portfolio construction forum

Evaluating the Australian bond market through a global lens

Chris Siniakov & Andrew Canobi | Franklin Templeton | 15 August 2014

On the global playing field, Australian bonds offer amongst the highest yields available to investors. Despite this, Australian investor's allocation to the fixed income sector ranks the lowest amongst their global peers. This 'under-investment' will change. Fixed income is an important asset class in a diversified portfolio and allocations will increase as the aging population enters its retirement phase and income needs grow.

While increasing allocations to Australian bonds makes for sound investment strategy it is important to pause and take time to consider how the Australian bond market has evolved with time. Australia is a very open, international market. The drivers of Australian bonds are as much global as they are local. Applying a global perspective to managing Australian fixed income portfolios presents opportunities for greater returns and better risk management. This paper discusses fixed income portfolio construction strategies required to maximise portfolio outcomes in this new context.

ASSET ALLOCATION – HOW TO MEET INVESTORS' LIABILITY NEEDS

Many factors are taken into consideration when determining asset allocations but in general the main objective is to provide for a specific future liability or need. In Australia, the pension plan system has been focused on the accumulation of assets and has traditionally applied growth focused strategic asset allocations. This is reflected in Figure 1 below. According to global investment consulting firm Mercer, the proportion of institutional Australian pension fund assets invested in growth assets was 68% in 2013 – the highest allocation in the nominated countries in the study which included both developed and developing countries. Consequently, the allocation to Fixed Income is 25% – a low number in absolute terms but also especially low on a global scale.

Figure 1: The proportion of pension fund assets invested

Country	Proportion invested in growth assets	Proportion invested in Fixed Income
Australia	68%	25%
Canada	57%	40%
Chile	43%	45%
China	20%	80%
Denmark	20%	65%
Japan	39%	50%
Korea (South)	6%	95%
Netherlands	24%	70%
Switzerland	51%	45%
UK	53%	45%
USA	53%	40%

Source: Mercer. Asset allocation of pension funds around the world, Feb 2014

Moving away from institutional pension plans into the Self Managed Super Funds, which now account for around one-third of Australia's retirement savings, the allocation to Fixed Income is alarmingly low at 1%.[1]

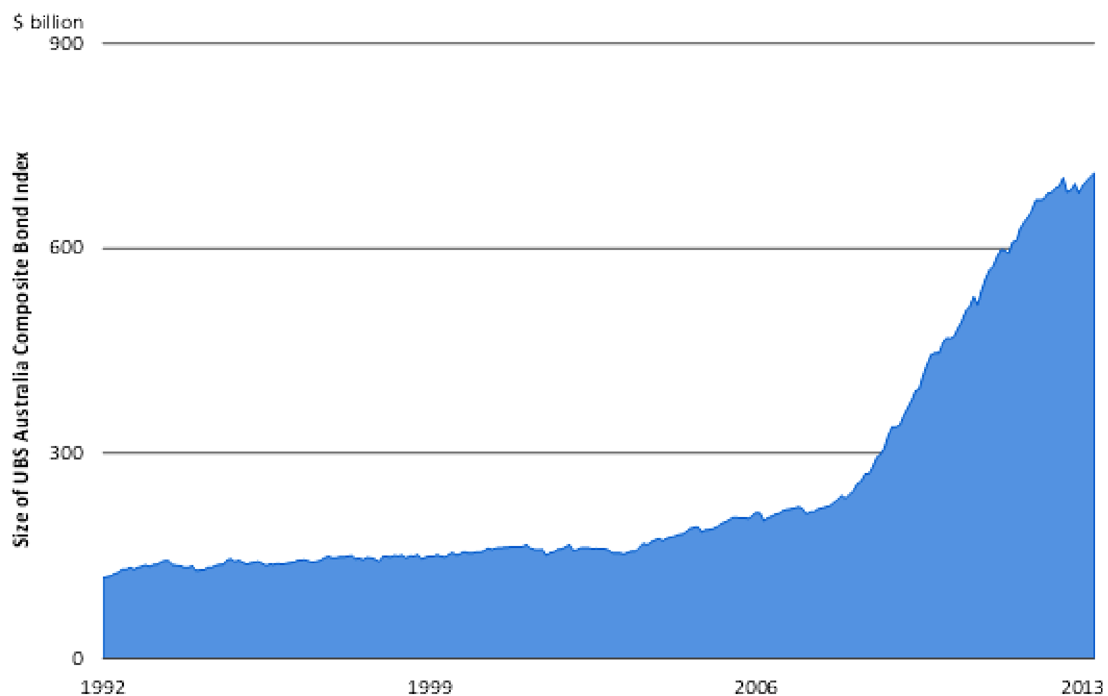
While the traditional 65% growth/35% defensive asset allocation mix may have been suitable for Australian investors over the past three decades, looking forward it is almost "pre-programmed" to change as Australia's population ages and as the accumulation phase of savings roles over into the pension/income phase. Australia's retirement savings plans are expected to decrease the proportion invested in growth assets, in favour of the fixed income/income sector. Whilst the transition may be gradual the timing of the potential increase in defensive assets (including fixed income) could be problematic if traditional fixed income exposures and approaches are adopted. Just at a time when Australian investors confront the task of constructing bond portfolios that will meet the changing needs of the future, the Australian market itself has become more complex and intertwined with the international fixed income landscape presenting a new set of challenges.

THE INTERNATIONALISATION OF AUSTRALIA'S FIXED INCOME MARKET

The Australian bond market is best understood by looking at the domestic market through a global lens. Investors in many asset classes may begin by examining local factors and drivers and then considering the impact of global drivers on the asset class as a secondary consideration. To fully understand the local fixed income asset class, however, increasingly requires a global perspective. Indeed the labelling of Australia's local bond market as 'domestic' is somewhat inconsistent with the characteristics of the market.

