SMSF

A GUIDE TO FIXED INCOME INVESTING IN A VOLATILE ENVIRONMENT

Global markets and investment strategy are at an interesting juncture. There appears to be a positive backdrop for global growth – partly due to the large amount of monetary stimulus still to come into the systems in Europe and Japan. This stimulus will keep yields and returns in sovereign fixed income markets low, and force the search for yield to endure for some time to come. As the global search for yield continues, corporate bonds can play an important defensive role in an investor's portfolio. That's because they can provide capital stability and a steady stream of returns upon which the rest of the portfolio can be built. In this paper, we explore the fundamentals of how bonds work and the key drivers of valuations.

We also discuss corporate bond investing as a way for SMSF investors to access the benefits of diversification as well as a higher income return than what is currently on offer from term deposits and government bonds.

INTRODUCTION: **WHY YIELD CURVES MATTER**

When an investor purchases a bond, they are lending money to a borrower. In return for the loan, the borrower commits to paying a specified rate of interest (also known as the coupon) for the life of the bond, and to repay the face value of the bond when it matures.

The yield is the income return on an investment – it is usually the interest received from a security expressed as an annual percentage. A yield curve depicts the difference that prevails at a given time in the marketplace between yields and maturities. It can be created for any segment of the bond market, however the government bond yield curve is the most widely used. This is because government bonds have no perceived credit risk which would influence yield levels, and because the government bond market includes securities of virtually every maturity, from three months to 30 years.

As a result, the government yield curve is used as a benchmark for pricing other fixed income securities.

THE YIELD CURVE IS IMPORTANT AS IT:

> Helps investors determine the relative attractiveness of a long-term bond versus a short-term bond. Generally, investors will receive higher yields on longer-term bonds as they expect greater compensation when they loan money for longer periods of time. Also, the longer the bond's maturity, the greater the effect of a change in interest rates on the bond's price.

> Illustrates the market's expectation on future interest rate movements.

> Facilitates strategies that may boost returns in different interest rate environments. By anticipating movements in the yield curve, active bond managers can attempt to earn above-average returns on their portfolios.

The shape or slope of a yield curve can be described as either normal, flat or inverted.

NORMAL YIELD CURVES

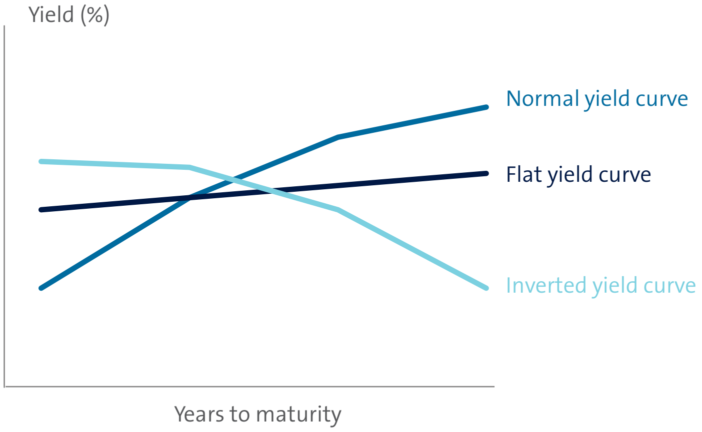
A normal yield curve slopes upwards from left to right. This means that bond yields usually rise as the maturity extends.

FLAT YIELD CURVES

A flat yield curve frequently signals an economic slowdown. The curve typically flattens when the central bank raises interest rates to restrain a rapidly growing economy. Short-term yields rise to reflect interest rate rises, while long-term rates fall as expectations of inflation moderate.

INVERTED YIELD CURVES

An inverted yield curve can be a leading indicator of recession. When yields on short-term bonds are higher than those of long-term bonds, it suggests that investors expect interest rates to decline in the future, usually in conjunction with a slowing economy and lower inflation.

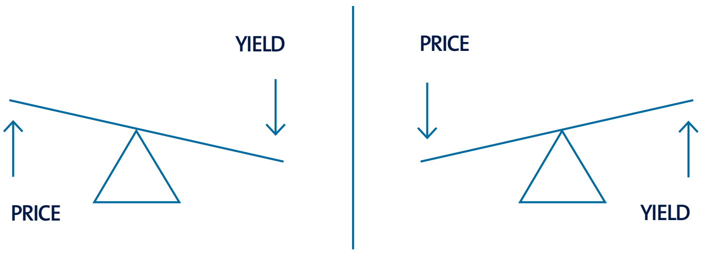


Source: AMP Capital, for illustrative purposes only.

