Portfolio Construction Forum

Investing across the capital structure

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Corporate capital structure

Same issuer default risk – but different recovery

Defensive

Growth

Capital structure		
Government Guaranteed		100% on application to the Commonwealth Government
Bank Loans / Secured Debt		First right of recourse over assets
Unsecured	–**Senior**	Most corporate bonds in this category. Depends on degree of subordination
	–**Subordinated**	… back in the queue
Capital Securities	–**Hybrids**	Primarily non-financial corporate issuers
	–**Tier 1 & Tier 2**	Primarily banks & insurers for regulatory purposes
	–**Sub / Mezzanine**	Just above equities. Limited recourse. May not get a seat at work-out table
Convertibles		Similar to equity
Equity		Last in line

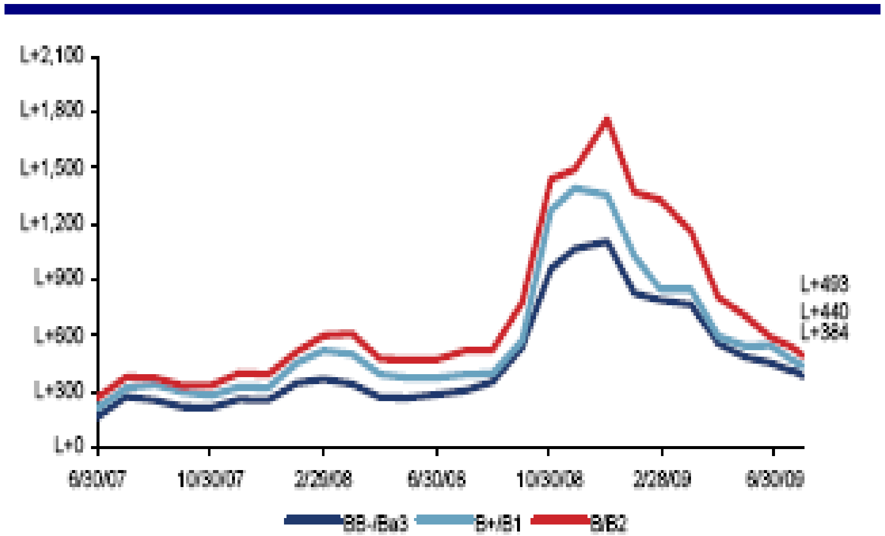
Source: Schroders

Bank Loans / Secured Debt

High in the capital structure but not without risk

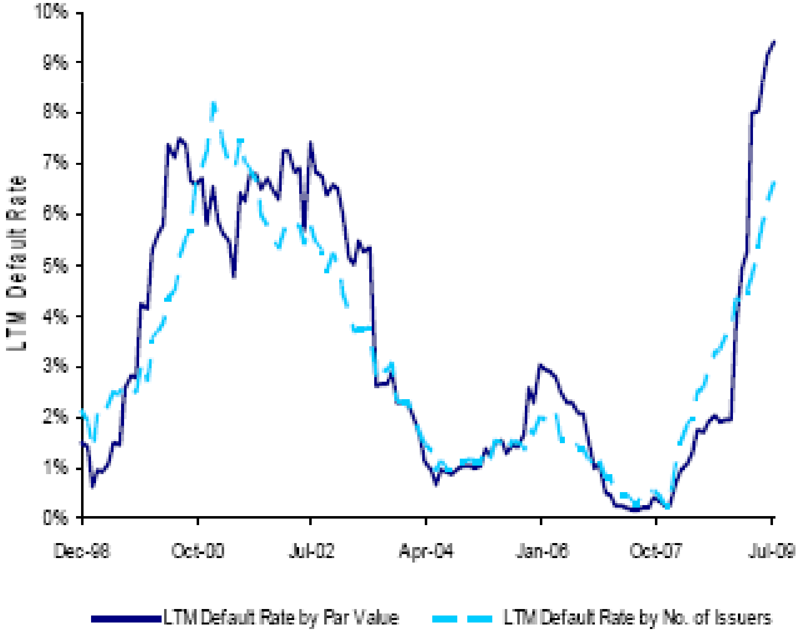
- Difficult to access
- Typically syndicated or via structured (CLO's)
- Poor visibility / lack of choice
- Poor mark to market
- Quality drift (LBO explosion)
- Embedded costs / Agency Risks