The Australian bond market has grown substantially over the last 15 years to the point that it is now developed, liquid and diverse in terms of the number of issuers that use it to raise debt capital. Figure 2 below highlights the actual growth of the domestic fixed income market as measured by the UBS Composite Bond Index. As can be seen, between 1992 and 2005 the local market ranged in size between A$100bn and $200bn, averaging around $150bn in size over this time. Since the latter part of the last decade growth has accelerated considerably and the size of the market is now more than A$700bn, representing a near 5 fold increase in average terms. When adding in the domestic floating rate note market the figure moves towards A$900bn and, with steady new issue supply, the market is rapidly approaching the trillion dollar mark in size of outstandings.

Figure 2: Growth of the Australian Domestic Bond Market
As at 31 December 2013



Sources: UBS Australia, Franklin Templeton Investments

The growth of the market itself is positive in terms of the additional depth and liquidity for participants but, perhaps even more remarkable is the internationalisation of the Australian bond market. This paper examines this from two perspectives. Firstly, the composition of the market itself as more non-Australian borrowers raise capital in the domestic market. Secondly, and related to its changing composition, the paper considers just how powerful global market forces are for local investors. On this second point, it isn't so much that when global fixed income markets sneeze Australian bond investors catch a cold but more likely when global markets get a sniffle, we rapidly lunge for the tissue box!

There are two distinct dimensions to the internationalised nature of the Australian market. Firstly, unlike domestic equities where the local market is almost exclusively composed of Australian corporations the fixed income market is quite distinctive in being, arguably, the most internationalised/un-domestic of all the domestic asset classes. Over the last 10-15 years the composition of Australia's domestic non-government bond market has shifted from being primarily composed of local Australian entities to a situation where international borrowers comprise the majority of issuers in the domestic market. Understanding this is significant for investors because it logically follows that traditional Australian bond portfolios might in fact already be quite globally oriented in nature in terms of both risk and return characteristics. The return drivers of Australia's credit market are, not surprisingly, inextricably linked to the performance of global credit markets in North America and Europe. In addition to this shift in composition, Australian bond yields have for a long time been relatively highly correlated with global bond yields and so the risk and return prospects for Australian fixed income are very beholden to global drivers. In short, to understand Australian fixed income in terms of risk, return and the relationship to other parts of a portfolio a deep and thorough understanding of global corporations and forces is now essential.

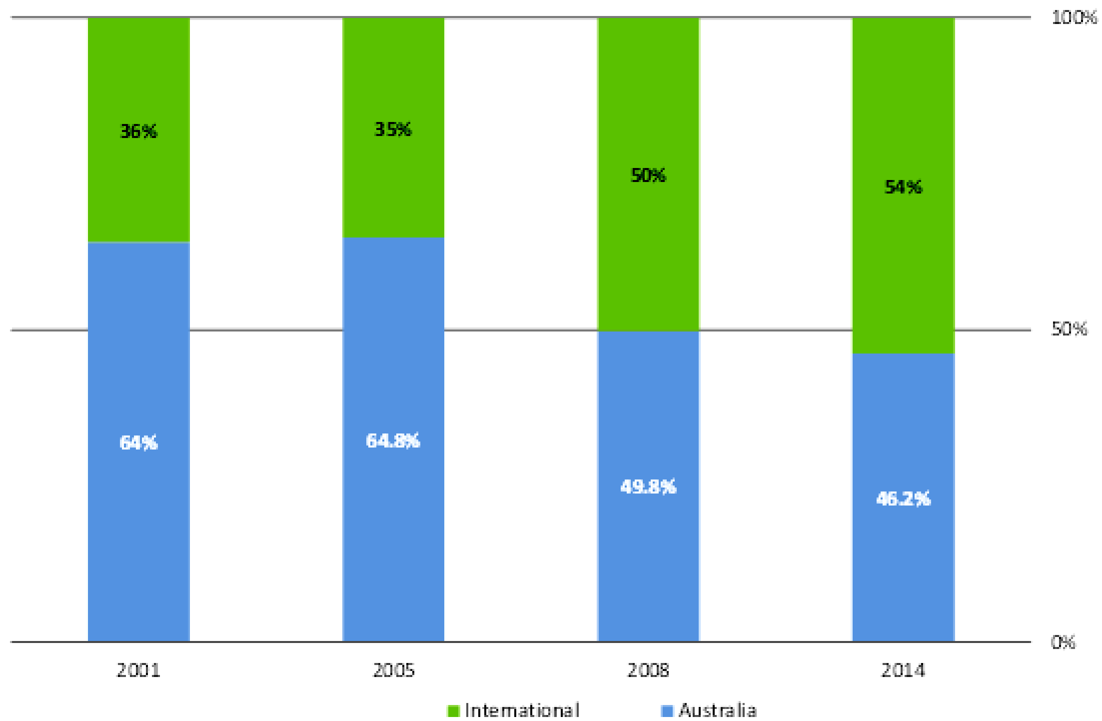
Market Composition

The dramatic shift in the composition of the Australian market, perhaps more so than the growth of the market, is one of its most remarkable trends over the last 10 to 15 years. The charts below show the changing mix of the domestic debt markets in terms of Australian versus international issuer participation (note, international is defined as pertaining to ultimate parent country of risk such that locally incorporated entities that are subsidiaries of non-Australian entities are defined as international). The following examines two aspects of this phenomena.

