THE ROLE OF FIXED INCOME IN A DIVERSIFIED PORTFOLIO

PERPETUAL INVESTMENTS
10/03/2019

Many investors are familiar with the concept of diversification, spreading investments across different asset classes. Most diversified portfolios include growth assets, such as shares and property, as well as defensive assets, such as fixed income and cash.

The defensive nature of fixed income means this asset class can often play an anchoring role in a diversified portfolio. Most fixed income securities are negatively or only slightly positively correlated with shares and generally exhibit lower risk. Regular interest payments provide a steady and predictable source of income. When the security reaches maturity, the face value is returned.

WHY INCLUDE FIXED INCOME IN A PORTFOLIO?

Fixed income investments have traditionally fulfilled three important roles in an investment portfolio:

Return of capital

Fixed income securities are generally designed to repay the investor's capital at maturity or over the term of the 'loan'. This makes many fixed income securities, especially government and semi-government bonds, an effective capital preservation tool. This assumes that the issuer doesn't default, which is where the in-depth analysis undertaken by Perpetual's experts comes into play.

An income stream

Fixed income provides income from regular coupon payments, which occur on set dates throughout the year. This income is dependable; investors know when and how much income they will receive at each payment period, which may be monthly, quarterly, twice yearly or annually.

Diversified returns

Most fixed income investments are classified as defensive assets, with a different risk and return profile to shares. As illustrated in our article Fixed income – a diversified array of investments, different types of securities have a different position in a company's capital structure and, in the event of a company being wound up, will be repaid accordingly.

Fixed income securities typically rank above portfolios of hybrids or equities. While the prices of fixed income securities may fluctuate according to interest rates and the economic cycle, historically, fixed income securities have experienced lower price volatility comparable to share prices.

BETTER THAN CASH

While investors turn to property and shares for income, they often turn to cash (such as bank accounts or term deposits) to minimise their overall risk exposure and reduce overall capital volatility. For those investors in, or close to, retirement, low capital volatility is a common need. However, as interest rates have fallen, bank accounts and term deposits no longer provide the same level of income as they once did and in many cases, barely keep pace with inflation.

Despite this, in a trend that emerged following the global financial crisis a decade ago, many Australian investors continue to rely heavily on term deposits for their defensive exposure; according to APRA[1], Australian households currently have more than $925 billion on deposit.

Many investors have a need for income but often only utilise a limited number of sources of income to meet that need. The overall ageing of Australia's population has resulted in a growing demand for income producing investments as retirees focus on meeting expenses and preserving capital. Across Australia, investment income is becoming an increasingly important part of an investor's portfolio.

Typical sources of income have traditionally included dividends from shares, rent from investment properties, and interest payments from cash and term deposits. Australia has been in a period of historically low interest rates and low growth, creating uncertainty for investors who rely on these sources of income. An alternative source of income includes fixed income assets such as corporate bonds, floating rate notes, asset-backed securities or mortgage-backed securities and private debt.

Fixed income assets should therefore appeal as a higher income producing alternative to cash. They have the additional advantage of being less risky than portfolios of shares, hybrids or property investments because, as debt assets, they sit higher in the capital structure than equity type assets.

FIXED INCOME – THE UNDERREPRESENTED ASSET CLASS

Despite a growing need for income and wealth preservation, there remains a gap in investors' portfolios; as illustrated in figure one, Australian investors have one of the lowest allocations to fixed income assets in the Organisation for Economic Co-operation and Development (OECD) countries.

