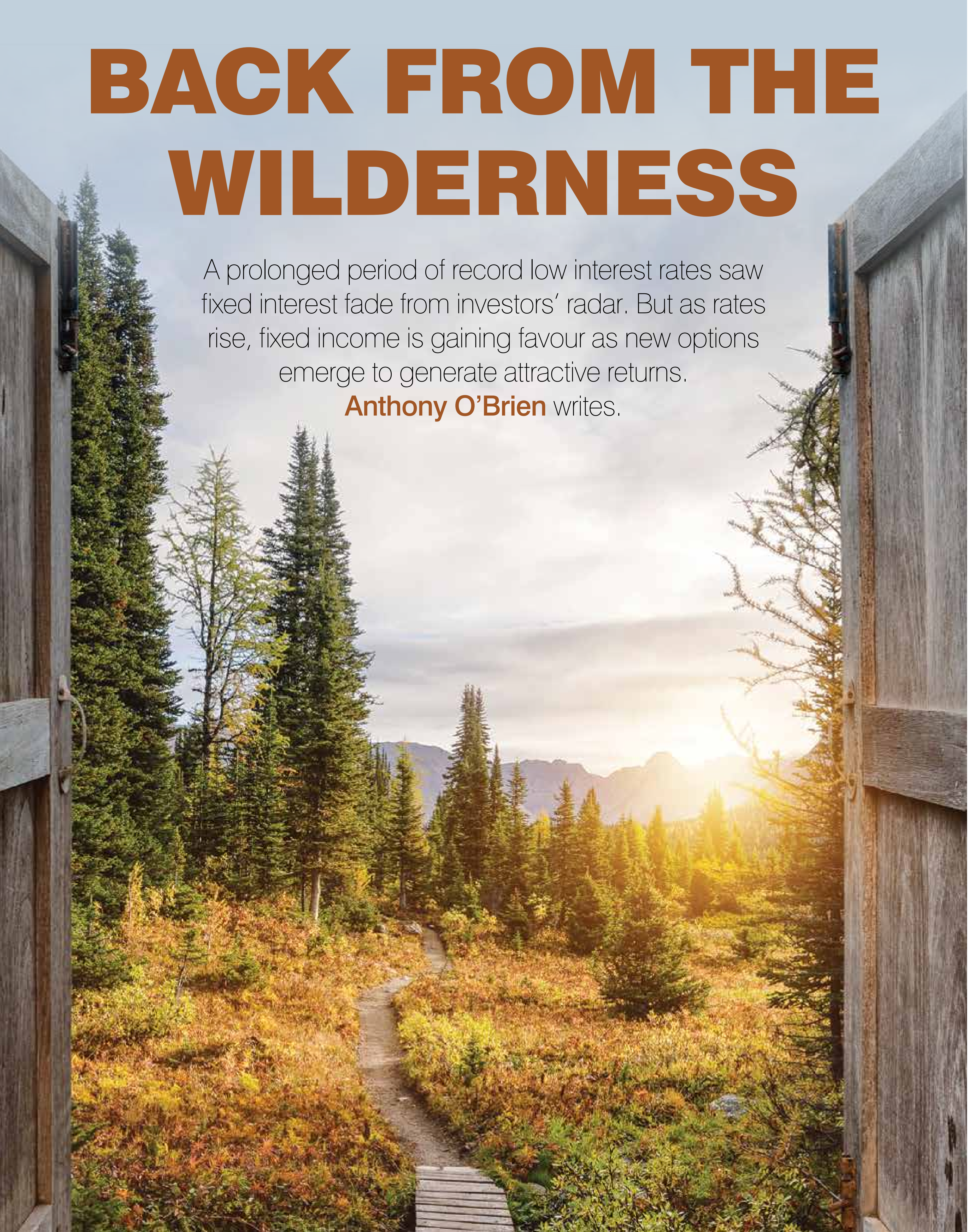
BACK FROM THE WILDERNESS

A prolonged period of record low interest rates saw fixed interest fade from investors' radar. But as rates rise, fixed income is gaining favour as new options emerge to generate attractive returns. **Anthony O'Brien** writes.



01:
Adam Grotzinger
senior portfolio manager
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02:
Jonathan Sheridan
director of fixed income and investment strategy
FIIG Securities

03:
Roy Keenan
co-head of Australian fixed income
Yarra Capital Management

It's no secret that fixed income has been seen as somewhat of a 'problem child' in portfolios in recent years, with the asset class seeing some of the worst returns in memory even as recently as the first half of this year.

However, as equity markets continue to suffer, fixed income is beginning to catch some investors' eyes again.

