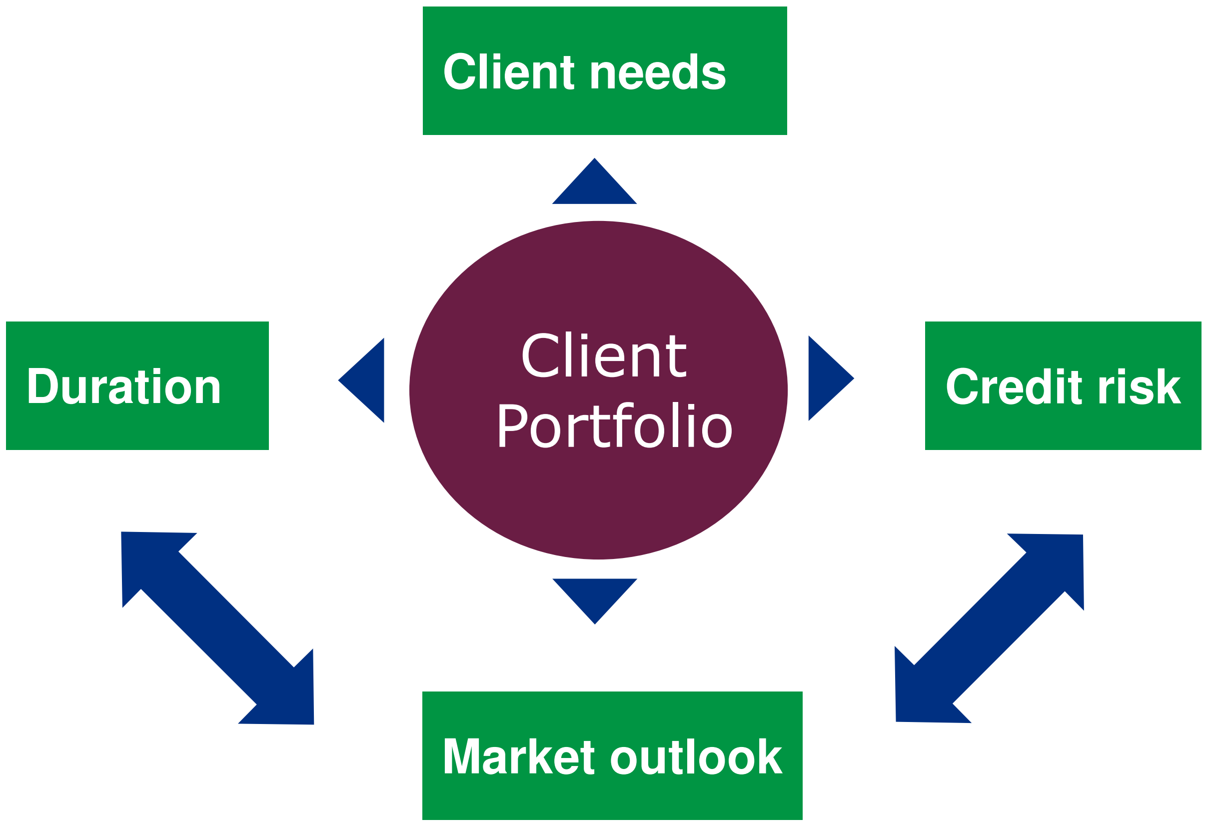
- 2.5yr senior bond
- BBB+ rated
- Credit spread of 385bps
- Perpetual risk score was 0.53

Evaluating risk – duration risk
Australian treasury yield curve



Source: Bloomberg, RBA – Aug 2009

Key building blocks for defensive portfolios



What does a good defensive portfolio look like?

- Establish specific criteria
  - What are the client’s immediate liquidity needs?
  - What is the client’s investment horizon?
  - What is the client’s appetite for volatility?