Figure 3 looks at the changing mix of the UBS Non-Govt index according to the mix of borrowers (% Australian versus international). Figure 3 looks at this mix according to the outstanding face value of securities. In both cases the conclusion is clear. Australia's capital market has evolved as it has grown and moved from being primarily domestically focused to

being internationally diverse as borrowers from around the world have increasingly drawn on Australia's large savings pool to raise capital and now represent a majority of the non-government credit risk in the domestic market!.

Figure 3: Market Value % of Issuers in the UBS Australia Non-Govt. Bond Index
As at Financial Year End



Sources: UBS Australia, Franklin Templeton Investments

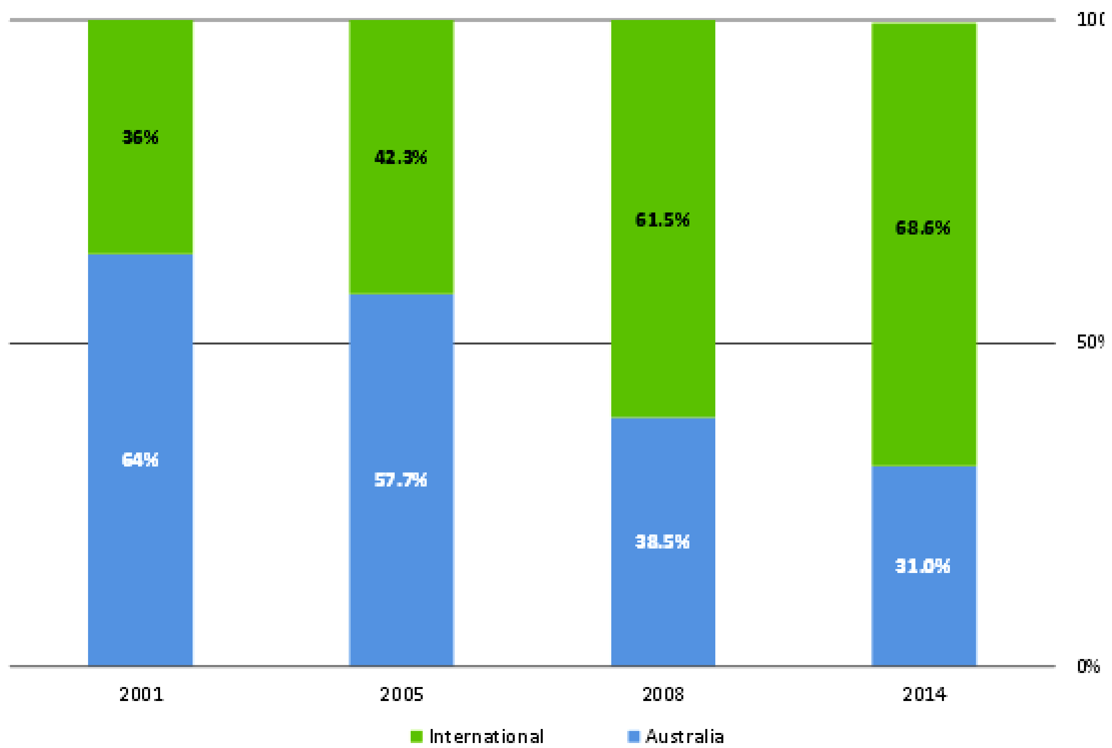
By examining the chart above, which really expresses the 'investible universe' of non-government bonds in Australia, observe that not only has the percentage of international borrowers overtaken Australian bonds but that the extent to which this is the case has significant implications for investors. In 2001, Australian borrowers accounted for c.64% of all outstanding securities compared with 36% for international. By June 2014 the proportion of international borrowers in the market was 59% compared with 41% for Australia.

The remarkable internationalisation of the market is even more pronounced when the same analysis is conducted looking at the value of securities outstanding from Australian and international borrowers (Figure 4). In 2001 securities issued by Australian borrowers represented approximately 64% of face value securities outstanding compared with 36% for overseas issuers. By 2014 this relationship had reversed such that 69% of the face value of securities outstanding are now related to international borrowers leaving Australian non-

government issuance firmly in the minority. In other words nearly 70% of all non-government issued debt in the Australian market is, in a sense, now non-Australian!

Figure 4: % of Market Face Value of Securities Outstanding in the UBS Australia Non-Govt. Bond Index

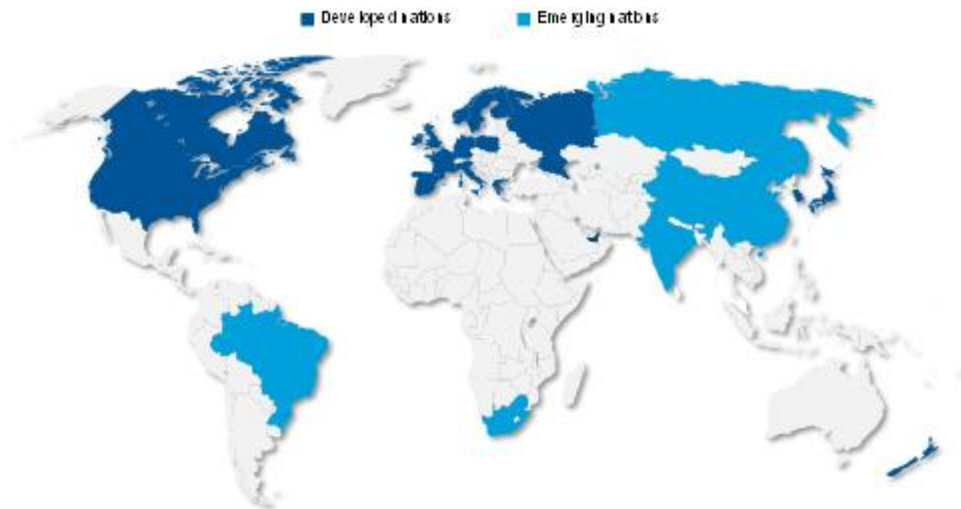
As at Financial Year End



Sources: UBS Australia, Franklin Templeton Investments

To visually characterise the changing landscape of the Australian bond market the graphic below highlights nations around the world that have issued debt securities in Australian dollars.