Bank Loan Secondary Spreads



Source: Bloomberg, GS Internal, S&P LCD News

LCD Loan Default Rates



Source: S&P LCD Loan Stats Weekly

The default rate by amount outstanding is now at decade highs

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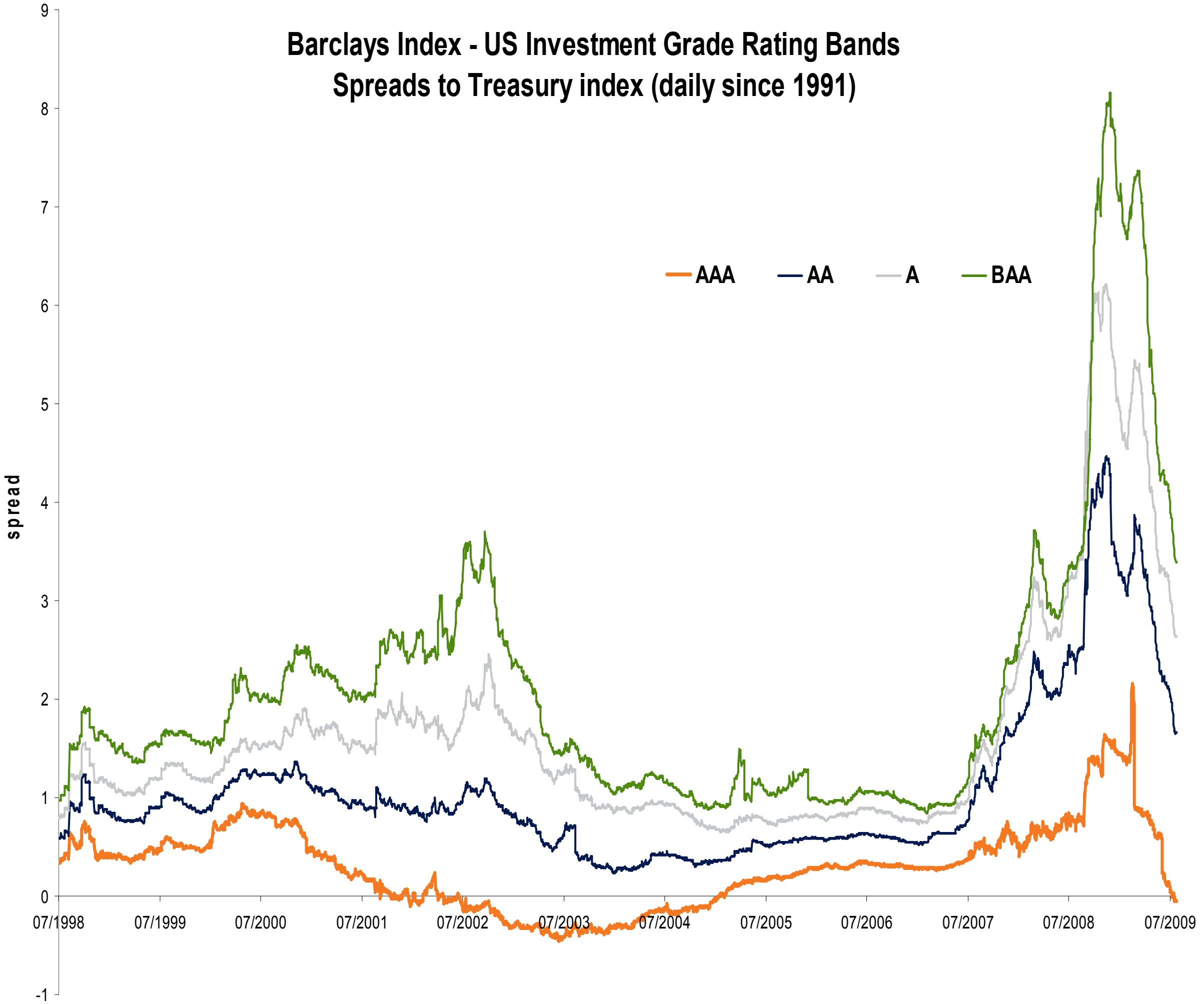
Source: Goldman Sachs

Unsecured debt (senior and subordinated)

Most corporate bonds

- Liquidity returning
- Breakdown of investment banks means now transacti based (little or no facilitatior books)
- Shift of constituents (banks now AA – but effectively guaranteed)
- Risk premium collapsed fro wides. Elevated defaults levels priced in.



 Source: Schroders, Datastream

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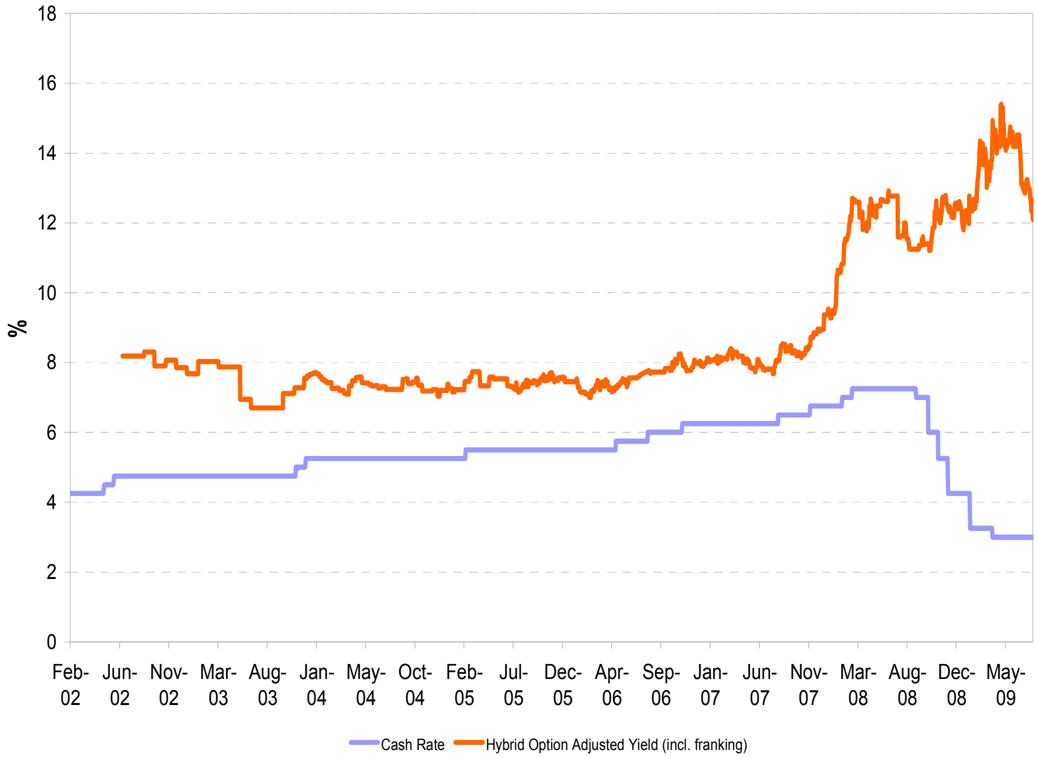
Capital securities
Hybrids remain attractive

