Fixing your approach **to Fixed Interest**

BT Investment Management

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With bond markets remaining near their highs, it's a brave investor to take the Fixed Interest sector on...isn't it? Here's why Australian bonds need to remain a central part of your portfolios:

Reason 1

Fixed Interest is providing higher returns and more protection than Term Deposits (TDs)

A walk past any bank branch now shows the problem facing investors looking for income: TD rates are low, particularly after the effects of tax and inflation. Most people are left wondering if they are worth it despite the safety they provide.

TDs have a Fixed Interest rate for a set period of time so the rate at the start of the agreed term is the same rate received throughout the whole term. TD returns continue to fall in tandem with the official interest rate set by the Reserve Bank of Australia (RBA) and market interest rates.

Chart 1: The BT Wholesale Fixed Interest Fund has outperformed Term Deposits

Source: BTIM, Morningstar, RBA

“Fixed Interest has outperformed Term Deposits.”

The principle behind Fixed Interest is relatively simple. The ‘issuer’ of the Fixed Interest security offers to pay the investor a known rate of income and a return of capital at a known date. In return the issuer gets to use the investor’s money until the bond ‘matures’. There are many different types of Fixed Interest investments including bonds and other forms of government debt, corporate debt and issued securities.

One of the major differences therefore between TDs and Fixed Interest investments is that the returns from Fixed Interest in the short term are affected by other movements in the market – the broad level of interest rates in the economy, the expected direction of those rates in the future, the bond’s credit and general supply and demand in the market.

Because of these fluctuations, the value of a bond will likely be higher or lower than its original face value if it is sold before it matures. In general, when interest rates fall, prices of outstanding bonds with higher rates rise. The inverse also holds true: when interest rates rise, prices of outstanding bonds with lower rates fall to bring the yield of those bonds into line with higher interest-bearing new issues. This is what is concerning bond investors now – that the prices of bonds will fall as interest rates globally (particularly in the US) start to rise.

However, as we have seen over the past few years, those who have invested on the basis that interest rates will rise imminently have paid a high opportunity cost. In the past five years while TD yields have fallen to the low single digits, the BT Wholesale Fixed Interest Fund, which is benchmarked to the UBS Composite Bond Index, has returned 8.09% over the past 12 months (post-fee, pre-tax, to end September 2015).

Reason 2

Fixed Interest plays an important role in your portfolio at any time

Despite Australian government bond yields and interest rates being at record lows, Australian Fixed Interest still plays a very important role in diversifying portfolios and should provide solid returns - especially if equity markets are under pressure.

Table 1: Australian Fixed Interest and Equities returns 2008-2014

Calendar Year	Australian Fixed Interest	Australian Equities
2008	14.9%	-38.9%
2009	1.7%	37.6%
2010	6.0%	1.9%
2011	11.4%	-11.0%
2012	7.7%	19.7%
2013	2.0%	19.7%
2014	9.8%	5.3%

Source: IRESS. Australian Fixed Interest: Bloomberg AusBond Composite 0+ Yr Index. Australian Equities: S&P/ASX300 Accum Index

Fixing your approach
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Chart 2: Equity/bond correlation - bonds have acted as a cushion in times of equity market stress