Figure 5: Domiciles of foreign Issuers in AUD debt market
As at 30 June 2014

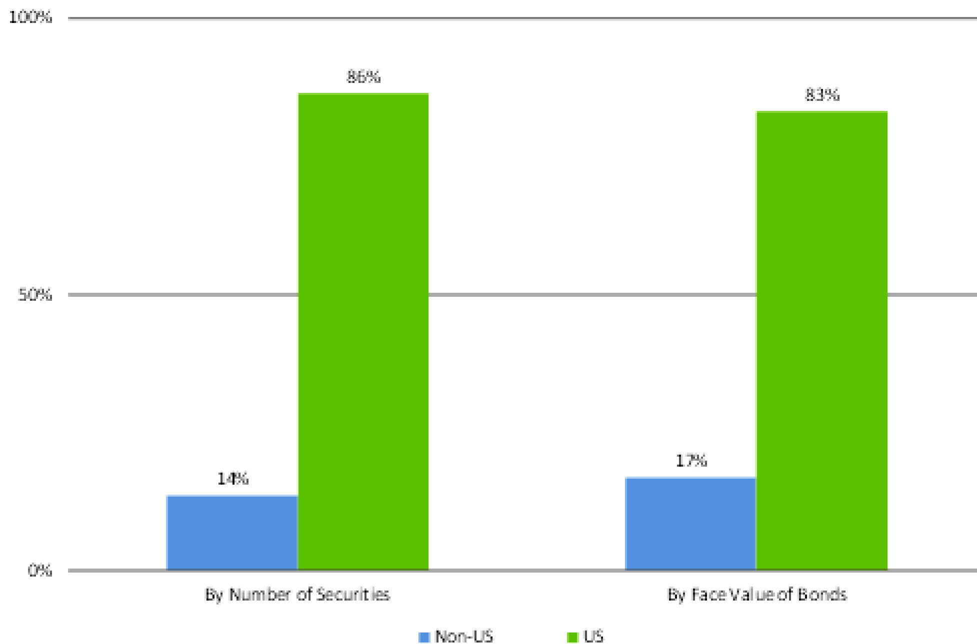


Sources: UBS Australia, Franklin Templeton Investments

As well as the traditional stream of issuers from North America, the United Kingdom and Western Europe, there is a growing trend of borrowers from Asia and various emerging markets. With the rapid growth and emergence of Asia it is particularly noteworthy that borrowers from South Korea, China and the Middle East are increasingly participating in the local bond market to raise capital.

The above observations are even more noteworthy when comparing the Australian market to other large developed bond markets around the world where a majority of index constituents are still essentially local. The largest investment grade non-government bond market in the world is the US corporate bond market. With outstanding securities of more than US$3.6 trillion[2] it remains significant in size, sophistication, and liquidity and for its attractiveness in drawing many global borrowers from around the world to raise capital. Despite these feature, Figure 6 below highlights that, in contrast to Australia, the market remains dominated by US borrowers with still only a small proportion of non-US issuers featuring in the major index, the Barclays US Aggregate Corporate, when using the same measures as previously - issuer or face value of securities.

Figure 6: Australian and US 10 Year Government Bond Yields
June 1979 to June 2104



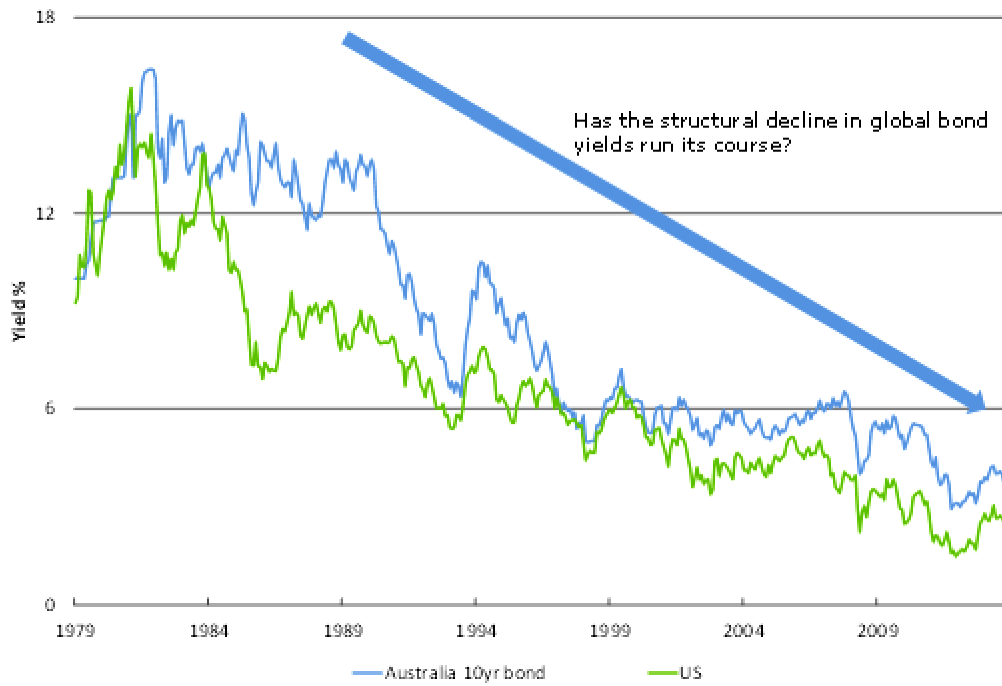
Sources: Barclays, Franklin Templeton Investments