- Issuance can support credit rating and avoid equity dilution
- Structural flexibility will enable tailoring (franking)
- Potential capital charge advantages
- Price transparency & liquidity due to ASX listing
- Market over-reacting to extension risk
- Under-owned by institutions / over-owned by retail
- Valuations supportive (esp. v cash)

Australian hybrids yield vs Cash rate



Source: Schroders, Datastream

Source: Schroders

Capital securities

Tier 1 bank debt oversold in Australia

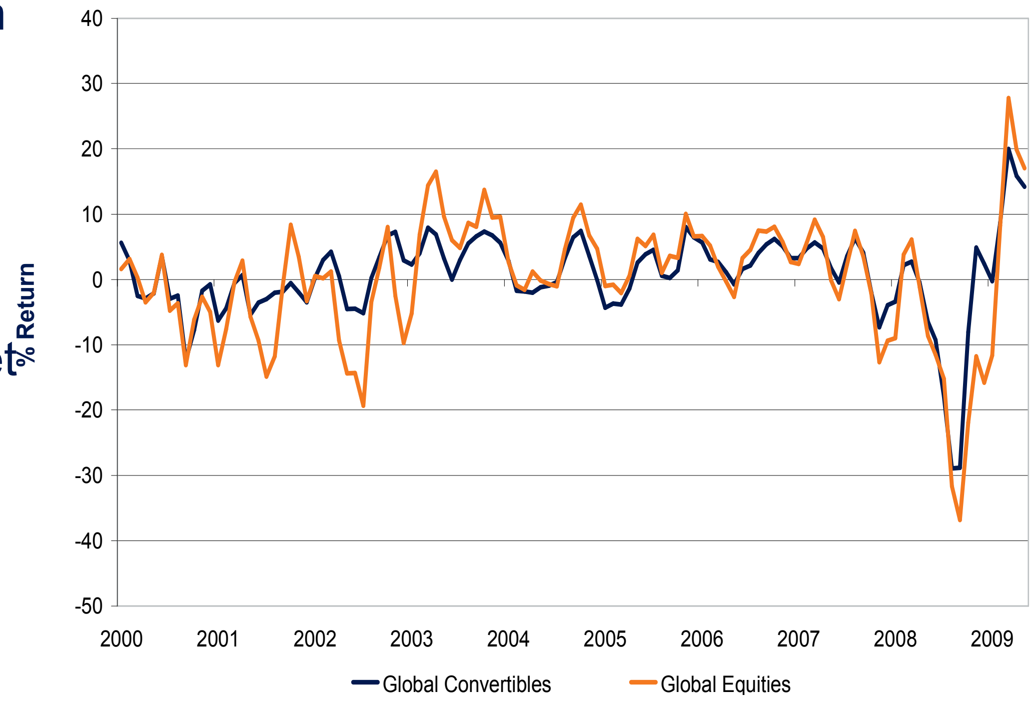
- Australian Tier 1 bank debt trading 70-95 cents, average spread 900bp over
- US/Europe Tier 1 – wide dispersion trading at 30 - 90 cents depending on issuer and structure
- Concerns capital restructuring will wipe out equity and see tier capital convert to equity or become perpetual
- Not likely to happen to Aussie banks in our view
- Case by case for offshore names

Global convertibles

More equity than debt

– Equity like returns due to high equity delta
– Higher in the capital structure
– Convertible bonds sold off substantially more than the bond market despite the asset class offering bond-like protection with upside optionality

3 month rolling returns
Global Equities vs Global Convertibles



Source: Schroders

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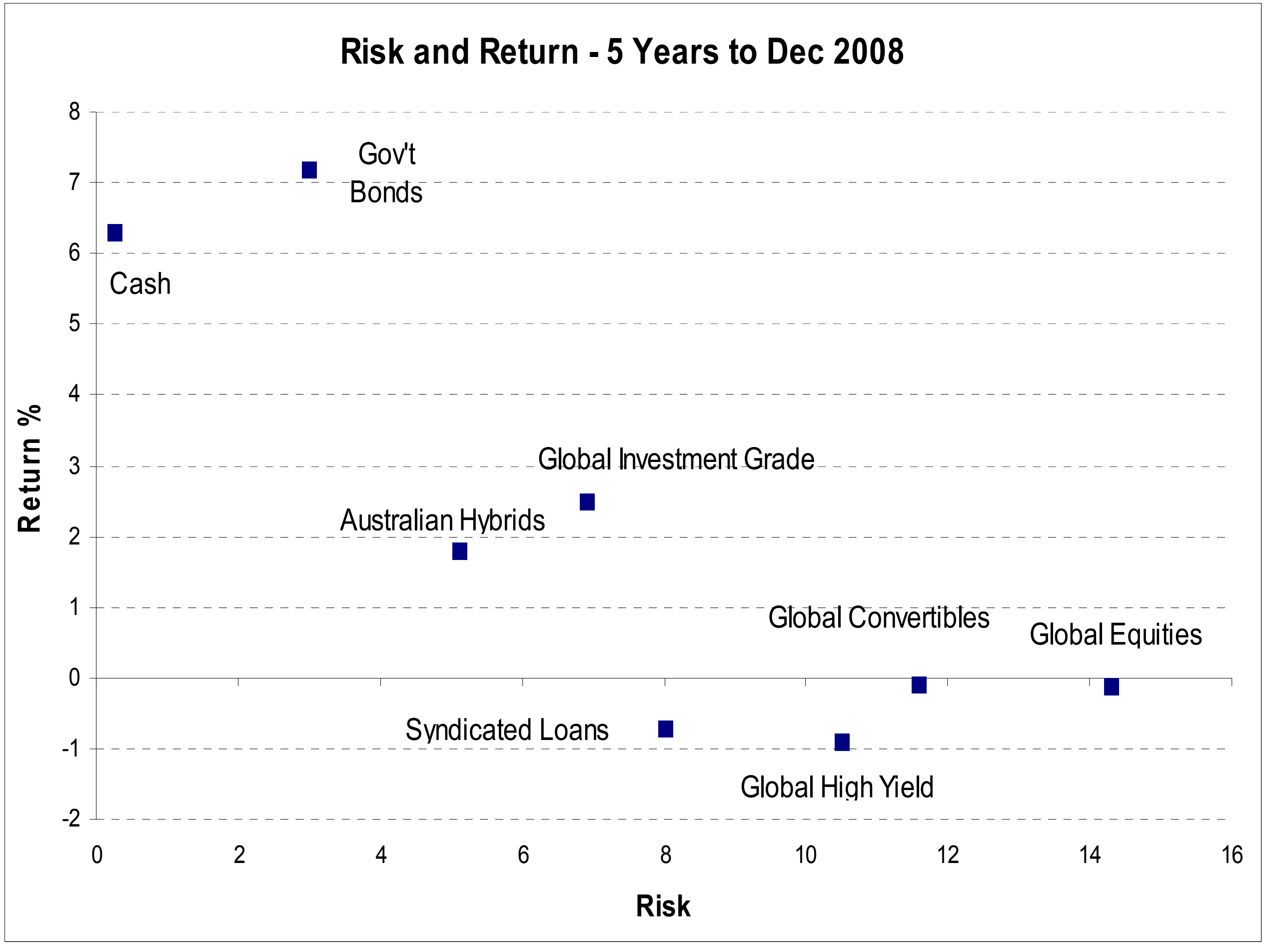
Investment characteristics