THE RELATIONSHIP BETWEEN PRICE AND YIELD

If investors purchase a new bond with the view of keeping it to maturity, then any change in the price of the bond, interest rates or yields would not be relevant. However, if an investor buys or sells an existing bond, the price that the market is willing to pay for the bond may fluctuate. As a result, the bond's yield (i.e. the expected return on the bond) may also change.

The first, and most important, concept to understand when discussing bond yields is that bond prices and yields have an inverse relationship. That is, when bond prices go up, bond yields go down and vice versa. To understand why this is, it helps to see bond yields as a measure of the profit from a bond investment. The less investors pay for the bond, the greater their profit is likely to be and the higher their yield. Conversely, the more investors pay for a bond, the smaller their likely profit and the lower their yield.



Source: AMP Capital, for illustrative purposes only.

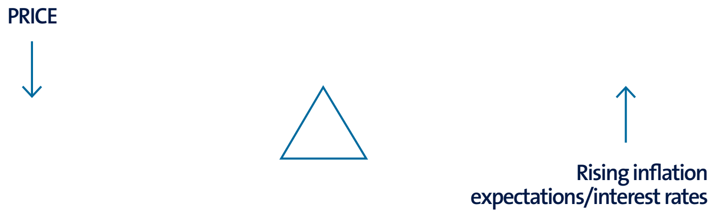
THE MAIN DRIVERS OF BOND PRICES

There are three main drivers of bond prices:

1. Inflation;

2. Interest rates; and

3. The financial health of the issuer.



Source: AMP Capital, for illustrative purposes only.

INFLATION

When the inflation rate rises, the price of a bond tends to drop. This is because the bond may not be paying enough interest to stay ahead of inflation (a bond's coupon rate is generally fixed and unchanged for the life of the bond). This means the longer a bond's maturity, the more chance that inflation will rise rapidly and lower the bond's price. This is one reason bonds with a long maturity offer somewhat higher interest rates to attract buyers who would otherwise fear a rising inflation rate.

INTEREST RATES

When interest rates rise, newly issued bonds typically offer higher yields to keep pace with the bonds that are already trading in the market. When this happens, existing bonds with lower coupon rates become less competitive. This is because investors are unlikely to buy an existing bond which offers a lower coupon rate unless they can get it at a lower price. So, higher interest rates generally mean lower prices for existing bonds. Conversely, when interest rates fall, an existing bond's coupon rate will usually become more appealing to investors, serving to drive the price up.

FINANCIAL HEALTH OF THE ISSUER

The financial health of the company or government entity issuing a bond affects the price investors are willing to pay for the bond. If the issuer is financially strong, investors are confident that the issuer will be capable of paying the interest on the bond and pay off the bond at maturity. If the issuer encounters financial problems, or investors think that it might, the investors may become less confident in the issuer. If so, the price they are willing to pay for the issuer's bonds may fall. Usually, the financial strength of the issuer is rated by credit rating agencies.

THE IMPORTANCE OF CREDIT RATINGS

A bond issuer's ability to pay its debts (i.e. to make all interest and principal payments in full and on schedule) is a critical concern for investors. Most corporate bonds are evaluated for credit quality by credit rating agencies Standard & Poor's and Moody's Investors Service.

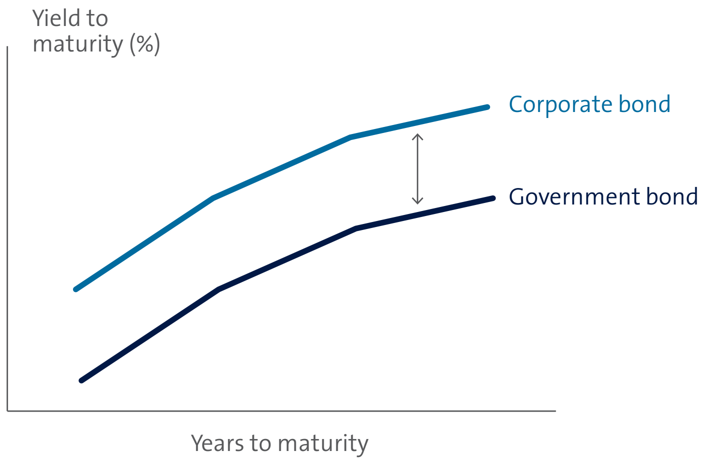
Bonds rated BBB or higher by Standard & Poor's and Baa or higher by Moody's, are widely considered 'investment grade'. This means that the quality of the securities is high enough for a prudent investor to purchase them. Historically, investment grade rated companies have generally been able to withstand a recession and not default, whereas non-investment grade companies tend to experience much higher default rates during recessions.