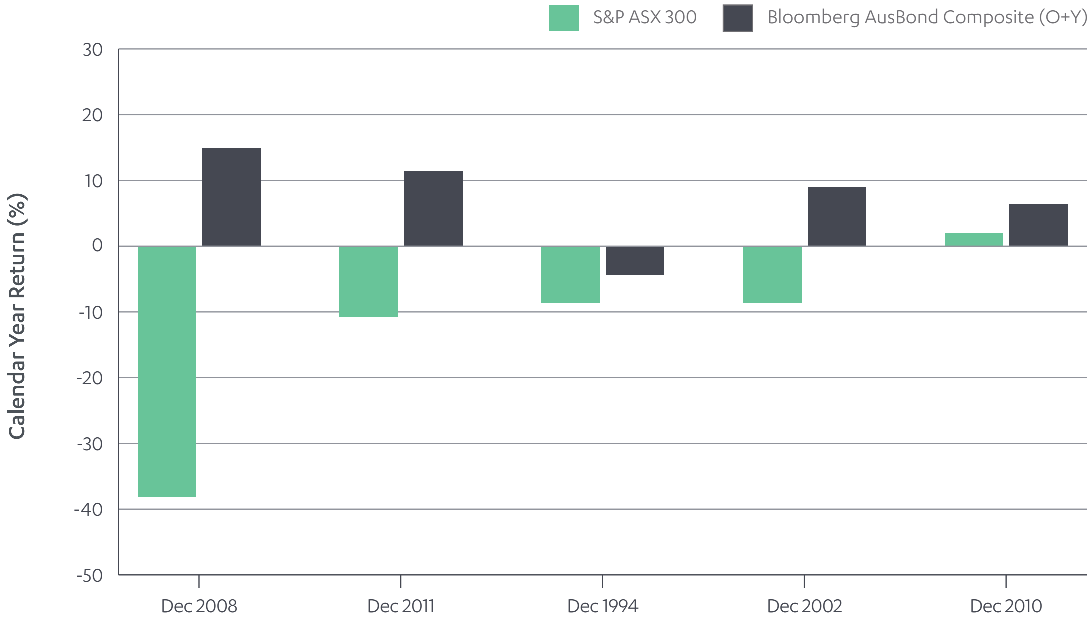
Source: BTIM, FactSet

A negative correlation occurs when as the value of one asset rises, the value of the other falls.

The chart above shows that in the US and Australia, Fixed Interest and equities are generally negatively correlated, and can therefore be used to protect an overall investment from reversals on the share market. When properly constructed, bond investments can gain in value at the same time as the share market falls, cushioning overall returns.

“Bonds have acted as a cushion in times of Equity market stress.”

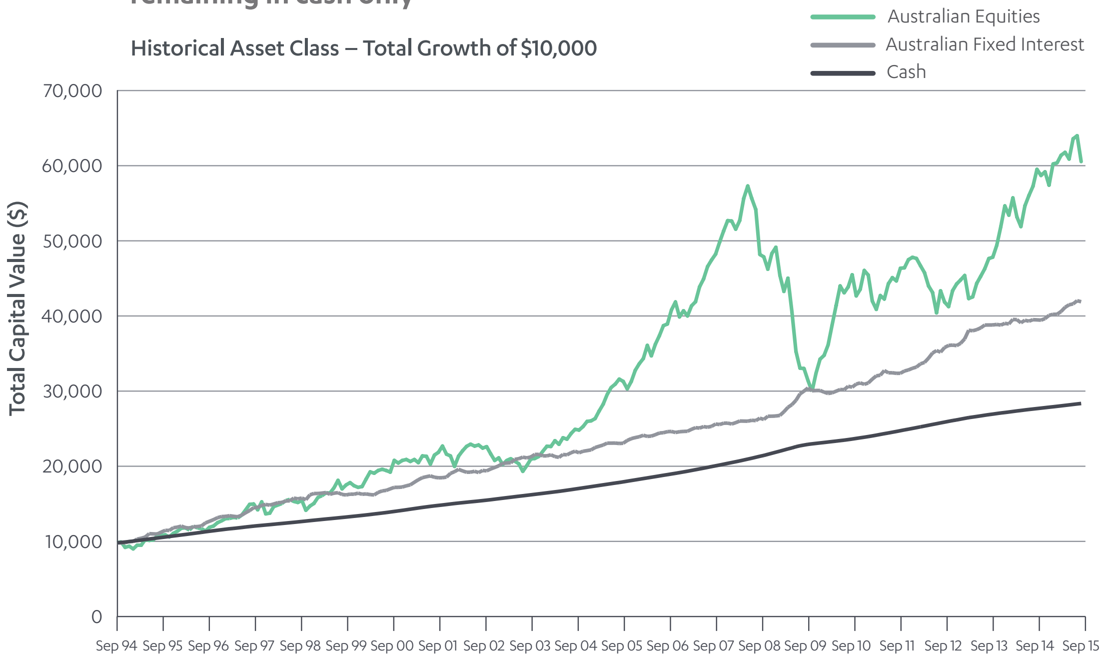
Chart 3a: When Australian Equities have fallen the most over the past 25 years, Fixed Interest has tended to rise...



Source: BTIM, FactSet

Chart 3b: ...leading to less volatile and stronger long-term investment results than remaining in cash only

Historical Asset Class – Total Growth of $10,000



Source: Factset, BTIM

Fixing your approach **to Fixed Interest** continued

Reason 3

The current environment *does* provide opportunities in Fixed Interest – with the right approach

Fixed Interest is meant to provide relative safety, income, and protection in times of volatility in equity markets. However, Fixed Interest portfolios need to be carefully built to ensure these features are effectively provided.