Risk and return comparison



Proxies: Are hedged back to in AUD. Global Investment Grade Credit = B Global Inv Grade; Global Convertible = ML Global Conn; Australian Government Bonds = UBS Govt Bond Index; Global High Yield – BG High Yield; Hybrids = Schroder Hybrid Securities Fund; Global Equities = MSCI World ex Aus. Syndicated Loans = S&P/LSTA

Risk is calculated as the standard deviation of monthly returns. Return is annualised performance over the 5 year period.

Different parts of the capital structure exhibit different risk return dynamics

Source: Schroders, Datastream

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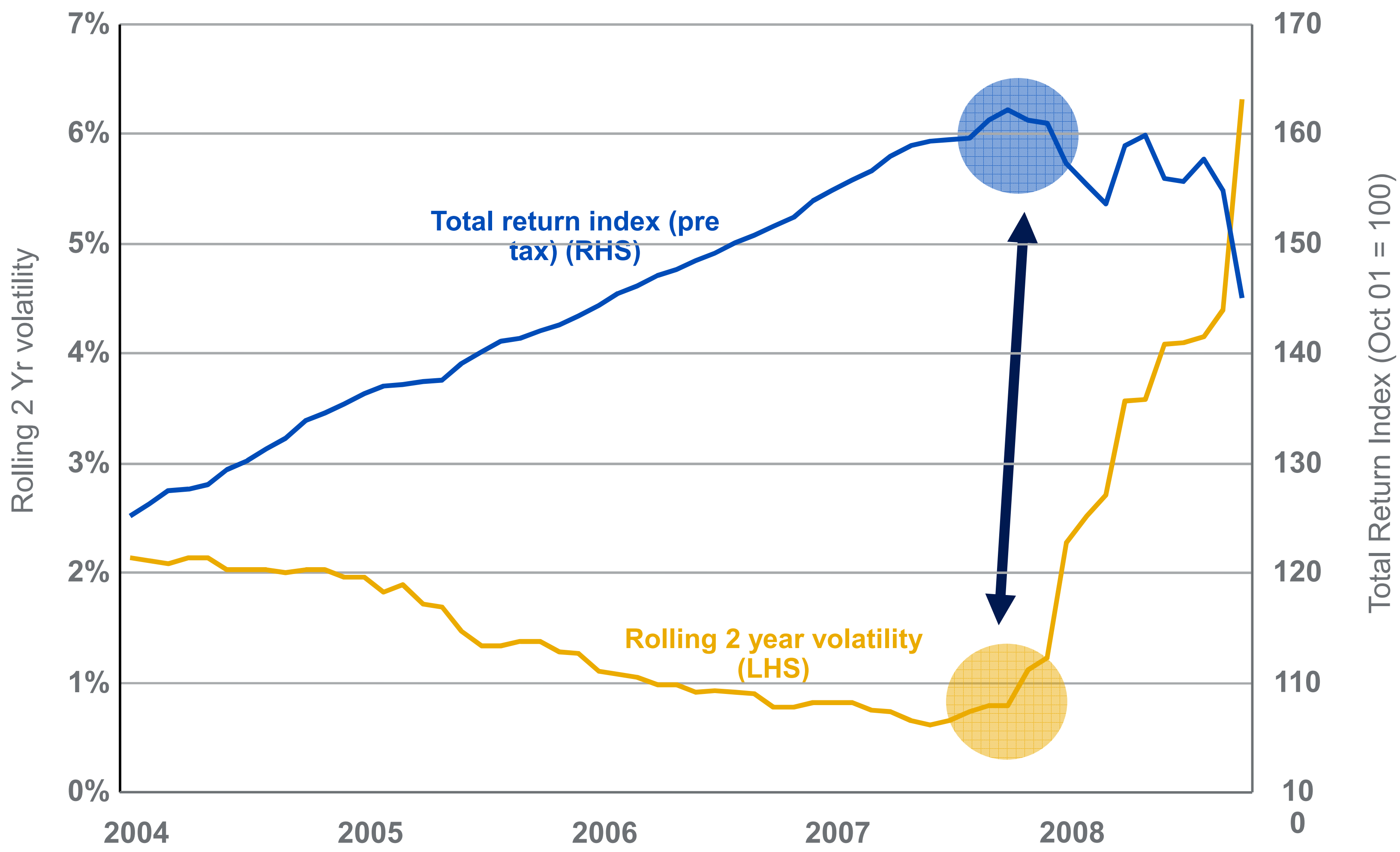
Low volatility doesn't mean low risk