"We are coming off what was a very low interest rate environment, and we have had a big repricing this year in fixed interest assets. So, what was once a low yielding asset class, is really no more. In our view, that is starting to create better value in fixed interest as an asset class today," Neuberger Berman senior portfolio manager Adam Grotzinger[01] explains.

Today, the US aggregate index is yielding about 3.75% and, he says, if you wind the clock back to the beginning of the year, it was 1.86%. Grotzinger says this shows fixed income is starting to look, once again, quite attractive; "We have had a recalibration to higher yield."

"So now, when clients are saying, 'I need a 5% yield', you can achieve that today in some combination of investment grade fixed interest securities, without taking a lot of credit risk," he says.

"And that is a far less volatile proposition than equities, and other assets that you used to have to own to get that yield in the past environment of financial repression."

For FIIG Securities director of fixed income and investment strategy Jonathan Sheridan[02], any consideration of fixed interest as an asset class should involve addressing both sides of the equation – risk and return.

On the return front, Sheridan says: "With the large rise in yields already priced into the market well ahead of the Reserve Bank of Australia (RBA) actually lifting overnight rates, there are very attractive nominal yields available on very sound credit – and amazingly, even with inflation on the rise, positive real yields."

He cites the example of the recently issued subordinated bond from Macquarie, which offers a yield around 5.7% for five years to the first call.

"This is just the return side of the equation. The risk side, which is usually completely ignored by most investors in Australia – both retail and institutional, means that with a rate-hiking cycle underway, which typically causes a recession, this risk has not yet been priced into riskier assets such as equities," he says.

Sheridan believes that right now investors should be looking to allocate more of their capital to safer investments as a measure of "capital protection given the large uncertainty in markets over the next year or two."

Interestingly, Yarra Capital Management went overweight fixed income for the first time in five years in the last month.

Yarra Capital Management co-head of Australian fixed income Roy Keenan[03] explains: "During the COVID period interest rates were very, very low, even by normal standards. But now we are starting to see rates get to a point where income again is meaningful. That is why we think having some allocation to it makes sense, whereas at half a percent yields, it probably did not make a lot of sense."

That said, Keenan believes the decision to move into fixed income comes down to an investor's individual needs.

"If you are a younger person who has a long time to go, fixed income may not be the most sensible place to be. But for people that need some kind of stability in their portfolios, fixed income still offers this quality – and it doesn't matter what type of fixed income it is," Keenan says.

"All fixed income tends to have the same underlying principles; it is relatively capital stable, and it gives you income. And that is really what you want more than anything."

With returns from fixed income looking set to improve in the year ahead, investors should be allocating back to bonds, says Schroders head of Australian fixed income Stuart Dear[04], pointing to valuations and higher income, the global economic outlook and return potential, and diversification.

"Rising yields have bought about some pain for investors, but there are now some great opportunities to reset portfolios that will generate strong returns over the next year," he says.

"The starting point for yields is much higher than a year ago, and this extra income provides a higher buffer to capital losses if market yields continue to rise."

In terms of the international outlook, Dear notes: "Inflation is peaking, and if central banks are successful in taming inflation, this could be at the expense of negative economic growth and/or recession."

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> **Stuart Dear**

According to Dear, fixed income is also becoming more valuable as a portfolio diversifier, citing Schroders' internal research that shows the negative correlation between bonds and equities is likely to hold unless there's a move to sustainably higher yields.

However, amid compelling arguments to increase fixed income portfolio weightings, not everyone is rushing in.

Hamilton Wealth managing partner Will Hamilton[05] is keeping an eye on the sector but says he has no plans to allocate until there is a sell-off in fixed income.

"Bond markets have experienced their worst year since records began, with the main Australian Composite Bond Index down more than 15% from peak to trough. I am watching the bond market closely and preparing to add to our portfolios at the appropriate time," he says.

"We are waiting for a few more triggers such as returns over 4%. Then we would definitely be looking to push some money there," he says.

Challenges and opportunities

Despite some relatively bullish outlooks, a confluence of events is playing out in bond markets, including a decelerating growth environment, as well as ongoing hawkish central bank rhetoric and action because of ongoing inflation pressures. This is creating ongoing volatility in government bond interest rates and fuelling uncertainty.

At the same time, Grotzinger says the opportunity is that a lot of this is already priced into the market.

"Corporate credit, outside of government bonds, is increasingly priced for recessionary outcomes. It is not a foregone conclusion that we will have a recession But, it is interesting that those markets are already pricing for a recessionary outcome today," he says.