- Consider the alternative sources of return and evaluate risks
  - Cash
  - Bonds – fixed rate (carry interest rate risk and credit risk)
  - Credit – floating rate (carry credit risk but not sensitive to interest rates)
  - Global vs domestic and more volatile alternatives like hybrids and syndicated loans

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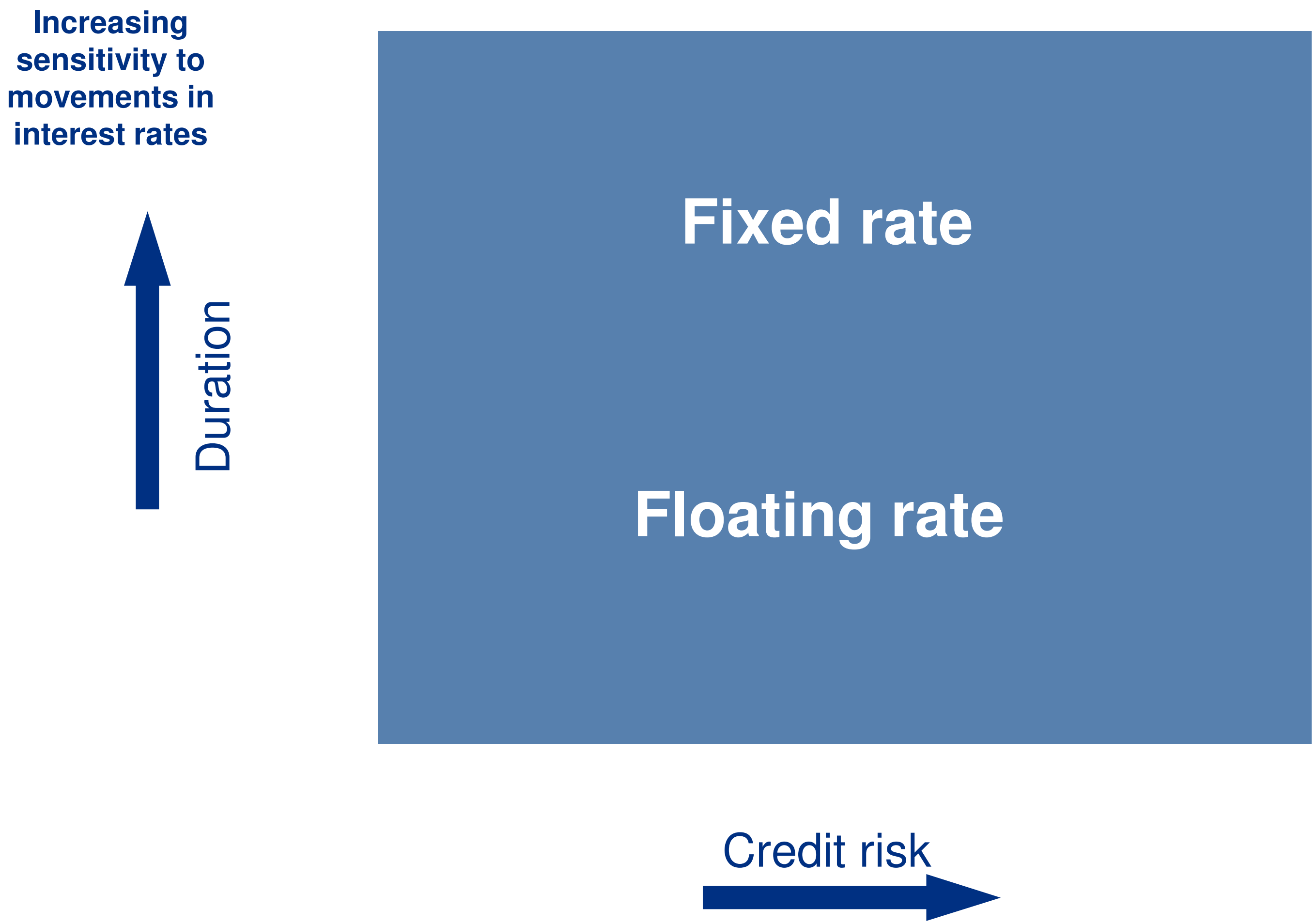
Understanding your defensive portfolio



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What do you have to know about fixed income?