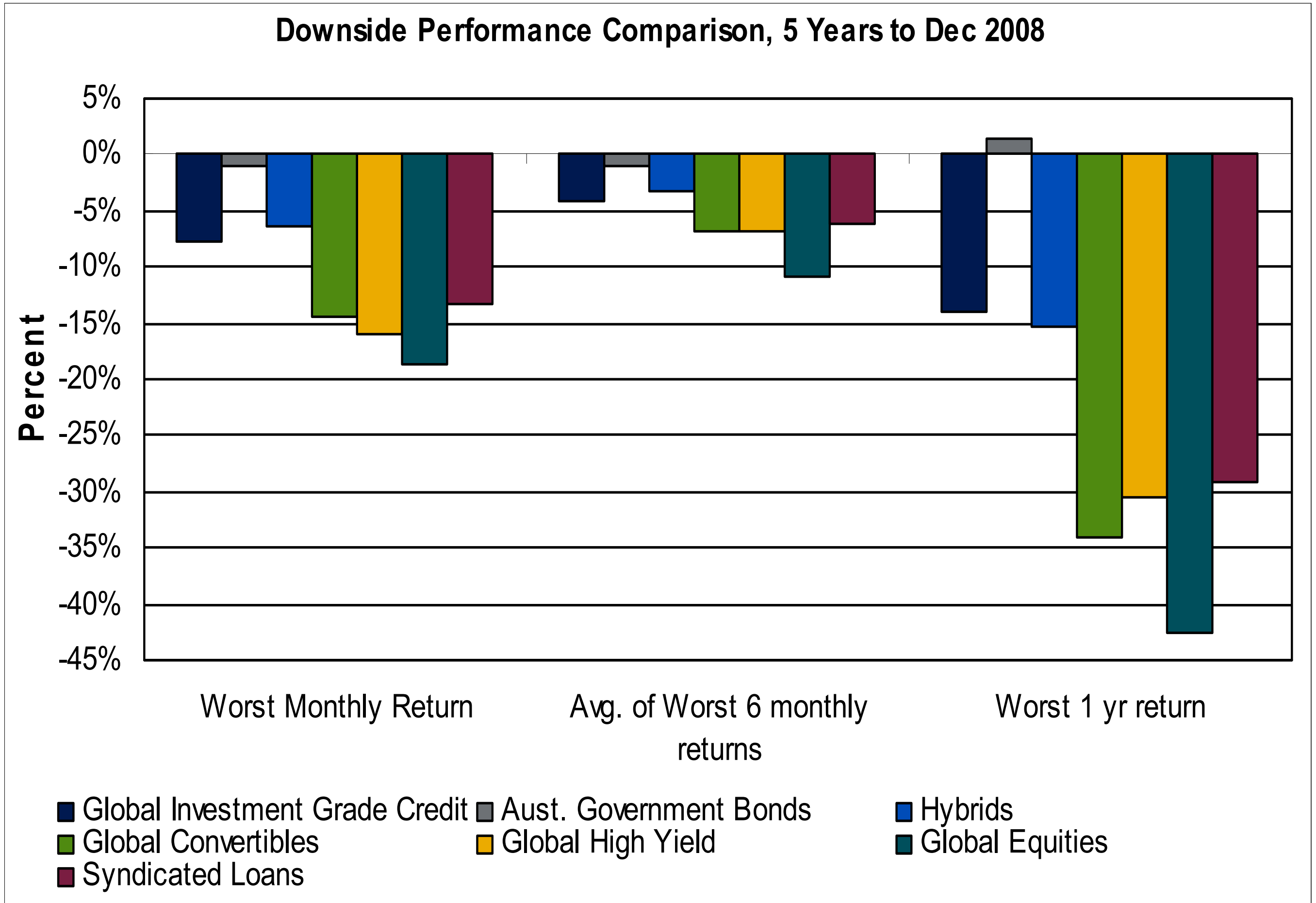
eg. The peak in hybrids corresponded to the low in hybrid volatility



Source: Schroders

It's not only return and volatility that matters

It's the downside risk that really hurts



Proxies: Global Investment Grade Credit = B Global Inv Grade (USD); Global Convertible = ML Global Conn (USD); Australian Government Bonds = UBS Govt Bond Index (AUD); Global High Yield – BG High Yield (USD); Hybrids = Schroder Hybrid Securities Fund (USD); Global Equities = MSCI World ex Aus (USD). Syndicated Loans = S&P/LSTA USD)

Source: Datastream, Schroders, S&P.