"So, it is manifested in the price, and as a result there is value in areas of credit markets."

However, fears of a recession are certainly settling in. But are they warranted?

"This could be the year of the monetary policy mistake, where playing catch up is hard

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04:
Stuart Dear
head of Australian fixed income
Schroders

05:
Will Hamilton
managing partner
Hamilton Wealth Management

to do. The risks to both growth and asset markets are far greater this cycle. Central banks need to raise interest rates aggressively and this significantly increases the risk of recession," Schroders' Dear says.

"This will be one of the best opportunities to buy government bonds."

The repricing of credit as we embark on a global tightening cycle may also provide an opportunity to get more constructive on asset classes such as emerging market debt and Asian credit, according to Dear.

"Valuations are already very attractive in investment grade credit if we assume no recession," he says.

Nick Lloyd[06], principal adviser at Income to Live Financial Planning, says the main challenge is the potential for further price declines if bond yields continue to rise further in the face of higher-than-expected inflation.

"The opportunity would be the reverse situation, whereby interest rates don't move as high as the market anticipated and yields decline (and therefore capital prices increase). We've seen this happen over the last month but only time will tell if we've seen the peak," he says.

Active or passive?

Investment markets have seen a significant boom in exchange traded funds (ETFs) focusing on fixed income. BlackRock is predicting assets under management across fixed income ETFs will hit US$5 trillion by 2030, but should investors in the fixed income space take an active approach or stay passive?

Dear acknowledges the appeal of ETFs for fixed income, saying: "Investing directly in the bond market can be challenging given it is an over-the-counter market and not listed on an exchange."

He notes too that fixed income ETFs offer several benefits to investors looking to add liquid bond exposure to their investment portfolio – with a level of simplicity and transparency that is not possible by investing in global bond markets directly.

However, he says: "We believe fixed income portfolios need to be actively managed to provide diversification and a low-risk source of income. These characteristics are expected to hold true even as the environment for bonds remains challenging."

The challenge to fixed income ETFs, in the case of high yield as an example, is that the liquidity in the high yield market often limits the securities that these ETFs can own in their attempts to replicate an index, Grotzinger says.

"The short of that is you often get tracking error issues in fixed income ETFs, relative to the index they're trying to track," he explains.

"And underperformance, in some cases, of those indices has resulted in that tracking error issue."

It could be that the main driver for fixed income ETFs is investors' desire for simplicity and low cost, which is common to most passively managed ETFs. There is also a certain appeal in passively managed ETFs for financial advisers, with FIIG Securities' Sheridan saying they allow the adviser to concentrate on asset allocation and "leave the performance to the market".

Nonetheless, he says: "This is a risky strategy as different market regimes should result in different asset allocations, and passive strategies can easily miss these shifts. The current environment, and the last six months or so, has been a salutary lesson in this."

Sheridan notes that a passive approach can work well with equities. However, when it comes to fixed income, he says: "There are many variables for each bond such as coupon rate, coupon type, different maturities, where in the structure the bond is issued from and so on, all of which contribute to the relative value of the particular instrument."

"This makes active management of bond portfolios so much more important in my opinion, and more likely to add value."

Alternatives

With volatility high across most asset classes at present, it can be worth considering fixed income alternatives that deliver income without a considerable uplift in risk.

"When we look at relative value across the world in fixed income, we are identifying a lot of attractive relative value in investment grade securities," Grotzinger says.

"And you can achieve upwards of 5% yield pretty easily with a high quality, straightforward investment grade portfolio."

He adds that corporate debt is attractive and believes the "triple B part of that market has some interesting value"; telecommunications, cable media, and US banks are three industries that offer good value.

"We also like current production agency mortgages in the US, which are a high-quality liquid asset, backed by the full faith and credit of the US government," he says.

WAM Alternative Assets portfolio manager Dania Zinurova[07] says there are numerous fixed income alternatives available to investors, and they can provide strong risk-adjusted yields with low volatility within the alternative assets space.

She believes these investments can provide a powerful alternative to conventional fixed income investments, adding: "Valuations on alternatives are done less frequently compared to more traditional asset classes, and thus more wholly reflect long term underlying fundamentals as opposed to short term market volatility."

Moreover, Zinurova says the highly specialised nature and low number of participants across the alternatives market mean that more favourable terms can often be negotiated – including high yield relative to publicly listed counterparts, and inflation hedging via CPI-linked cash flows embedded in contracts.