This can be seen in the period during and after the GFC when equities were under stress. Unfortunately for many advisers and their clients invested in Fixed Interest funds, they missed out on the benefits of the higher returns available in the sector because their managers failed to recognise the impacts the slowing global economy and an attractive domestic government bond market would have on bond prices.

At BT Investment Management we utilise an alpha/beta approach where we look to replicate the index exposure to clients and then look to generate additional returns through active management, not taking large medium terms bets between credit (corporate securities) and government bonds. This allows us to be more true to label for clients looking for that negative correlation to equities in their portfolio.

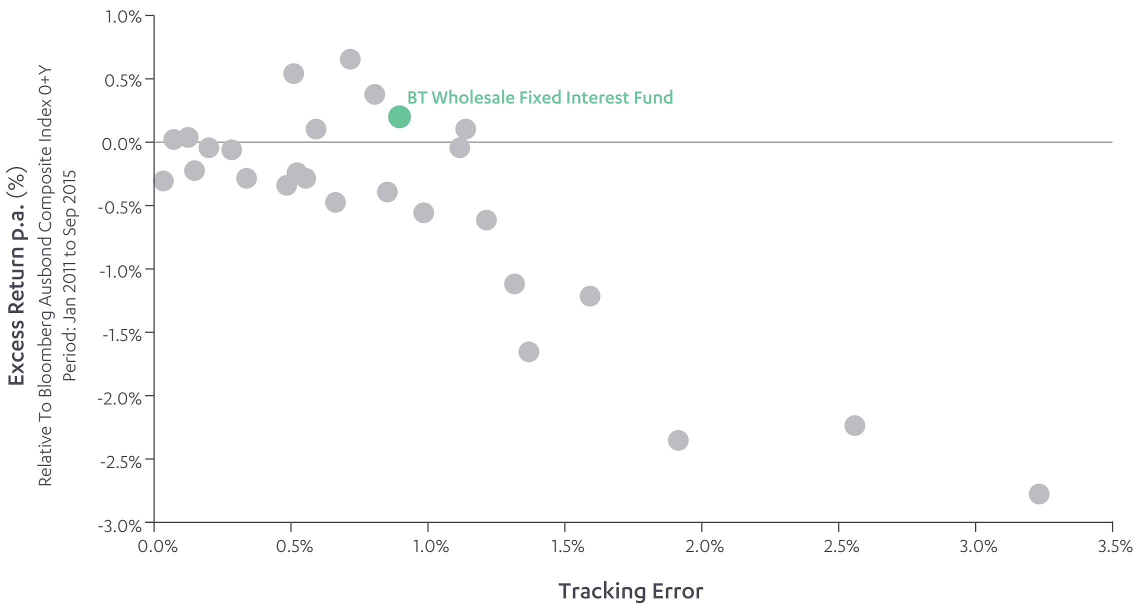
> "Fixed Interest is meant to provide relative safety, income, and protection in times of volatility in equity markets."

“The construction of individual Fixed Interest funds is crucial.”

Additionally, we utilise a top down macro approach, that considers Australia in a global context. This process has allowed us to quickly interpret offshore data which showed slowing growth globally and that interest rates around the world would be lower for longer.

As you can see below, the BT Wholesale Fixed Interest strategy provided our clients with excellent excess returns.

Chart 5: Risk and return – Fixed Interest universe



Source: Morningstar

Fixing your approach **to Fixed Interest** continued

Not all Fixed Interest investments are the same – government, semi-government, corporate debt, and hybrids are just some of the types of Fixed Interest available, all of which offer very different risk profiles. Often, investors do not have a good understanding how these different types of securities behave in varying market conditions, and that's where they can get into trouble.

For many people having a manager choose their Fixed Interest investments is a smart way to go. Even then, however, investors have to choose their Fixed Interest manager carefully. If a manager is too dependent on achieving higher returns by investing in riskier Fixed Interest investments, or alternatively takes a passive approach, they may not provide the diversification benefits that are sought from this more defensive part of your portfolio.

We may be closer to the end of a cycle in Fixed Interest than the beginning. However, even if this is the case, when considered over the long term the size of the drawdown compared with equities in stressed markets are relatively small:

Chart 6: Drawdowns in the Australian equity and Fixed Interest markets, medium term

From an overall portfolio perspective, the risk of negative returns from appropriately constructed Fixed Interest portfolios should be more than offset by rising equity markets.

“The sizes of the drawdowns in Fixed Interest compared with equities in stressed markets are relatively small.”