Schroders

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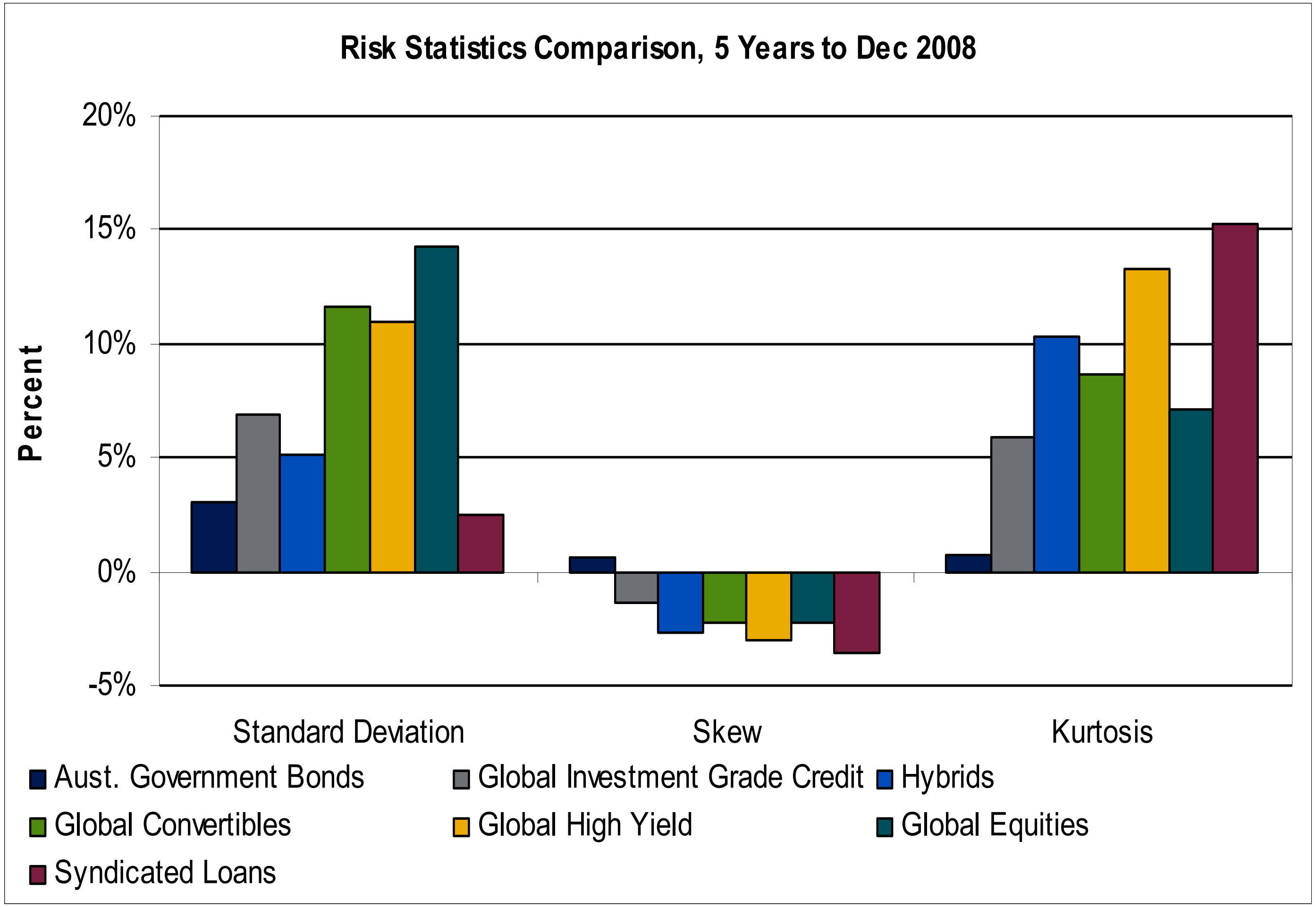

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Source: Datastream, Schroders, S&P.

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Correlations across the capital structure

Differing correlations provide diversification benefits

Correlation matrix - 5 years to December 2008

	UBS Credit Index (A$)	ML Global 300 Convertible (A$ hedged)	Lehman Global Agg-Credit (A$ hedged)	MSCI World ex Australia Accum Index (A$ hedged)	Lehman Global HY Corporate 2% Cap (A$ hedged)	Hybrid Securities (A$)	S&P/LSTA (loans)
UBS Credit Index (A$)	1.00	-0.14	0.08	-0.24	-0.23	-0.32	-0.37
ML Global 300 Convertible (A$ hedged)	-0.14	1.00	0.76	0.81	0.82	0.60	0.66
Lehman Global Agg-Credit (A$ hedged)	0.08	0.76	1.00	0.81	0.82	0.60	0.66
MSCI World ex Australia Accum Index (A$ hedged)	-0.24	0.81	0.38	1.00	0.81	0.78	0.80
Lehman Global HY Corporate 2% Cap (A$ hedged)	-0.23	0.82	0.62	0.81	1.00	0.81	0.85
Hybrid Securities (A$)	-0.23	0.82	0.62	0.81	0.81	1.00	0.90
S&P/LSTA (loans)	-0.37	0.66	0.36	0.80	0.85	0.90	1.00

Move tactically across the capital structure owning assets at the right time that also provide diversification benefits.