MOODY'S	S&P	DESCRIPTION	
Aaa	AAA	High grade	Investment grade
Aa1	AA+		
Aa2	AA		
Aa3	AA-		
A1	A+	Upper medium grade	
A2	A		
A3	A-		
Baa1	BBB+	Lower medium grade	
Baa2	BBB		
Baa3	BBB-		
Ba1	BB+	Non-investment grade speculative	Sub-investment grade
Ba2	BB		
Ba3	BB-		
B1	B+	Highly speculative	
B2	B		
B3	B-		
Caa1	CCC+	Substantial risks	
Caa2	CCC	Extremely speculative	
Caa3	CCC-	In default with little prospect for recovery	
Ca	CC		
	D	In default	

Source: AMP Capital, for illustrative purposes only.

DEMYSTIFYING CREDIT SPREADS

Spreads are the common way market participants compare the value of one bond to another. A credit spread refers to the difference between the yield of a corporate bond and a government bond of the same maturity. The credit spread reflects the additional yield an investor can earn from a security with more credit risk relative to one with less credit risk. The spread is usually referred to in terms of basis points (bps). One basis point equates to one hundredth of a percentage point. After purchasing a corporate bond, the bondholder may benefit from a narrowing of the credit spread which contributes to a smaller yield to maturity. This drives up the price of the bond, delivering a capital gain.



Source: AMP Capital, for illustrative purposes only.

DURATION AS A MEASURE OF RISK

Duration is a measure of the sensitivity of the bond's price to changes in interest rates. Duration incorporates a bond's yield, coupon and maturity and is expressed as a number of years. It is the most widely used measure of bond risk. For example: A security with a duration of five years means the bond is expected to decrease in value by 5% if interest rates rise 1%. Conversely, the security is expected to rise in value by 5% if interest rates fall 1%.

Duration is a weighted average of all the cash-flows from a bond or portfolio of bonds. Therefore, the price of a bond with long-term cash-flows has more interest rate sensitivity than an asset with cash-flows in the near future.

Generally, the higher the duration (i.e. the longer an investor needs to wait for the bulk of the payments), the more its price will drop as interest rates go up. If an investor expects interest rates to fall during the course of time, a bond with a long duration would be appealing because the bond's price would increase more than comparable bonds with shorter durations. Likewise, if an investor expects interest rates to fall, a bond with a shorter duration would be appealing.

WHY INVEST IN FIXED INCOME?

A well-diversified, actively managed fixed income fund plays an important role in an SMSF investor's overall investment strategy regardless of the market environment. Benefits such as protection of capital, income generation and diversification can make an investment in fixed income an attractive option for investors.

CAPITAL PROTECTION

Fixed income investments can be appealing to risk-averse investors such as those nearing or in retirement. A diversified portfolio of fixed income securities tends to be much less volatile than an equity portfolio, which means it is less likely to incur large losses in a short period of time. The basic principle of fixed income securities is the repayment of principal at maturity. SMSF investors are repaid the amount of money they originally invested at the end of the agreed period.

INCOME GENERATION

While many investments provide some form of income, fixed income investments tend to offer attractive and reliable income streams. Most importantly, a diversified fixed income portfolio can provide income with a lower level of risk than equities, and may offer higher income than money market funds or term deposits.

DIVERSIFICATION

Over the long-term, diversification can provide investors with better risk-adjusted returns. Bonds can also help reduce volatility and preserve capital, especially for investors with exposure to equities.

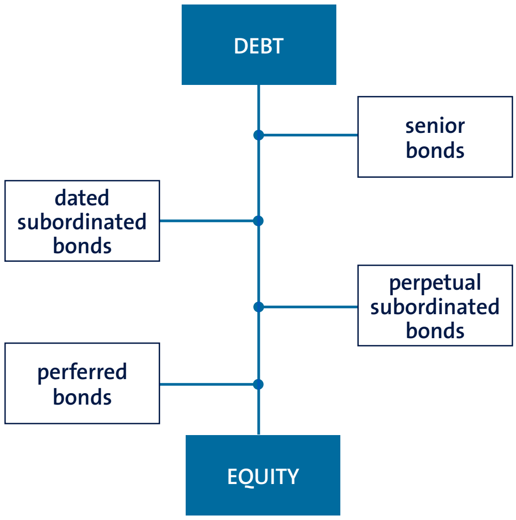
TYPES OF FIXED INCOME SECURITIES

Among the types of fixed income securities investors can choose from are government and agency securities, municipal bonds, corporate bonds, and asset-backed securities such as mortgage-backed bonds.

