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Time to extract more from bonds and cash

When the bond yield take is nearly empty, investors need to look for alternatives.

by **Chris Wright**

Mainstream bonds have rarely earned you less. Today, a German 10-year government bond yields you a mighty 0.02 per cent, and Switzerland, minus half a per cent. Japan, too, costs you money rather than paying you, and even in Australia – one of the highest-yielding government bond markets in the developed world – a rate of 2.18 per cent on 10-year debt is far, far lower than investors have come to expect.

So, what to do? This week we look at credit and cash enhanced products – the science of trying to extract a bit more from a dormant asset class.

"Rates are low, and we have a real return objective, so being in cash is not going to help," Phillip Win, senior financial planner at Profile Financial Services, says. "We're not into bonds; we don't think bonds are a great place to be. We believe that with the interest rate cycle as it is, you're not being rewarded."

At the edges, though, there are products that Win still finds interesting, most notably in the credit space – that is, taking a little more risk in order to get a decent return. One is from the US fund manager Payden & Rygel, whose bond products include funds for global inflation-linked, global high yield and emerging markets corporate bonds, all of them in UCITs (mutual funds based in Europe) form and therefore relatively easy to invest in.

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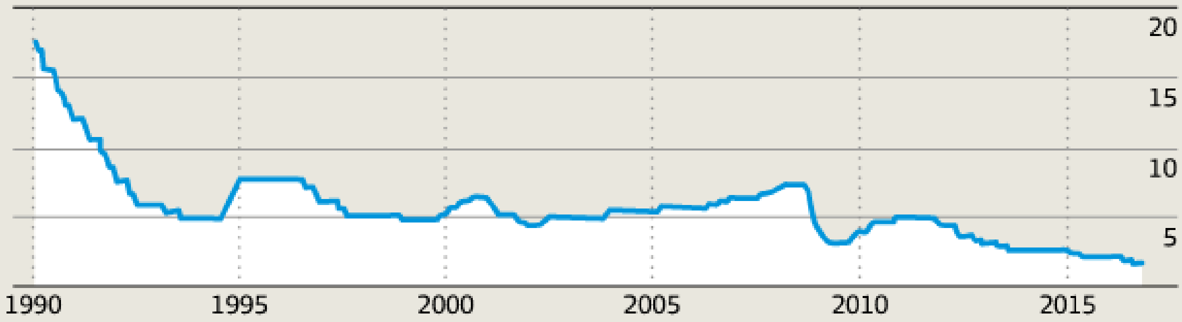
Low down

Official cash rate (%)



Details of selected bond and cash funds

	Fund size ($m)	Mgmt fee (%)	Target return
Bentham Syndicated Loan Fund	3600	0.84	BBSW* plus 3-4%
Bentham Global Income Fund	1300	0.77	4-5% of mthly unit price
Kapstream Absolute Return Fund	4600	0.70	3.54% **
Henderson Global FI Total Return Fund	39	0.68	6.87% **
Macquarie Income Opportunities Fund	2500	0.49	4.47% **
PIMCO Global Credit Fund	1000	0.61	8.57% **
Vanguard Aust Government Index Bond Fund	450	0.20	5.80% **
iShares Core Composite Bond ETF	340	0.20	5.54% *
BetaShares Aust High Interest Cash ETF	924	0.18	3.46% **

* Bank bill swap rate ** Actual

SOURCE: RBA, COMPANY WEBSITES

"It has been a low return environment but they have still been delivering," Win says. "I'm not looking to get 8s and 9s from them because if they're doing that, they've gone further up the risk spectrum. At the end of the day, the asset class is in your portfolio as a buffer."

He also admires T. Rowe Price. "They are going into markets that aren't traditional. It is harder to get coupons unless you are moving further up the risk spectrum." This manager gets good results from developing economies with well-developed bond markets that are chiefly held by locals rather than foreigners. "That way you get a higher yield, but not the capital fluctuation," Win says. "And they keep liquidity through exposure to more liquid markets like US bonds, so you don't get stuck."

Considering risk

Darren Johns, financial planner at Align Financial, still invests in Australian and global bond funds, but has noticed a change in expectation from clients. "Over the past 12 to 18 months, our clients who perhaps hold 20 to 30 per cent in cash are starting to see returns on that cash of less than 3 per cent," he says. "It's funny how people perceive their risk appetite to change when the cash rate falls so low. They are starting to look at subordinated debt, capital notes and hybrid notes, fully aware that they have a far different risk profile than cash in the bank."

Johns is wary of the fact that some hybrid instruments with equity-type characteristics can end up behaving like stocks, rather than a diversifier away from them. Nevertheless there are hybrid notes he holds, focusing on two or three issuers so as to stay on top of risk more effectively. They tend to be top tier. "I take more comfort if the issuer is a top 10 bank or supermarket rather than an energy company or a casino," he says. He favours the PERLs series from the Commonwealth Bank of Australia, now on series 8. "Investors who got in the earlier issues have done quite well: had their money returned, interest repaid, and franking credits."

Johns uses bond funds too, favouring the Vanguard Australian Government Index Bond Fund – a passive product – and the Dimensional Diversified Five Year Bond Fund, which is an active fund but which "tends to stay high up the credit curve. We don't tend to drift down to the lower end of the scale, because the biggest risk is not getting repaid. We try to mitigate that risk".

Other financial planners find different ways of turning mainstream cash and bonds into returns. Louise Lakomy, director of Crystal Wealth Partners, says her firm saw an opportunity to put a US dollar tilt in place when the Australian dollar was high, so as to take advantage if the Aussie/US dollar cross rate reverted to norms (which it did).

"We decided to realise the opportunity by adding effectively a small variable US dollar cash allocation," Lakomy says. This is achieved by buying an exchange traded fund – BetaShares, for example, has one which is basically just US dollar cash. "This allows us to easily change the tilt at various times, taking profits where appropriate or putting back more currency exposure for clients at the expense of equity risk," she says.

Taking the benchmark

Then there's the argument that, since it's so difficult to outperform in such a difficult environment, one might as well just take the benchmark. Nigel Douglas, chief executive of Douglas Funds Consulting, quotes a 2016 mid-year review by Dow Jones which showed that over the past five years, about 90 per cent of active fixed interest managers underperformed the benchmark index. "So in hindsight, the best option for investors would have been to hold a quality passive fund or an exchange traded fund," he says, highlighting Vanguard funds and the iShares Core Composite Bond ETF. For those who prefer an active Australian bond manager, he favours Perpetual and Western Asset Management.

Among specialist and credit funds, Douglas notes Bentham (Syndicated Loan and Global income), Kapstream Absolute Return, the Henderson Global Fixed Interest Total Return Fund, Macquarie Income Opportunities Fund, and in the credit space, the PIMCO Global Credit Fund.

"Enhanced cash is an area where investors have to be careful as fund managers can sometimes take greater than expected credit and duration risk," Douglas says. A conservative option, he says, would be the UBS Cash Plus fund, and another option the BetaShares Australian High Interest Cash ETF.

It's worth adding one other voice to the debate: Jeff Grow, senior portfolio manager for fixed income at UBS. He is speaking out in defence of bonds in the face of widespread prophecies of misery for the asset class. "Fixed income has delivered positive absolute returns to investors for the past 25 years," he says. "It's time to spurn the supernova talk, and stick with the core, defensive anchor provided by global fixed income."

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