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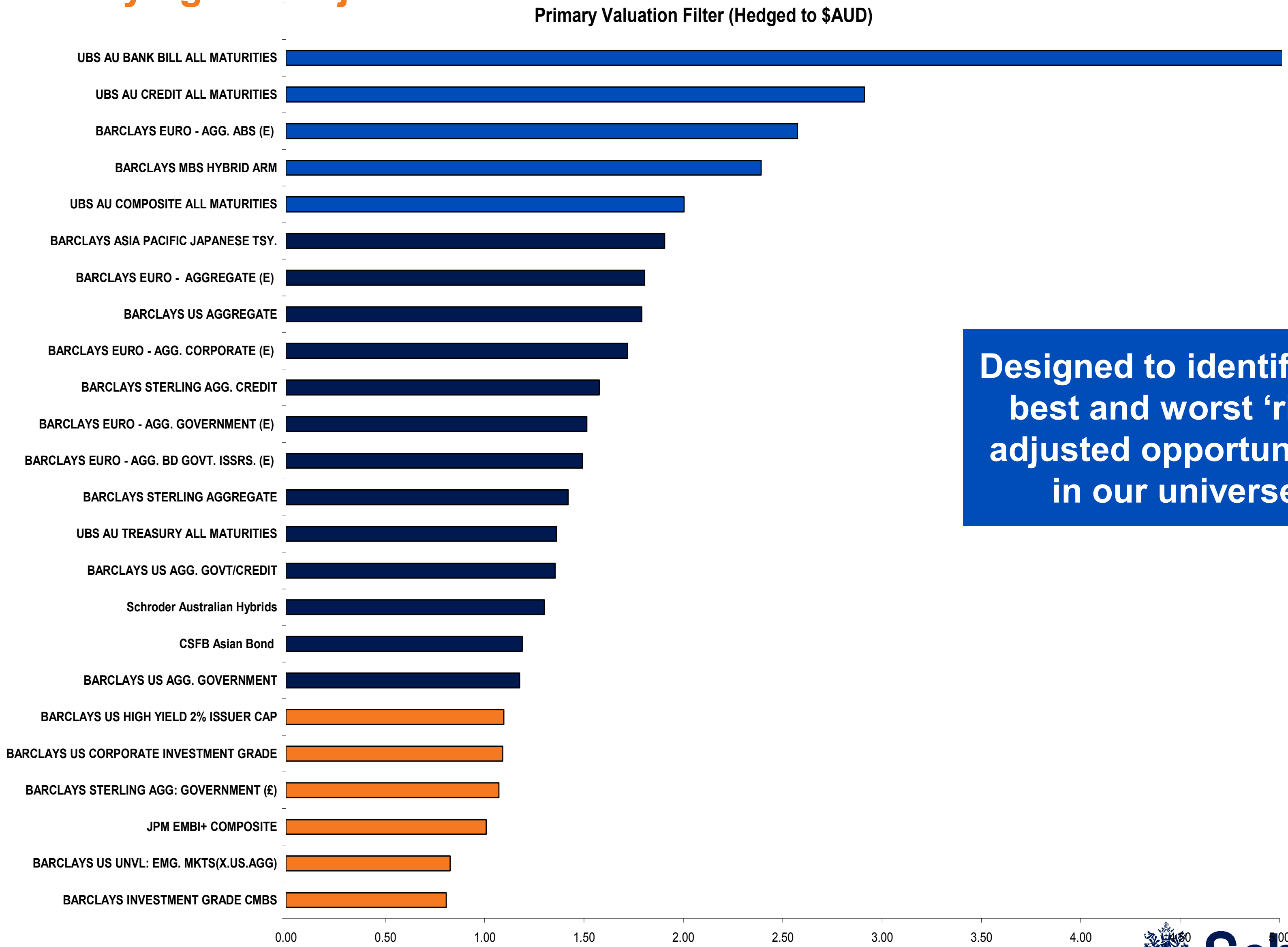
Source: Schroders, Datastream

Assessing opportunities

Identifying risk adjusted value



Designed to identify the best and worst 'risk' adjusted opportunities in our universe

Source: Schroders, Datastream, Bloomberg – July 2009

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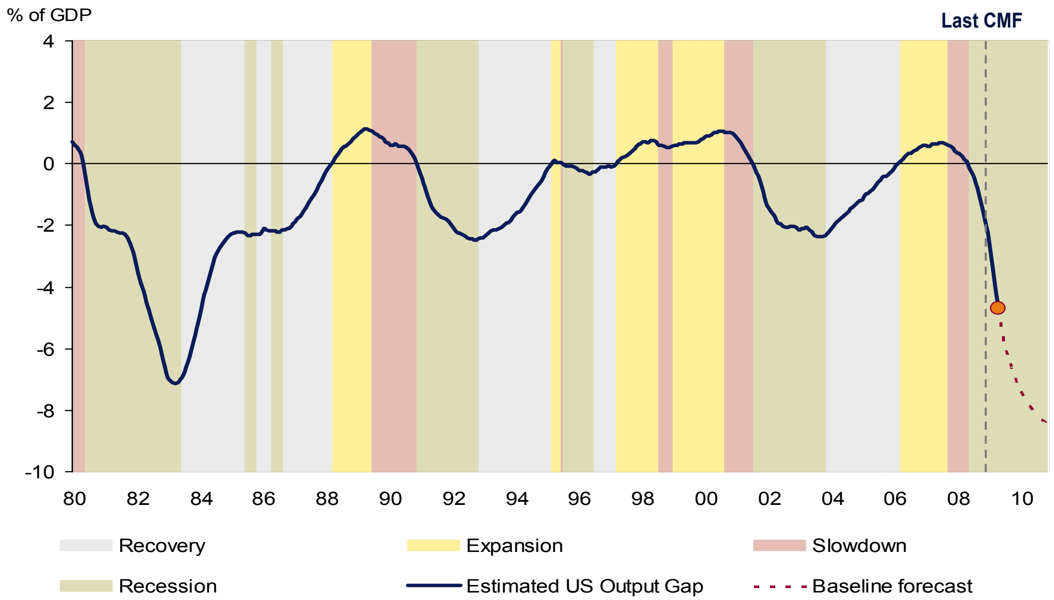
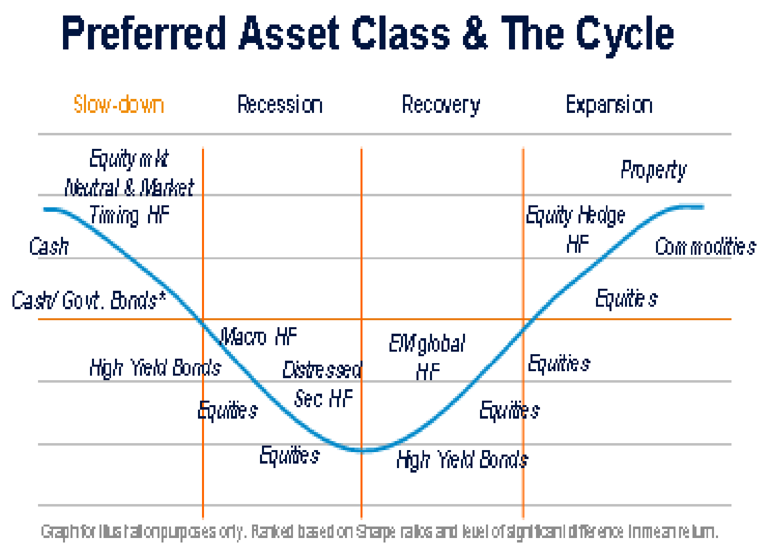
Early recession favours quality