The yield is generally higher for corporate bonds compared to that of government bonds. This is because the perceived risk for investing in corporate bonds is higher. Mortgage-backed bonds have a yield that typically exceeds high-grade corporate bonds with comparable maturity, and have a low credit risk.

Type	Description
Government	Government bonds are also known as Sovereigns and Treasuries. Governments issue bonds to pay for government activities and pay off their debt obligations.
Agency	Government agencies issue bonds to support their mandates, typically to ensure that various constituencies have access to sufficient credit at affordable rates.
Corporate	Corporate bonds are also referred to as credit. Corporations issue bonds to expand, modernise, cover expenses and finance other activities.
Asset-backed	Banks and other lending institutions pool assets, such as mortgages, and offer them as a security to investors. This raises money so the institutions can offer more mortgages.

Within corporate bonds, there are a number of classes of debt, ranging from senior bonds to preferred securities. Senior bonds have greater seniority in the issuer's capital structure than subordinated debt and preferred securities. That is to say, in the event the issuer goes bankrupt, senior debt must be repaid before other creditors receive any payment. Senior debt is often secured by collateral on which the lender has put in place a 'first lien' or legal right to secure the payment of debt.



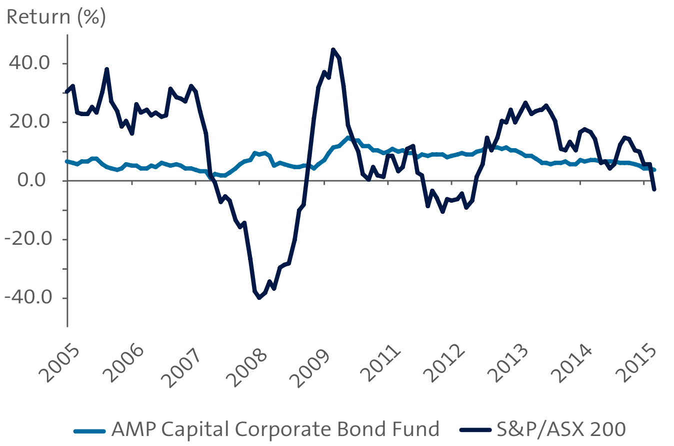
Source: AMP Capital, for illustrative purposes only.

A CLOSER LOOK AT CORPORATE BONDS

For SMSF investors looking to source income with stability, corporate bonds present a compelling investment opportunity. And for those who have ongoing liquidity requirements, this can be provided effectively through an actively managed corporate bond fund. Below are some key reasons for considering corporate bonds as part of a diversified portfolio.

A strong buffer against share market volatility

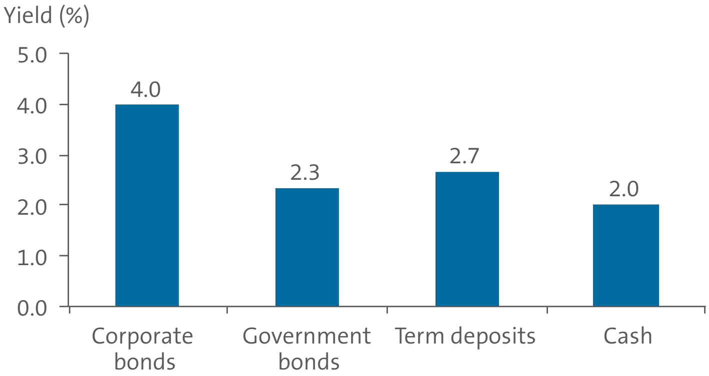
Corporate bonds offer relatively stable cash flows and may be considered a lower risk way of gaining exposure to corporates than investing in equities. Since corporate bonds and Australian equities often move in opposite directions to one another, an allocation to corporate bonds can add to the defensive properties of a diversified portfolio.



Source: AMP Capital, Bloomberg, 12 month rolling returns, 31 August 2005 to 31 August 2015.
Past performance is not a reliable indicator of future performance.

Higher income than term deposits and government bonds

The excess yield offered by corporate bonds over term deposits and government debt is expected to remain relatively high over the medium-term, providing an ongoing source of enhanced income for investors. Moreover, given sound company fundamentals, corporate bonds are well positioned in the current economic backdrop and can benefit from further economic recovery.