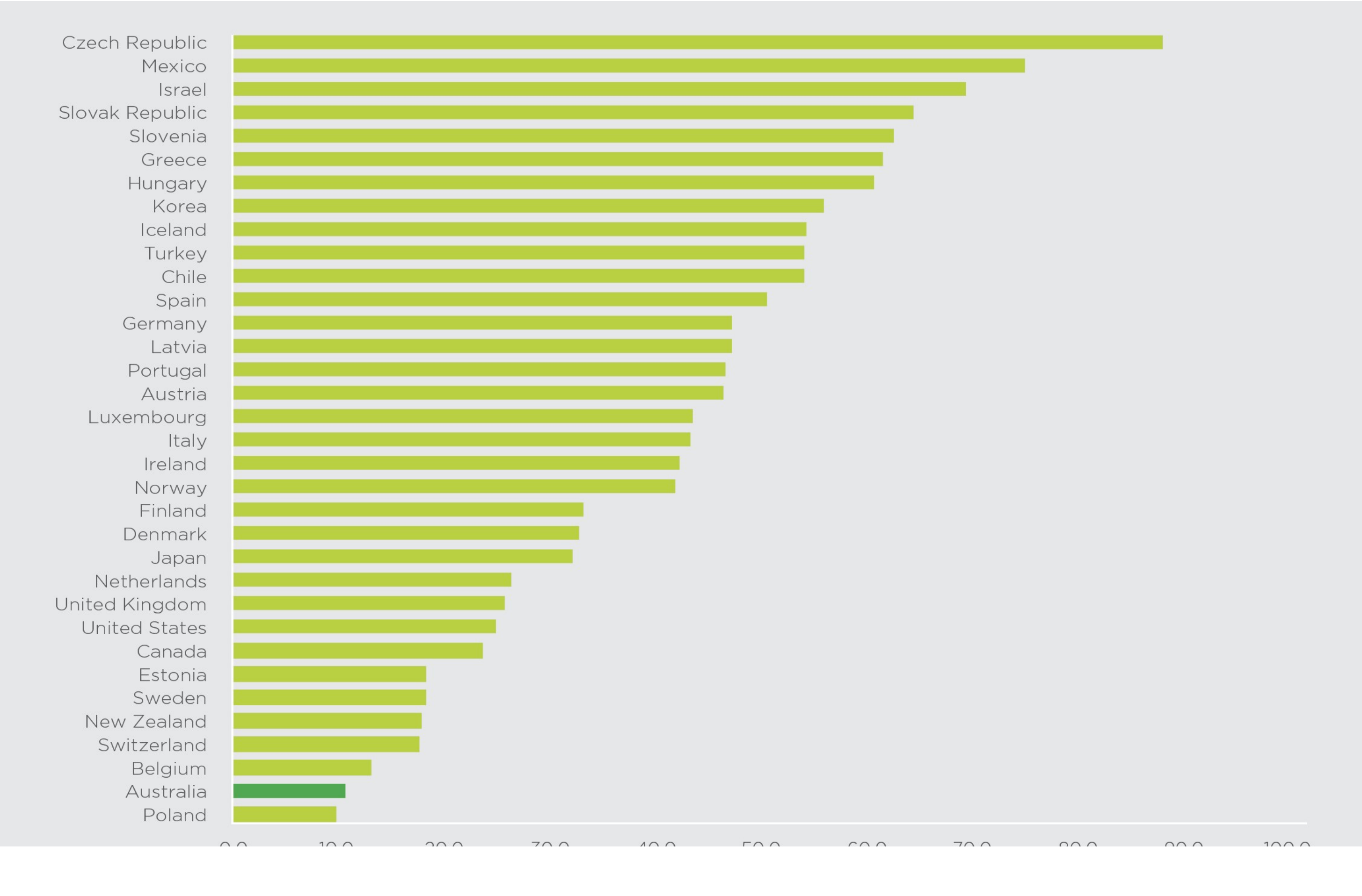

Figure one: Allocation of fixed income assets in OECD countries

Source: OECD Pension Markets in Focus No. 15, 2018

Even with the multitude of investment options available, Australian investors have historically looked to three asset classes to generate income – Australian shares, cash or term deposits and property. Figure two shows how self-managed super fund (SMSF) investors have heavily weighted their investment portfolios towards these assets.

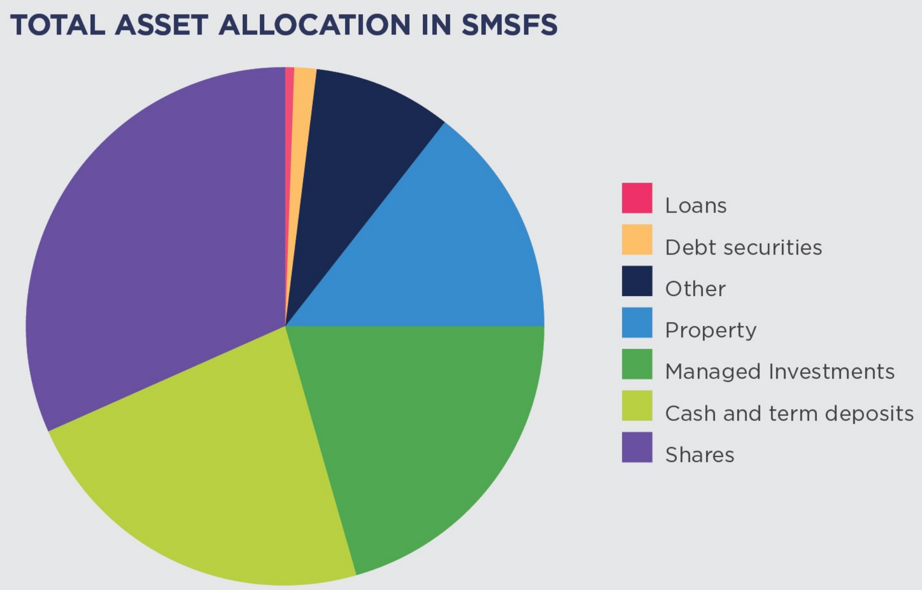

Figure two: ATO estimates of direct assets held in SMSFs

Source: ATO Self-managed super fund quarterly statistical report – September 2018

This lack of diversification may have negative consequences for investors during an economic downturn, as property and shares are generally highly correlated with one another and with the economic cycle. In other words, the value of these assets tend to rise and fall at the same time. Fixed income markets, however, tend to move in the opposite direction to broad movements in equity markets.

Fixed income assets can complement a portfolio by providing a reliable income stream with generally low correlation to shares, property and cash. Add that to the return of capital at maturity, fixed income assets are generally a lower risk option than shares and property, although typically higher risk than cash.

The key to a successful investment strategy is having the right mix of assets in a portfolio. A diversified portfolio, one which includes fixed income, is generally better positioned to balance risk and return and ultimately meet investors' investment objectives.

Find out more about Perpetual's suite of credit and fixed income solutions.

1. APRA Monthly Banking Statistics, December 2018