Late recession favours risk (move down the capital structure)

The economic cycle in the US and phase of the cycle





 Source: Schroders

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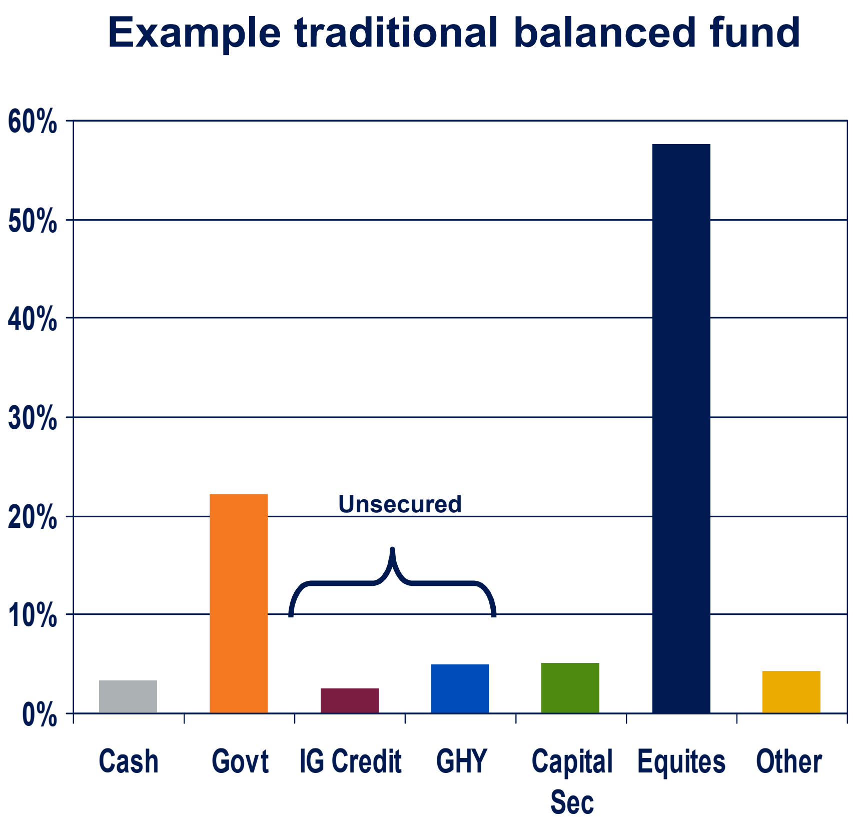
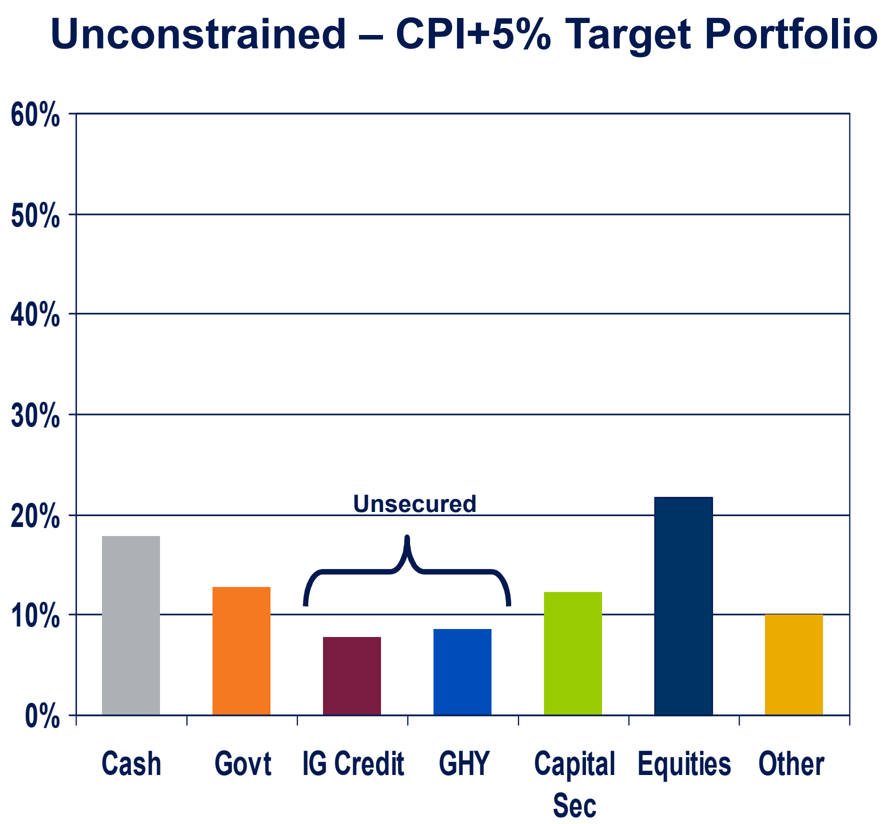
Our views
Indicative portfolio positioning



Example diversified portfolio concentrates risk in equities



More effective use of the capital structure

Conclusions

- **Investor focus on bonds and equities is too narrow**
- **Hedge Funds/ Alternatives not the answer**
- **Need to continually re-evaluate opportunities across the capital structure**
- **Broadening opportunity set can improve portfolio diversification and return outcomes**

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