Debt securities can be issued as fixed or floating interest rate securities

- **Fixed rate** securities are typically issued by govt, semi-govt and corporates
- Tend to be benchmarked to **UBSA Composite Bond Index** (duration of > 3yrs)
- Sensitive to both interest rate movements and credit risk

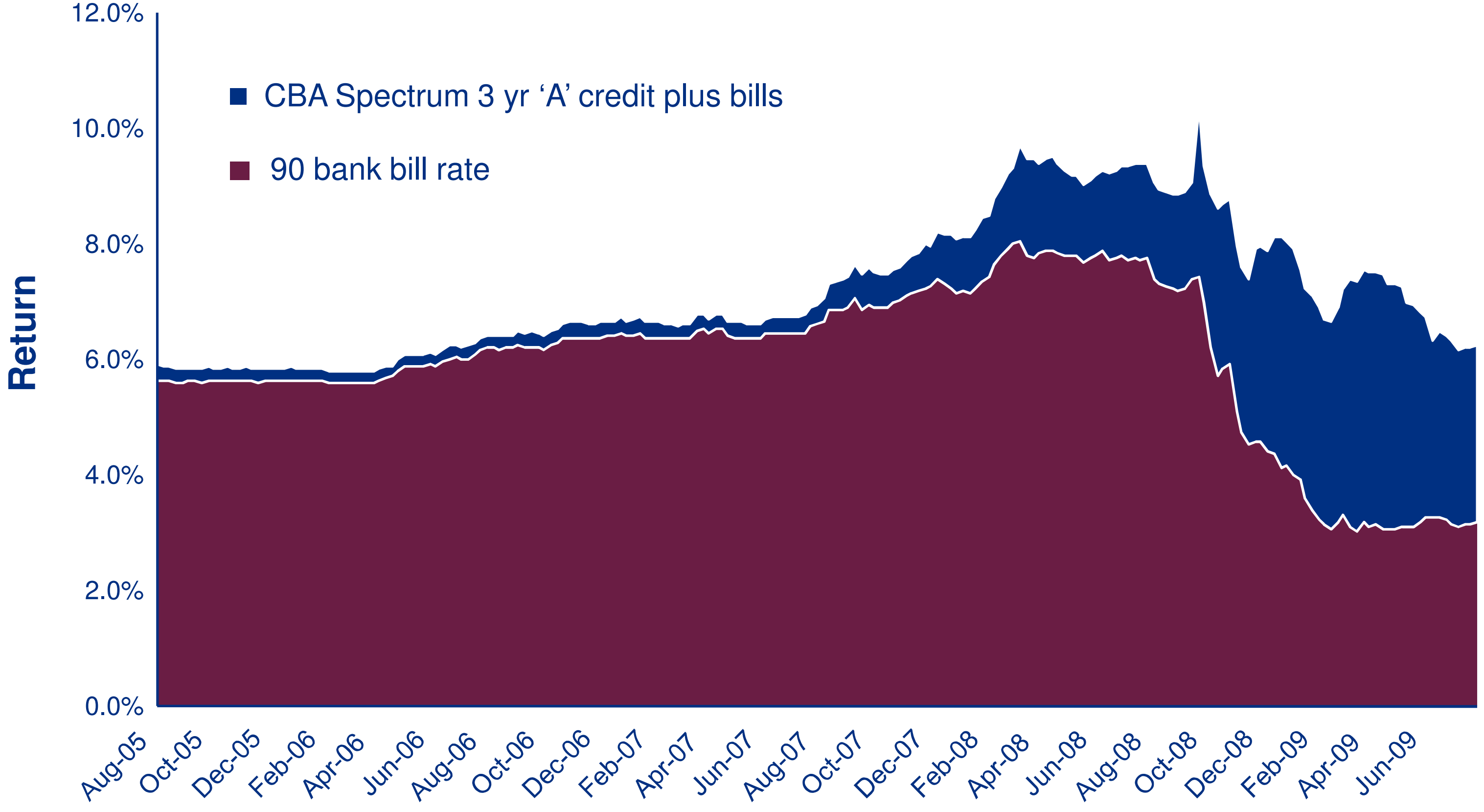
- **Floating rate** securities are typically issued by corporates, asset backed
- Tend to be benchmarked to **UBSA Bank Bill Index** (Duration of > 0.1yrs)
- Sensitive to credit risk but little sensitivity to interest rates

The term (or maturity) of a security will impact the sensitiveness of a debt security to changes in interest rates/credit spreads. The longer the term, the greater the impact.