Reason 4

Australian economic growth will remain patchy for some time – this is likely to be supportive for bonds

While the US economy has shown at least some signs of life, the domestic economy continues to deal with significant issues. In particular, the iron ore price is down to US$51 a tonne from above US$60 in February and many smaller miners are now close to the break-even level on the cost of production. The Federal Government has even prepared for a price of US$35 a tonne. This has had a trickle-down effect into many areas of the economy, especially business investment.

Associated to the iron ore price is the economic health of Australia’s largest trading partner, China. Iron ores and concentrates are far and away Australia’s largest export to China, five times greater than the next largest export (coal). With China one of the largest users of iron ore in the world, Australian economic watchers keep a close eye on the strength of the Asian superpower.

The news recently has not been good, with exports down and Chinese domestic demand down to an extent that the Chinese Government has embarked on an aggressive loosening of monetary policy in order to reach its (quarter-century low) 7% growth target.

A typical rate reduction cycle in Australia consists of at least two to four cuts. Further falls in the iron ore price and Chinese economic weakness is likely to increase demand that these cuts come sooner rather than later, supporting bond prices, and that these relatively loose settings be held lower, for longer.

The Reserve Bank has moved to cut interest rates to all-time lows but the jury is still out on whether that will be enough to prop up the economy. A lack of economic growth in response to the moves will tend to put a cushion under bond yields for some time yet.

Fixing your approach
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Reason 5

Australia's sovereign yields are attractive compared to global peers, supporting inflows

When compared with other countries, Australian Fixed Interest offers good returns for the risks being taken. The following chart shows the return on a 10 year bond in AAA (top-rated) countries:

Chart 7: Australian bonds provide good value for money

Source: BTIM, FactSet, IMF

Although there are some variables in this equation, it becomes clear that Australia provides a far higher return than comparative countries, particularly when government gross debt levels are taken into account. This means that Australian bonds are offering outsized returns compared to the level of risk taken on by investors. This will remain the case if and when a rate tightening cycle begins, meaning in essence, the market for domestic bonds will continue to be supported compared to that of other countries.

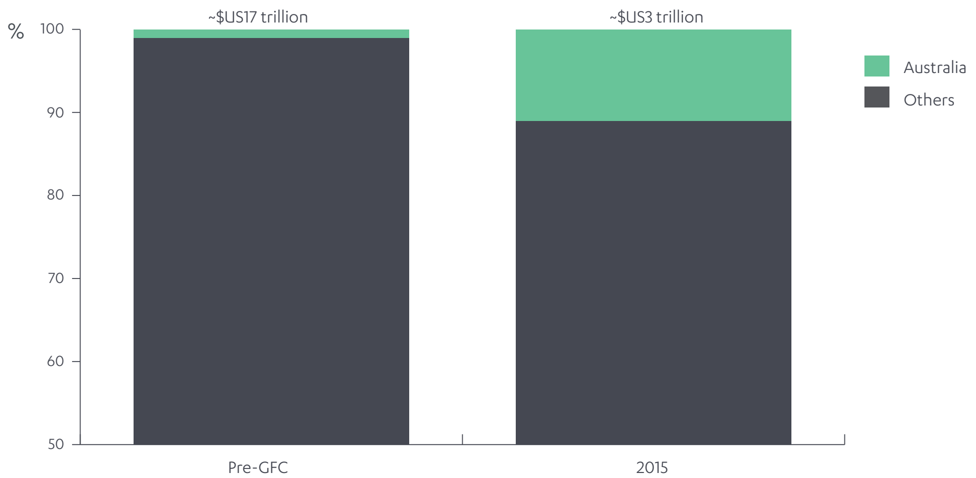
“Australian bonds provide good value for money compared to other markets.”

Reason 6

Global investors such as pension funds, governments and insurance companies have to invest in AAA-rated assets, further supporting Australian sovereign debt

We have noted above that Australia represents good value versus other AAA-rated countries, offering a relatively high yield and solid government balance sheet.

Chart 8: Australia’s share of the super-AAA pool has increased



Source: Bloomberg, UBS

This is likely to be further encouraged by the shrinking stock of AAA-rated assets. According to the International Monetary Fund (IMF) the number of nations whose debt is considered safe has fallen. Its projections show between 2012 and 2016 about US$9 trillion or roughly 16% of the projected total of safe haven assets is being removed from the system. The IMF goes on to say the private sector production of safe assets has also declined as poor securitisation in the US (linked to asset-backed securities) has tainted these securities as well.

At the same time, regulatory change prompted by the GFC has increased demand for AAA assets from insurance companies, banks and sovereign wealth funds.