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> *There is never a free ride. If you are getting something, you are paying something else for it.*
> **Roy Keenan**

"Certain types of unlisted infrastructure investments, which are largely non-discretionary in nature (such as schools, hospitals and renewable energy) are often characterised by long term contracts with highly creditworthy counterparties, and monopolies or high barriers to entry can provide regular and reliable streams of income through economic cycles," she says.

"Investments in some types of natural resources, such as investments in water rights, can be a valuable source of diversification in the income-producing component of a portfolio due to their returns being driven by a different underlying risk premium (that is, climactic conditions) than that of publicly listed stocks (the equity risk premium)."

Dear argues that it is important to distinguish between risk to underlying cashflows and mark-to-market risk.

"Some fixed income alternatives have avoided the market-to-market volatility but could be subject to underlying cashflow impairment ahead," he observes.

Meanwhile, Schroders sees opportunities in private debt, which has avoided much of the market-to-market volatility by virtue of its floating rate nature and reduced sensitivity to daily market moves.

Even so, he says: "A very prudent approach to assessing credit risks is required as we enter the more difficult phase of the economic cycle for borrowers."

Dear notes that other fixed income alternatives may be appealing if they genuinely offer exposure to different types of underlying economic risk.

"If your portfolio has a concentrated exposure to corporate risk, various forms of securitised debt may offer some diversification," he advises.

"Debt linked to activities with low correlation to the economic cycle, for example, insurance linked securities, are likely to be truer diversifiers."

As Yarra's Keenan points out, the issue of where to generate income without too much risk is the million-dollar question for all investors.

"There are lots of asset classes that people say will give you income, but capital volatility is quite often the trade-off," he says.

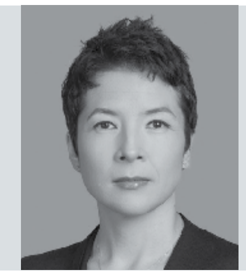
"As much as fixed income over the last couple of months has been very volatile relative to its long-term history, it has still been less volatile than many other asset classes. But it is a truly income-focused product. You're not really in there for the capital gains that you may be trying to get with equities."

He highlights that it is "very hard" to get additional return without taking risk – and cautions that the risk may be hidden in some alternative products. It could be liquidity risk, or some other financial risk that isn't obvious – especially to retail investors.

"There is never a free ride," he adds.

"If you are getting something, you are paying something else for it."

06:
Nick Lloyd
principal adviser
Income to Live Financial Planning



07:
Dania Zinurova
portfolio manager
WAM Alternative Assets

Is private debt promising?

Australia's superannuation sector is increasingly showing interest in private debt opportunities, and there are a range of factors driving both activity and opportunities in the space – but it is an asset class that also brings challenges.

"Private debt is often considered a safe harbour in times of economic turbulence – with covenant packages and often real asset security providing additional comfort. This allows managers to step in early and take pro-active steps to protect the principal of their investors at the first signs of stress," Dear explains.

He adds that with rate hikes underway – and more expected in the near-term, the floating rate nature of private debt can provide reassurance to investors' principal and interest in the event of rate rises.

"With inflation risk looming on the horizon, history tells us that rates generally rise as inflation pressures mount. So, whilst not a direct hedge, floating rate debt may act as a protection mechanism against such inflationary pressures," he says.

Dear suggests that credit analysis needs to be even more focused in such times, as these pressures are also creating stress on the cashflows of underlying borrowers. He believes this calls for an increase in the amount of downside analyses on cashflows that should be undertaken.

Notwithstanding this, he says: "The benefit of private debt is the depth and breadth of information provided about company cashflows. This, combined with the ability to get much closer to the management of our borrowers, allows for a more granular understanding of how strong these cashflows are in relation to the terms and conditions on offer."

Private debt, like many alternative asset classes, encompasses a broad range of strategies that vary significantly in their risk-return characteristics. This enables the asset class to perform well across market cycles and work well as an alternative to fixed income investments.

Zinurova says: "The withdrawal of liquidity from the banking sector has led to a supply and demand imbalance, creating the potential for strong risk adjusted returns."

"Over the past decade, low interest rates have driven demand for higher yielding alternatives and have led institutional investors to increasingly shift their allocations from conventional fixed income to private debt in order to achieve their risk/return objectives."

Moving forward, she expects this trend to be further supported by the floating rate structure of many private debt instruments, which provides a valuable interest rate hedge in the current high inflationary and increasing interest rate environment.

Historically, lending in Australia has been dominated by the big four banks. However, recent regulatory changes, led by the Basel Accords, have seen them withdraw from the sector. As a larger provision of debt financing is required from non-bank financial institutions, Australia's nascent private debt industry has been growing rapidly.