Understanding your defensive portfolio

The return for taking on credit risk is unusually high

Average 'A' rated corporate credit spreads (Aug 05 – Jun 09)



Source: Commonwealth Bank Research, Perpetual – Aug 2009

Summary – main points to remember

- Risk management is critical in fixed income. The keys to success are:
  - to select high quality securities and use caution for riskier assets
  - properly valuing default risk and liquidity
  - portfolio diversification
  - active management
- Fixed income returns are highly predictable – remember the pull to par concept. Invest with three main goals in mind:
  - capital preservation
  - producing a consistent income stream
  - maintaining liquidity

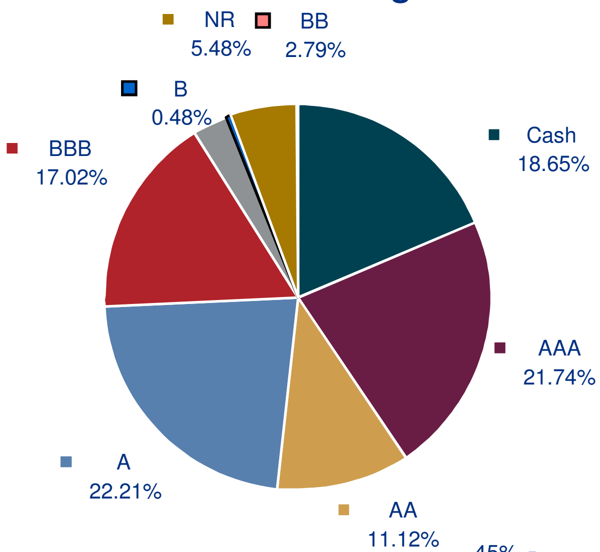
High quality, diversified portfolios should deliver strong predictable returns

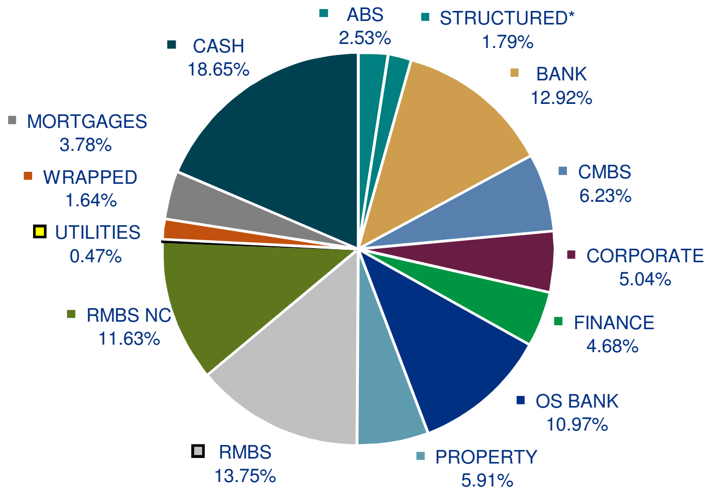
Perpetual's Wholesale Diversified Income Fund

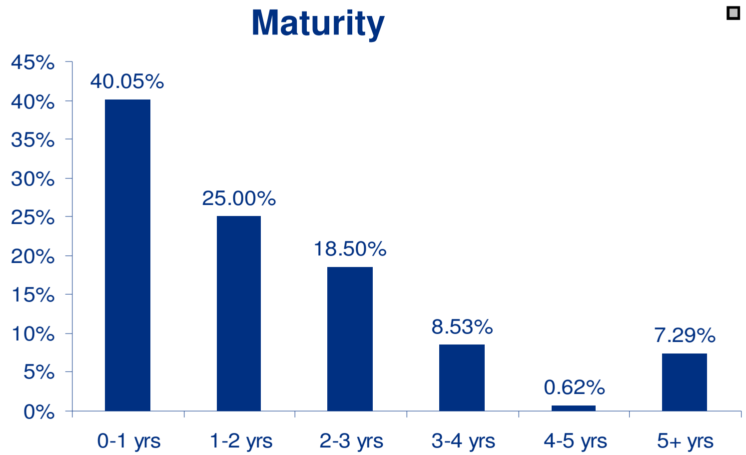
- Broad investment strategy and active approach
- Floating rate portfolio = Little interest rate sensitivity (0.1 years duration)
- Focus on investment grade securities, and the top of the capital structure
- High levels of diversification
- High liquidity = remained open throughout credit crisis
- Experienced, disciplined and risk aware team