More than 85% of Australian bonds are now owned by offshore investors. They are not so concerned about how low our rates are but if the rates are attractive on a comparable basis. Again, on a relative basis Australian government Fixed Interest looks attractive and this is not likely to change notwithstanding the ebbs and flows of the interest rate cycle.

In aggregate, the supply of AAA assets as provided by Australia has fallen while demand has increased, leaving Australian government bonds in relatively good shape if and when we do enter a tightening cycle.

Fixing your approach **to Fixed Interest** continued

Reason 7

Internationally, interest rates are likely to be lower for longer than the market expects, supporting bond yields

Investors are now waiting for the US to enter an interest rate tightening cycle. The jury is still out on if and when this will occur. If and when it does occur, there is also debate on how many interest rate increases are likely to be required in the US to put its economy on a sustainable growth path.

In Japan and Europe the central banks are continuing to use QE policies to fight the spectre of disinflation. Although there have been signs that these QE policies have led to some economic improvements, they have been patchy, and the central banks have shown no signs of cutting back on them.

These QE policies, compared with US need for economic growth, will keep bond prices lower for longer.

Why BT Investment Management for your Fixed Interest investments?

We have been successful:

The BT Wholesale Fixed Interest Fund outperformed all of its peers in 2011 and 2014 (Mercer).

We are truly active:

We aim to achieve our outperformance by using many different inputs and investment strategies, particularly when markets are volatile.

We don't take unnecessary risks:

Every active position in the portfolio is constantly monitored and measured to ensure that we can take profits when markets are going our way and cut losses quickly when they are not.

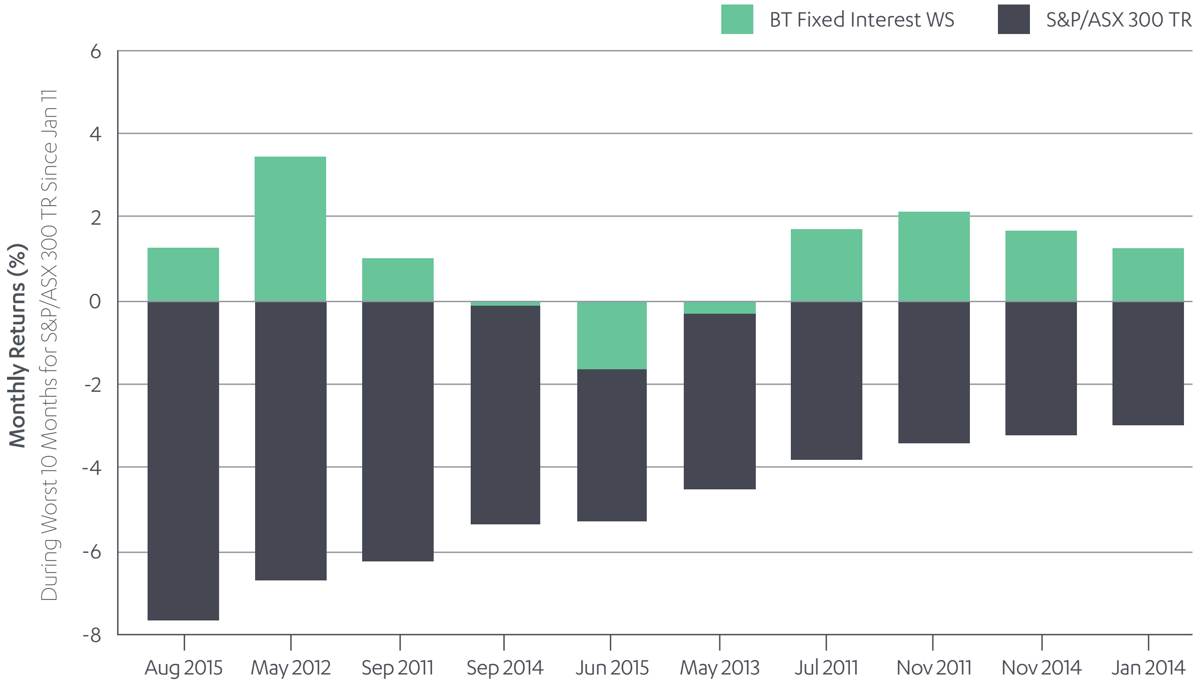
We're defensively positioned when you need us to be:

Our portfolio is positioned defensively in times of equity market stress, like in 2011 and 2014. In fact, in 2011 only 7 out of 29 fixed income funds in BTIM's peer group outperformed the benchmark. In 2014, BT Investment Management's funds were 2 of just 4 funds to achieve this feat out of 27 in total (Morningstar).