Source: Bloomberg and AMP Capital as at 31 August, 2015, Corporate bonds: AMP Capital Corporate Bond Fund, Term deposits: RBA Retail deposit and investment rates, banks' term deposits ($10,000), 3 years; Government bonds: AusBond Government 0+ Year Index and Cash: RBA cash rate. Past performance is not indicative of future performance.

Minimise the risk of capital loss

Active bond managers will commonly adjust a bond portfolio's duration which measures the sensitivity of a bond portfolio's capital value to a change in interest rates. Put simply, the duration will determine how long, in years, it takes for the price of the corporate bond to be repaid by its internal cash flows. This is important because generally speaking, corporate bonds with higher durations carry more risk and have higher price volatility than bonds with lower durations. By managing the fund's duration, an investment manager can aim to limit the risk of capital loss in a rising interest rate environment.

Gain access to the benefits of diversification

In an actively managed, corporate bond fund, investors are able to spread their portfolio risk by being exposed to a range of issuers, industries and geographies. Typically, when investors have exposure to a large number (upwards of 100) of securities the likelihood that a default or systemic event will have a major impact on the portfolio is minimised. Diversification across varying levels of investment grade corporate bonds continues to pay rewards, with the BBB-rated sector in particular performing well recently.

RISKS ASSOCIATED WITH INVESTING

Although bond investments normally pay a set amount of interest income over time, their value can fluctuate in accordance with market pricing. If market bond yields rise, the investment value of the investment will decline. Conversely, a fall in bond yields will increase the value of the investment.

Bond investments are sensitive to movements in credit spreads; namely the size of the bond yield margin above a risk-free asset yield which compensates investors for the associated credit risk. Certain types of bond investments may also be subject to liquidity risk. These investments are also subject to default risk.

A default occurs when the issuer fails to make an interest payment or repay the invested capital. International fixed income investments may also be subject to offshore investment risks including currency risk.

OUR POSITION ON CORPORATE BONDS

Investors remain progressively more cautious in the near term, with rising risks emanating from China and related commodity markets, low bond yields, and ongoing concerns regarding Greece, despite the Greek vote in July.

While the broader European region is in good shape politically and has a strong policy toolset to protect against contagion, the ongoing bailout discussions and execution risks as well as anti-austerity party movement across the periphery will continue to drag on sentiment. We do see this as an opportunity to ultimately add risk due to underlying policy support, other broader macroeconomic data trends and valuation adjustments. Global central bank policy and liquidity conditions continue to drive differing investor behaviour. Yet a rise in broader volatility across asset classes has ensured there is also an acknowledgement of liquidity and underlying positioning that may impact market pricing during this difference in timing and transition phase for global central banks.

Sharp movements in global bond yields year-to-date have underscored these investor concerns as we approach the first rate hike in the US and the interpretation of the next cycle. At this stage, we expect that markets to be volatile into the first hike; indeed, we have started to see signs of this playing out indirectly through linkages into emerging market stress. The risks of a more disruptive outcome are increasing, and we are positioning the portfolios defensively accordingly.

Overall from a credit perspective, corporate balance sheets remain sound as many corporates went into this phase of the cycle in great shape. The rise in leverage is not concerning, with coverage metrics having improved due to lower funding costs and the extension of debt profiles. Top-line revenue (excluding energy-related sectors) remains constructive and cost-cutting over the years has provided support via operational leverage for future quarters. Further cost-cutting initiatives from here should be fairly limited, as will the benefits seen post-crisis from lower interest expense and lower effective tax rates. As such, credit headroom remains very solid, but it will be increasingly important for investors to watch out for corporates that have incentives to re-lever or are overly 'shareholder-friendly'.

HOW WE PLAN TO MANAGE ONGOING UNCERTAINTY

We remain constructive but cautious (in the near term due to timing and transitioning) on the 'top-down' picture for credit. However, increased volatility and recent credit spread widening will ultimately provide an opportunity to tactically add back some risk, particularly as overall global policy conditions primarily still remain supportive.

Our macro credit scorecard is moderately constructive on global credit over the next six to 12 months, and recognises that credit spreads continue to overcompensate for a benign default and volatility backdrop. While we acknowledge that the reduction in overall tail risk in Europe has aided investor sentiment over the last few years, Greece and now China will test the market in the near term. We are seeing signs that geopolitical tensions are becoming more prevalent and the oil price impacts have become much more embedded into sentiment, which may lead to recurrences of market volatility.