Market drivers inextricably global

With the rapid internationalization of Australia's domestic market it comes as little surprise to learn that the actual return drivers of the local market are heavily driven by international markets. Indeed this phenomenon is not new as for many years Australia's government bond yields have been significantly influenced by the direction of global bond yields, in particular the US treasury market. Over the last 20 years to 30 June 2014 the correlation between Australian and US 10 year yields has been 0.84 measured over quarterly periods with an r2 of 0.71 (source: Bloomberg data). This close relationship between Australian and US bonds is exhibited in Figure 7 during the 30+ year period of structural decline in global bond yields.

portfolio construction forum

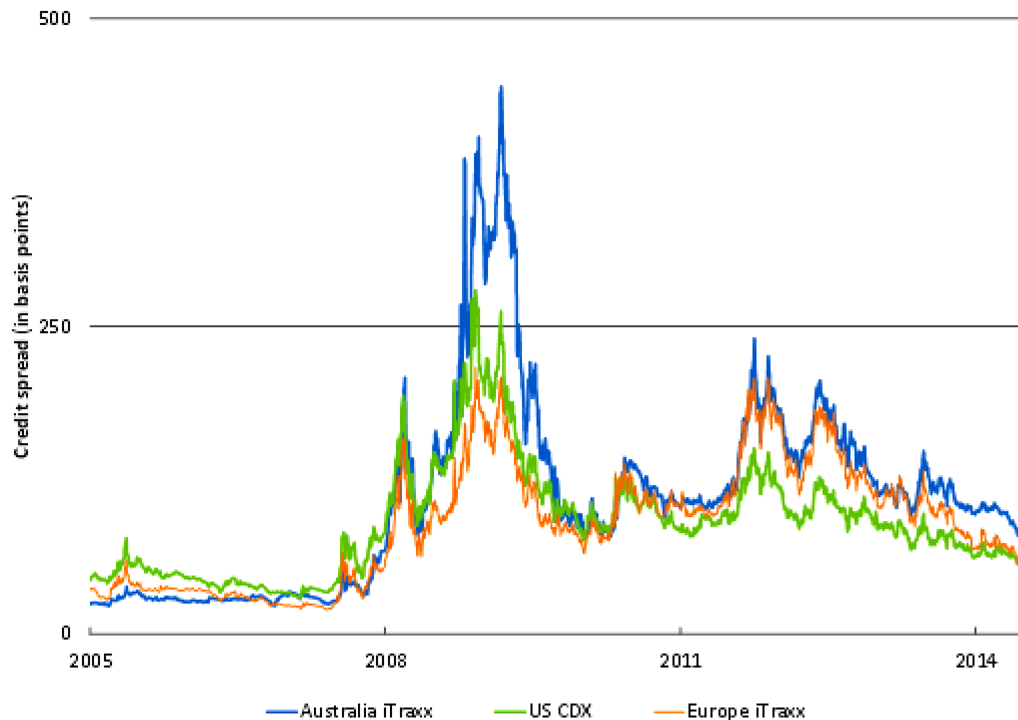
Figure 7: Composition of US Corporate Bond Market
As at 30 May 2014



Sources: Bloomberg, Franklin Templeton Investments

In addition, given the predominance of overseas entities in the Australian non-government market, the performance of Australia's credit market is heavily linked to the direction of global credit markets in North America and Europe. To emphasize the extant of this relationship the chart below simply shows the Australian five year Investment Grade Credit Index against its North American and European Equivalents. In general when global credit markets are performing, so is Australia's and vice versa. Whilst local corporate trends matter, the significant trends in credit markets are global in nature.