> “When the Australian share market is experiencing its worst months, the Fund has tended to deliver positive returns.”

BT Investment Management aims to be the most defensive Fixed Interest manager in Australia. This is highlighted by the chart below, which shows that when the Australian share market is experiencing its worst months, the BT Wholesale Fixed Interest Fund has tended to deliver positive returns.

Chart 10: Monthly Returns for BT Wholesale Fixed Interest Fund when Australian equities were falling in 2011 and 2014



Source: BTIM, Morningstar Direct

We consider Australia in a global context

We draw on global factors when assessing the domestic environment and above all else look at the risks, then the potential returns that these risks can generate. We are also cognisant that the demand for Australian bonds is driven primarily by offshore investors (who now own more than 80% of all Australian bonds) rather than domestic investors. We therefore look at Australian government bonds from their global perspective when many of our peers do not.

Summary

In a year that promises to be volatile the protection historically provided by fixed interest should not be ignored.

At BT Investment Management we take a very defensive approach to fixed interest to help protect your overall portfolio during times of equity market stress.

Fixing your approach
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Why Fixed Interest investments?

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Fixed Interest is providing higher returns and more protection than TDs

Reason 2

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Reason 3

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Reason 5

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Reason 6

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Reason 7

Internationally, interest rates are likely to be lower for longer than the market expects, supporting bond yields

Table 2: Performance of flagship Fixed Interest Funds to 30 September 2015

	6 months (%)	1 year (pa) (%)	2 years (pa) (%)	3 years (pa) (%)	5 years (pa) (%)	Since incep. (pa) (%)
BT Wholesale Fixed Interest Fund						
Total Return (post-fee, pre-tax)	-0.26	8.09	7.14	5.06	6.79	6.94
Benchmark	0.17	6.91	6.46	4.89	6.64	7.06
BT Pure Alpha Fixed Income Fund						
Total Return (post-fee, pre-tax)	1.11	7.81	4.99	N/A	N/A	3.89
Benchmark	1.10	2.47	2.56	N/A	N/A	2.68
BT Wholesale Monthly Income Plus Fund						
Total Return (post-fee, pre-tax)	-0.22	5.68	5.27	5.74	5.74	6.12
Benchmark	1.03	2.26	2.40	2.58	3.34	3.45

The BT Wholesale Fixed Interest Fund aims to provide a return (before fees, costs and taxes) that exceeds the Bloomberg AusBond Composite 0+ Yr Index. It gives benchmark-based exposure to the Australian Fixed Interest market by investing in a combination of Commonwealth-government, semi-government and corporate debt and short-term money market securities.

The BT Pure Alpha Fixed Income Fund has an absolute return focus, with a low correlation to equity and bond markets by investing in fixed interest, credit and foreign exchange markets. It may suit investors wanting exposure to Fixed Interest but not wanting to take on the interest rate risk inherent in the benchmark.

The BT Wholesale Monthly Income Plus Fund is designed for investors who want the potential for regular income and some long-term capital growth to protect against inflation. It aims to provide a return (before fees, costs and taxes) that exceeds the RBA Cash Rate over rolling 3-year periods by investing in a number of income generating strategies across a range of asset classes, including fixed interest, shares, cash and alternative investments.

Meet the portfolio manager

Vimal Gor joined BT Investment Management in November 2009 and was appointed Head of Income & Fixed Interest in June 2010. He is responsible for leading the team, process and strategy for all of our Sovereign and Credit Funds. Prior to working with us, Vimal was at Aviva Investors in London for over 10 years where he was responsible for the management of the global bond portfolios within the sovereign team. He was also the lead fund manager globally for all of Aviva Investor's Global Aggregate Bond Funds and worked on the G7 and Fixed Income Macro hedge funds. He was co-chair of the Global Aggregate Asset Allocation process. Prior to Aviva, Vimal was a Fund Manager at Murray Johnstone in 1994 before moving to Scottish Mutual in 1996 where he was a Fund Manager for three years. Vimal holds a First Class BSc (Hons) Degree in Economics and Computer Science from Salford University.

MONEYMANAGEMENT
FUND MANAGER OF THE YEAR 2015
WINNER | Australian Fixed Income (inc Diversified)

We offer an experienced team, a transparent investment process and a proven track record.

For more information

Please call 1800 813 886, contact your dedicated sales representative or visit btim.com.au

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