For investors seeking strong income with reduced volatility through economic cycles, Zinurova says senior loans in particular, offer the potential for stable, frequent cash returns.

"Senior loans are characterised by lending to highly cash-generative businesses, extensive due diligence processes, first ranking security (that is, paid out first in the case of insolvency or bankruptcy) and bespoke structures with extensive maintenance covenants to protect against credit deterioration and ensure recoverability in the case of a default," she says.

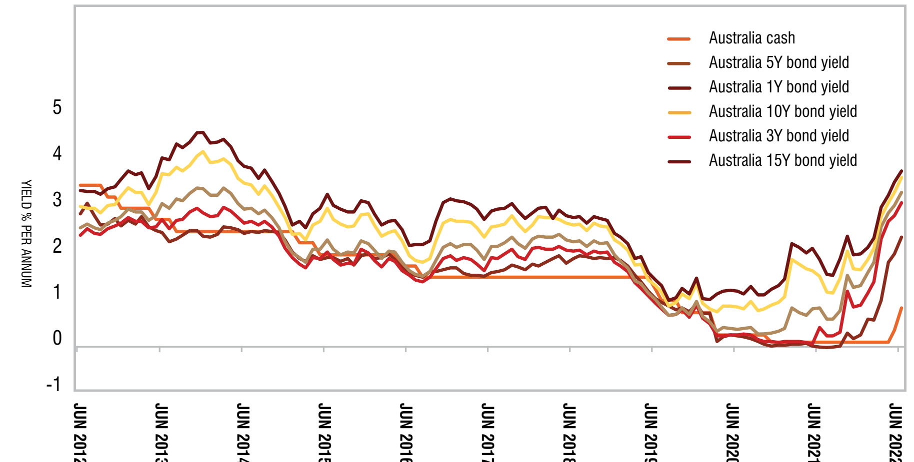
Risk versus return

For Hamilton, the benefits of private debt need to be balanced with additional risks.

"We had a designated private debt allocation, and I want to stress it is very, very different from fixed income. You need to look at liquidity. You need to look at what the underlying investments are, and what the risk is," he warns.

"This is an area for us that over the last eight years or so has paid good, stable returns. But we also recognise economically that the environment is different, and we are watching it with a lot more caution."

Figure 1. **Australian Yield Curve**



Source: FactSet, 2022

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> *Clients are increasingly blurring the lines between public and private, or liquid and illiquid fixed income. It's simple: It's about, how can I get more unit of return, higher levels of yield, and continue to reduce my volatility?*
> **Adam Grotzinger**

Neuberger Berman manages a $16 billion private debt business globally, and Grotzinger confirms an appetite for private debt spanning institutional clients and high-net-worth individuals. He says this is partly a function of wanting to achieve higher levels of running yield and lower levels of mark to market volatility in a portfolio.

"What we have also seen, particularly as the private debt market has grown over the last 15 to 20 years, is that it has expanded to all types of areas of private debt – not only corporate, GP-backed, mid-market loans, but also consumer financed areas of the business," he says.

"Clients are increasingly blurring the lines between public and private, or liquid and illiquid fixed income. It's simple: It's about, how can I get more unit of return, higher levels of yield, and continue to reduce my volatility?"

While he can see the benefits of the sector and why it's growing, Sheridan sees two main points of appeal driving the market.

The first is opportunities to lend to issuers/borrowers who have no need to access public markets for whatever reason.

"It may be that they do not want to pay for a credit rating, or their business is too small to satisfy the minimum size requirements of a public issue (typically $200 million-plus), or the borrower is in a specialised field where detailed credit work is required to understand the particular risks," he says.

The second driver is the opportunity to capture an illiquidity premium.

"Just as in private equity, private debt is not marked to market. This sometimes offers the illusion of stability in capital price as the positions are not marked to market on a regular basis," he explains.

"As most of these loans are not made in security format and therefore are not tradeable on a public market, the illiquidity for the investor must be compensated for in the form of a higher return than might be paid for an identical issue in the public markets."

Summing up, Lloyd says private debt is stepping into the opportunity created by regulated banks moving out of lending to certain sectors – or where their pricing was uncompetitive, and where corporate bond markets are not accessible to borrowers.

Private debt can offer attractive risk-adjusted returns as part of a diversified portfolio – so long as the underlying portfolio is well managed.

"The challenge is primarily in the management of the portfolio" Lloyd cautions.

"In the listed private debt space, we saw a dislocation of prices to NTA during the crunch of COVID in early 2020 and again last month.

"This can be seen as both a challenge and an opportunity." FS