Figure 8: Global Investment Grade Credit Spreads
As at 21 July 2014



Sources: Bloomberg, Franklin Templeton Investments

RETHINKING DOMESTIC BOND INVESTMENT OPPORTUNITIES

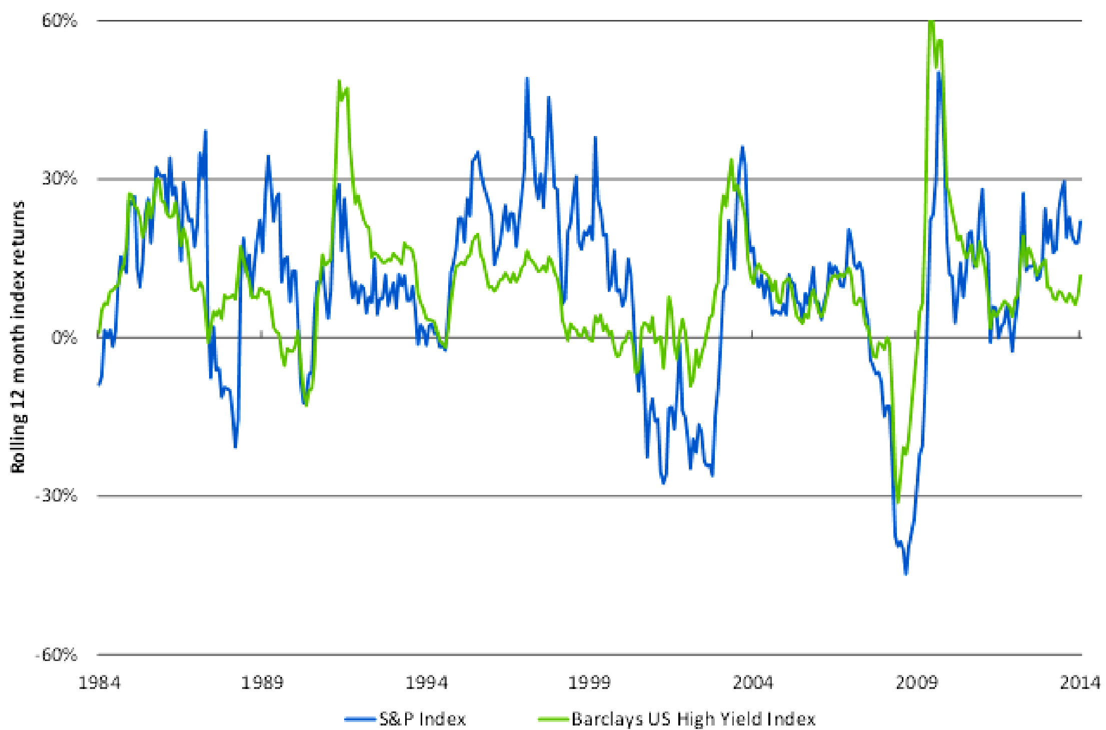
The strong influence of global forces on Australia's bond market is neither a new phenomenon nor contained to the credit, or non-government universe. But, the approach to how fixed income portfolios are constructed needs to be rethought with a more "bottom up" approach based on meeting specific investor needs of both risk and return. In the search for better solutions investors must not simply go into credit or extend duration. Rather than allocating into higher risk global solutions and riding the unintended consequences, managers of Australian portfolios need to bring their global expertise to effectively deliver more robust portfolio outcomes to Australian fixed income portfolios.

Traditional approaches, unintended consequences

While credit securities can provide additional yield to portfolios it is important not to fall into the trap of putting all your in eggs one basket. Historically credit cycles through time show that portfolios are likely to be exposed to similar risks / have a high correlation to equities during inevitable periods of cyclical downturns and market distress. This is clearly demonstrated in Figure 9 which shows the rolling 12 month returns for the US Equity and

High Yield Credit markets over the last 20 years. A high correlation is evident through the very tight relationship between these return profiles with peaks and troughs coinciding frequently. In addition to Credit's high correlation with equities, credit spreads – or, the incremental yield paid for the additional risk of investing in credit – appear to be approaching relatively expensive valuations. According to Figure 10, Credit spread levels have returned to pre-GFC levels, begging the question, are investors being rewarded enough for the additional level of risk?

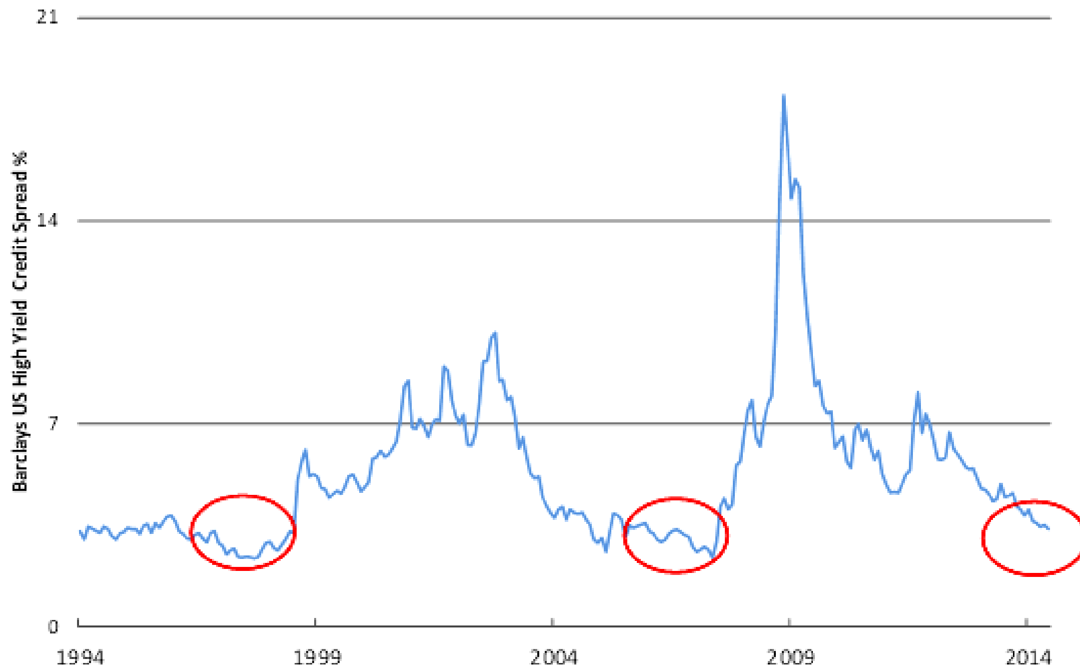
Figure 9: Rolling 12-month returns highlight strong correlation between credit and equity markets
June 1984 to June 2014



