A low interest rate world and fixed income in portfolios

Background: Significant RBA policy moves in November

1. Reduction of the official cash rate to 0.10%

2. Quantitative Easing program: Purchase of $100B of Commonwealth & state government bonds with maturities between 5 and 10 years (5% of GDP).

Reasons:

- Focus on assisting the economy with level of unemployment (although inflation is still a key target).
- Support lower borrowing costs to provide confidence and stability to businesses & household finances.
- Helps keep the AUD low benefiting exporters, by reducing the attraction of Australian bonds. Though the AUD has strengthened recently with higher iron ore prices a strong contributor.

For investors, it means low-interest rates for even longer – with the RBA indicating a rate hike is unlikely in the next few years.

As market expectations for yields over the next 12 months are close to zero, this obviously has an impact on not just cash products, but also on absolute return products.

As such, many investors are questioning whether fixed income strategies are still appropriate for the future environment. In particular longer duration investments which are more sensitive to changes in market interest rates (yield curve movements).

Why are low interest rates expected to persist in the near to the medium term?

In short, due to low inflation and employment for at least the next 2 years.

Inflation expectations are low across 3, 5, 10 year expectations, and are currently expected to remain below 2%. To provide further context, the RBA's inflation target is 2 – 3% and inflation expectations are at/below the lower bound of 2%, and has been for the last 5 years.

The RBA board also notes slow wages growth. This is important as wages are often the largest cost associated with the production of goods & services. Businesses would have to consider their profitability if wages are increased, as in the end, so will prices consumers pay.

Thus without wage growth, the expected increase in inflation will be low for number years to come.

Vanguard forecasts for fixed income

Vanguard ISG Forecasts	10 year outlook
Australian fixed interest	0.5% - 1.5%
Global fixed interest	1% - 2%

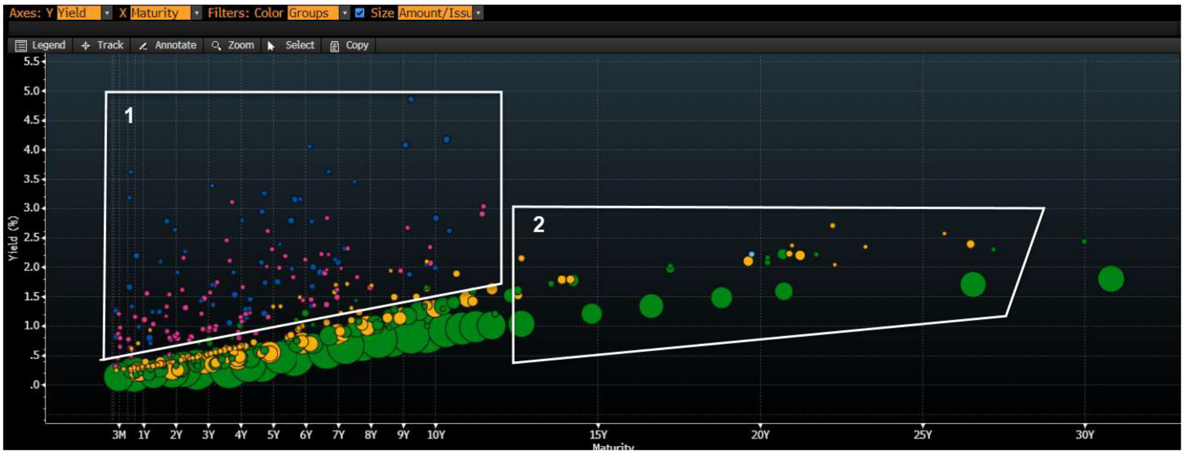
Investors and the market are getting accustomed to the fact that there are going to be lower returns from fixed income, which naturally leads to investors thinking about stretching for yield, however not all bonds are created equally.

Where then can we / should we be looking for yield?

Some areas with potentially higher yield are described below, however an investor's individual situation, goals and risk tolerance should ultimately be the first consideration.

With the outlook being lower for government bonds, other areas to look at are investment grade credit markets.

The Australian Investment Grade Bond Market



1. Corporate debt, higher yield reflecting the credit premium of a more risky borrower.
   - Smaller pink and blue bubbles, predominantly in the 1 – 10 year part.

2. Higher returns with a risk-free rate can be provided by longer duration government bonds, the caveat being this suits investors with a much longer term investment timeframe.
   - Green bubbles – Government bonds
   - Yellow bubbles – Semi- government / government related bonds

<u>Additional Notes</u>

The above chart is illustrative of buying a bond index fund. It provides great diversification, as you automatically get exposure across different types of bonds, industries, different parts of the yield curve (different maturities), within the fund itself.