Quality and diversification

Portfolio characteristics as at 30 June 2009







* Prior to Aug-07 Structured recorded as part of ABS

Source: Perpetual – July 2009

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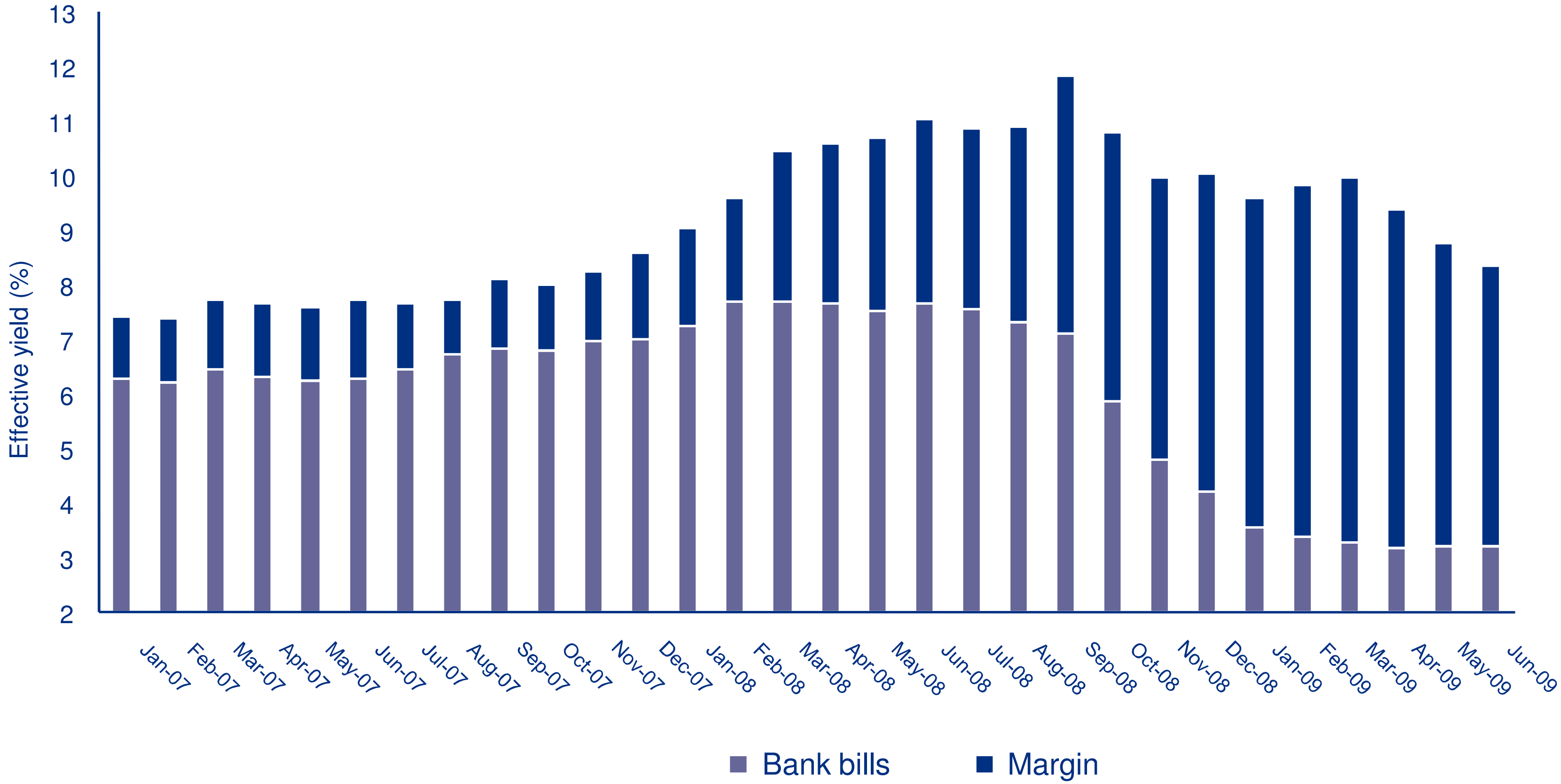
Historical running yield

At 30 June the portfolio running yield was 8.35% and the average margin to bills was 5.15%
Portfolio weighted average maturity = 2.2 years



Source: Perpetual – July 2009

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