We remain active and nimble, with the use of more liquid credit derivative markets to efficiently navigate through any volatility by focusing on regions, industry concentrations and credit quality to add value with much lower transaction costs. These instruments also allow us to hold onto credit amidst volatile backdrops by utilising credit default swaps to hedge credit beta without having to give back stock to the market. We believe our active use of derivatives is a key competitive advantage and allows for a more robust performance outcome across the cycle. That is, our process has led us to hedge our credit exposure at crucial points.

Over the medium-term, we are focusing on sectors and issuers which should perform well despite a lower global growth backdrop that we anticipate will have a more meaningful impact on certain more cyclical sectors. We are also monitoring supply-side dynamics and global relative value pricing as more primary issuance comes to market. Our preference is for exposures to defensive or non-cyclical industries, or to those credits which can illustrate solid deleveraging stories. We continue to have a preference for Australian credit. We also prefer US credit over European credit due to an improved technical backdrop, improved economic data and less negative fiscal feedback loops, although we will be watching movements in bond yields closely as we approach the first rate hike from the US Federal Reserve.

THE IMPORTANCE OF ACTIVE MANAGEMENT

By investing in an actively managed, diversified bond fund investors are able to spread portfolio risk. When investors have exposure to only a small number of securities this exposes them to a concentrated risk in issuers, industries or geographies, and a systemic event can impact a large part of the portfolio.

Active bond managers will commonly adjust a bond portfolio's duration to protect the capital value of the fund. For example, a bond manager expecting interest rates to fall would normally 'lengthen' the portfolio's duration by buying longer-term bonds and selling shorter-term bonds. This is because, in this circumstance, the price of a longer duration portfolio should rise more than that of a shorter duration portfolio.

Bond prices can sometimes increase significantly more than 'par', and in the extreme case of a company defaulting, prices can fall to zero. That is why, unlike equities where one poor performing stock can be compensated with a strong performing stock, bond risk needs to be spread widely.

At AMP Capital, we are constantly tracking data within the market, and factoring ongoing volatility into our scenario analysis. In the face of unchanged fundamentals, volatility events can present opportunities for investors with a sound process that can cut through the noise.

FINAL THOUGHTS

Recent volatility in global markets, ongoing geopolitical risks and diverging central bank policy means SMSF investors need to look even harder for investment opportunities with downside protection. Corporate bonds are traditionally considered lower down the risk spectrum than shares. Nevertheless, when exploring income investing from corporate bond issuance it is prudent to have a focus on investment-grade credit.

While the search for yield leaves many investors with choices surrounding how much risk to carry, it is important to invest in companies with strong or improving corporate fundamentals and a solid management team with bondholder focus, whereby a normalisation of global growth could translate into revenue and earnings growth and further improvements in its credit profile.

ABOUT THE AUTHOR

DAVID CARRUTHERS

Head of Credit and Core

David Carruthers is the Head of Credit and Core at AMP Capital where he leads the Global Fixed Income team's credit and core bond fund capabilities and is responsible for macro credit strategy.

ABOUT FIXED INCOME AT AMP CAPITAL

Our global presence helps us deliver outstanding investment outcomes for clients.

With offices in Australia, New Zealand, Hong Kong and the US, we believe that our global presence helps us deliver superior insights that benefit the performance of our clients' portfolios.

Our transparent and repeatable investment process covers all major sovereign and currency markets, as well as global credit across the US, Europe and Asia Pacific. In addition to this, we believe an independent, valuation driven approach to fixed income investing can generate outstanding investment outcomes for clients.

MEETING THE NEEDS OF OUR CLIENTS

We offer a range of products and solutions to meet the diverse needs of our clients. These range from solutions to address their income, total return, liability matching and liquidity requirements. Our clients range from insurance companies to pension funds, banks to fund of funds, and individual retail clients.

INFORMATION SHARING LEADS TO BETTER RESULTS

As part of AMP Capital, we offer clients the benefit of shared insights across our investment business. Our macro views are enhanced through the economic foresight of our Investment Strategy and Economics team. Our credit analysts also share knowledge and learning with AMP Capital's equity and Environment, Social and Governance research teams for a larger picture on risk and opportunity. We believe this unique contribution of insights provides a basis for stronger investment decisions and better risk management outcomes.

For more information about how to access AMP Capital's capabilities in fixed income, go to the www.ampcapital.com.au/smsf

CONTACT DETAILS

For more information on how AMP Capital can help grow your portfolio, visit our website, www.ampcapital.com.au/smsf

INVESTOR DISCLOSURES