Sources: Bloomberg, Franklin Templeton Investments

© PortfolioConstruction Forum 2014

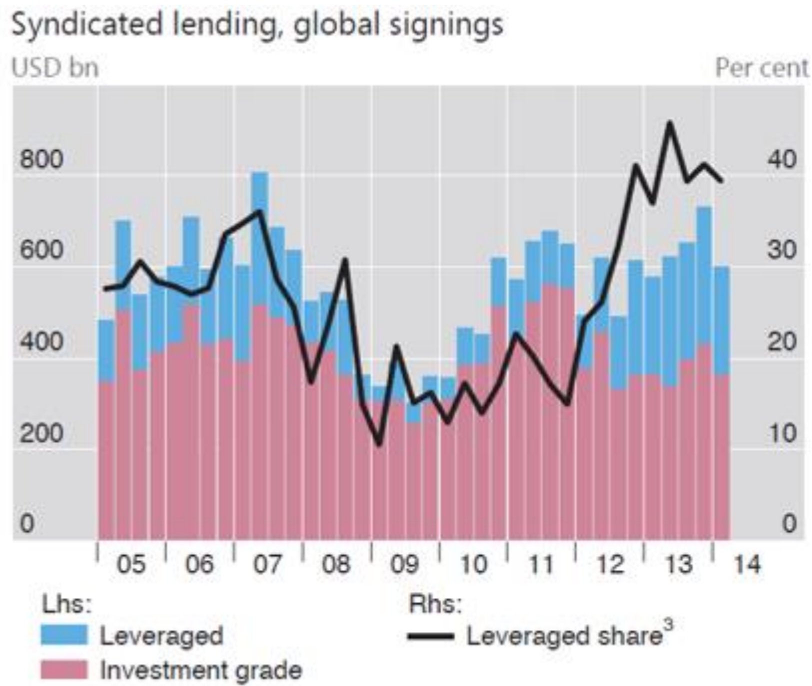
Figure 10: Credit spreads returning towards pre-GFC levels
February 1984 to June 2014



Sources: Barclays, Franklin Templeton Investments

As observed through time, market memories are short and some worrisome behaviours are creeping back as a consequence of the growing 'reach for yield', as investors buy ever more complex debt securities, often with leverage, to generate greater return. The Bank for International Settlements has recently noted this in its latest annual report (BIS 84th Annual Report, June 2014). Amongst other observations, the BIS notes that syndicated loans to lower-rated leveraged borrowers have exceeded 40% of new signings for much of 2013. Figure 11 shows this current proportion is higher than the pre-GFC period from 2005 to mid-2007. More than ever, it is important that investors tread judiciously with new allocations to "defensive" strategies dependent solely on credit as the source of return.

Figure 11: Leveraged syndicated loans grow more at more rapid rate than pre-GFC
As at March 2014

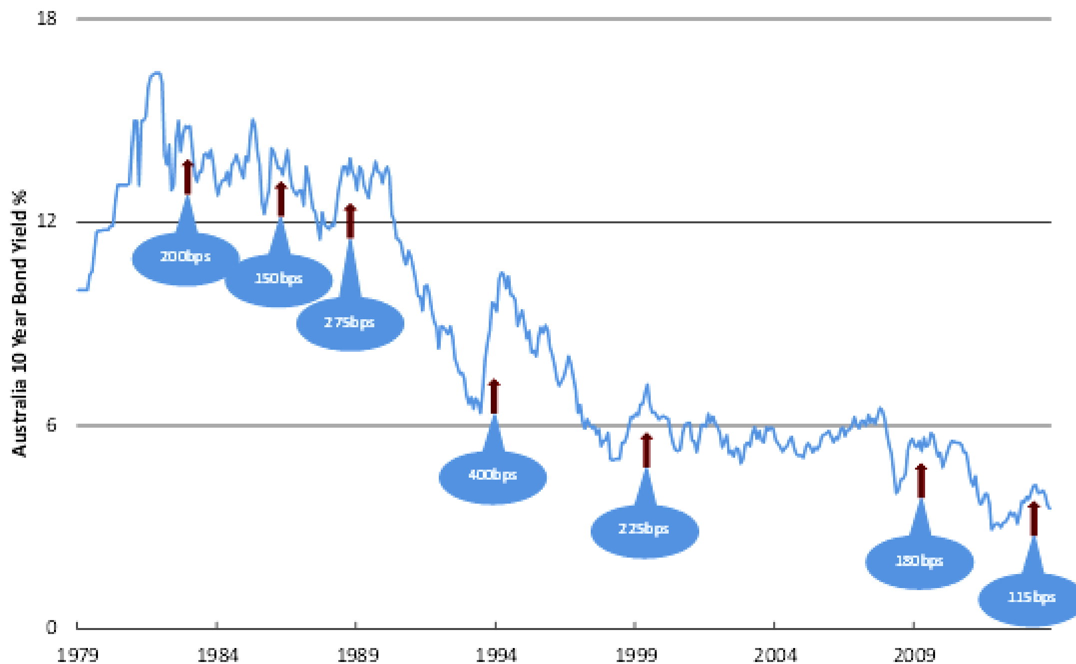


Sources: BIS

Shifting the focus to outright yield levels, government bond yields have experienced a 30+ year structural decline and currently reside around near record low levels. Whether or not the structural decline in yields has run its course is difficult to determine and not the purpose of this paper to conclude. But, yield curve (or duration) management and the selection of an appropriate portfolio benchmark (with its inherent duration) is more important than ever. Figure 12 highlights the shifts in Australian bond yields through time. The size of each red arrow represents a 100bp rise in yields. As can be seen, even through a period of structural decline, yields regularly increase by 100bps or more over short periods of time. Using the current yield of 3.5% (as at 30 June 2014), a 100bp increase over the next year will translate to a negative return of approximately minus 4% over a one year period! Over a shorter time frame, the same 100bp move higher in yield would result in an even larger negative total return. In short, there is very little “cushion” against rising yields.

Figure 12: Australian Bond Yield Sensitivity

September 1979 to June 2014



Sources: Bloomberg, Franklin Templeton Investments

So, whether you believe in a new period of structural rise in yields or an extended low yield ranging environment, investors do need to think very carefully about the inherent duration in the benchmark prescribed to their fixed income allocation.

Intentional investing, opportunities

Australian bond portfolios increasingly incorporate international exposures. It therefore makes sense that Australian bond portfolios would be exposed to alternative international investment opportunities that, whilst not necessarily readily available domestically, are entirely consistent with those typically accessible locally. Importantly, these can be intentionally included within the one portfolio under the one risk budget which enables portfolio managers to deliver investment solutions that have superior diversification in areas of idiosyncratic credit risk and macro positioning. Ultimately, this can help the bond portfolio relate to other parts of the diversified investment portfolio in a less correlated manner.

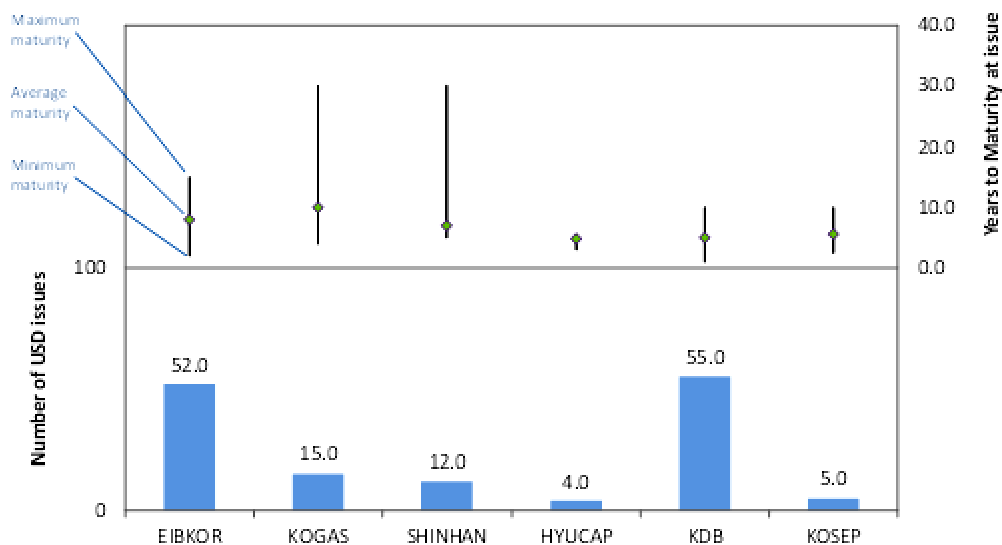
Here is a practical example to help illustrate:-

Korea South East Power (KOSEP) joined a list of South Korean borrowers in issuing bonds into the local market in 2013. For a domestic investor to fully take advantage of this investment opportunity requires: a) A deep understanding of the South Korean economy from a macro

perspective, b) clear insight into KOSEP and its credit strengths and weaknesses and c) an understanding of the fair value of KOSEP in other global credit markets and how this compares to the pricing offered domestically. In working through the above one conclusion might be that, whilst the domestically issued KOSEP is a worthwhile investment a comparable security from the same issuer in US dollars might offer a better yield when purchased and hedged back to AUD.

As at 30 June, the Australian Composite Bond index contained six Korean issuers. Collectively, these six issuers have seven AUD fixed income issues in the Australian market. Figure 13 helps to introduce the same Korean issuers available offshore in US dollars. The bottom panel of the chart highlights that each issuer has multiple issues available in USD, with the majority of issuers each offering more than ten issues. The top panel of the chart explores the maturity range of securities available under each issuer. Extending on the KOSEP example, the chart shows that there are five KOSEP issues. Of those five, the maturity range begins at 2.5 years and extends out to 10.0 years, with an average maturity of 5.6 years. In contrast, in the Australian bond market the same issuer has only one security and, therefore, no alternative if you don't like the maturity. Using the broader universe of KOSEP securities, the portfolio manager can target the same credit risk and also manage the duration and spread risk by moving between shorter and longer dated bonds. This flexibility provides for very efficient implementation of investment exposures to the Manager's preferred companies whilst also balancing the target macro positions for the portfolio.

Figure 13: Korean Issuer Overview



Sources: Bloomberg, UBS, Franklin Templeton Investments

A logical next step is to then consider other similar style and quality South Korean entities that may present even better risk and return characteristics for an Australian investor whilst

evaluating the original opportunity. In adopting this broader approach it may make sense to consider a security from, for example, Korea Electric Power (which has yet to issue in AUD) which exhibits very similar credit and macro risks to KOSEP for example. Additionally, there are multiple household names such as Samsung and Kia which offer valuable opportunities in the offshore market. To sum up, the evaluation of the seemingly 'domestic' fixed income opportunity really requires international skill and focus to best maximise the 'domestic' investment decision.

CONCLUSION

Evaluating and capturing the full breadth of opportunity in Australian fixed income requires a global lens. At a time when the demand for fixed income/income style exposure is expected to grow investors need to pause and consider how to best construct portfolios that will deliver optimal risk and returns and relate better to their overall portfolios. Simply investing into credit markets or extending duration will not deliver the desired outcomes going forward. The changing nature of the Australian bond market has resulted in an asset class that is international in composition and drivers of return. This therefore creates broader scope to build portfolios that blend local opportunities with alternative global exposure to maximise return outcomes.

ENDNOTES

1. Source: Rainmaker Roundup, MAR Quarter 2014. Research Feature 1: Superannuation system wide asset allocation.

2. Source: Barclays. As at 30-June-2014

Chris Siniakov is Managing Director, Australian Fixed Income at Franklin Templeton Investments. He is responsible for developing a range of local fixed income strategies. Andrew Canobi, CFA is Director, Australian Fixed Income at Franklin Templeton Investments.