With corporate debt, investors need to be willing to take on risk, and security selection will be even more crucial. As we know, there are sector 'winners' and 'losers' affected by Covid. (E.g. Winners: e-commerce, tech companies. Losers: airlines, tourism related).

From an investment implications perspective, investors need to be mindful not to chase 'COVID winners' as they could be fully valued, and not to disregard all 'COVID losers' as some companies in these segments could emerge with more market share, less competition or improved business models.

This is where actively managed credit funds can potentially add value. If you are interested to read more on this topic, please follow the below link to Vanguard's Fixed Income Group 'Corporate Credit's COVID-19 winners and losers'.

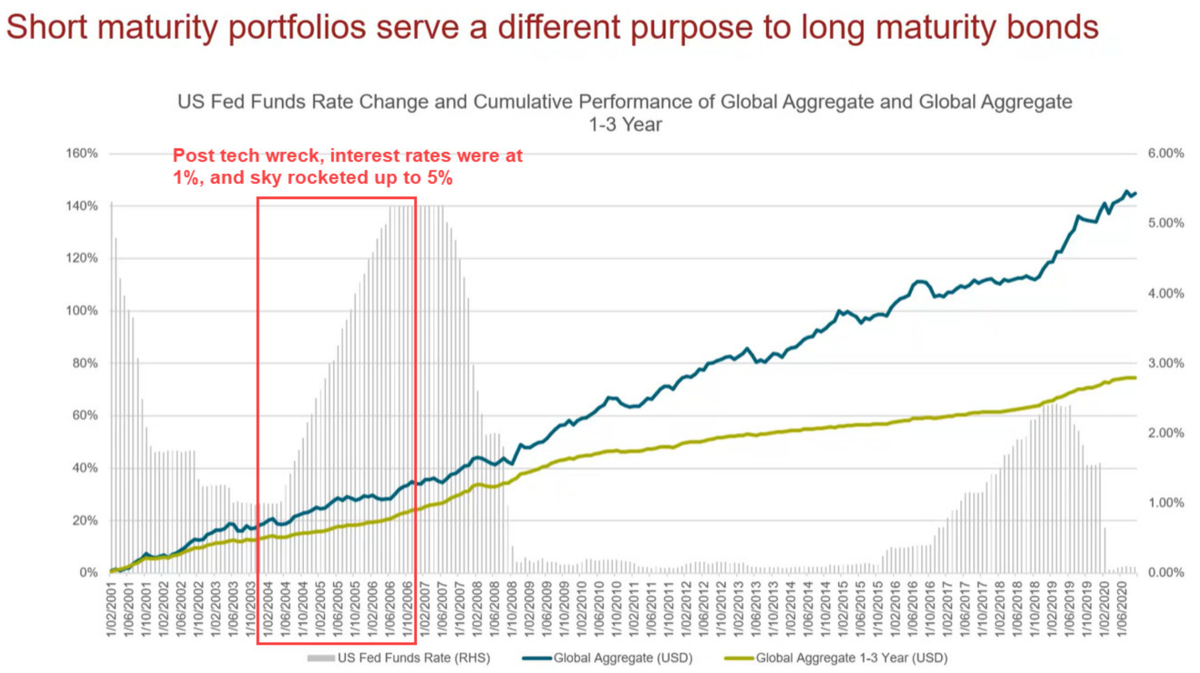
https://intl.assets.vgdynamic.info/intl/australia/documents/articles/Vanguard-FIG-2020-covid-winner-losers.pdf

Impact of rising interest rates on fixed income in portfolios

It is a common misconception that rising interest rates are bad news for bonds, however this is not necessarily the case.

If the rate rise was ***unexpected***, there would be short term capital losses. However over the medium to long term, your portfolio will experience higher returns, as the index fund reinvests into new bonds with higher yields.

Below chart is a great real life example of this.



- The green line is returns on short term (1 – 3 year) global bonds, the line is smoother as there is less volatility.
- The blue line is returns on aggregate global bonds which includes longer maturity bonds compared to the green. There is a bit more volatility but also higher returns.

Post tech wreck (area in red on chart), interest rate were at 1%, however rose up to as high as 5% in the few years that followed. However cumulative returns on bonds continued to build and increase, and be positive. (Green and blue lines)

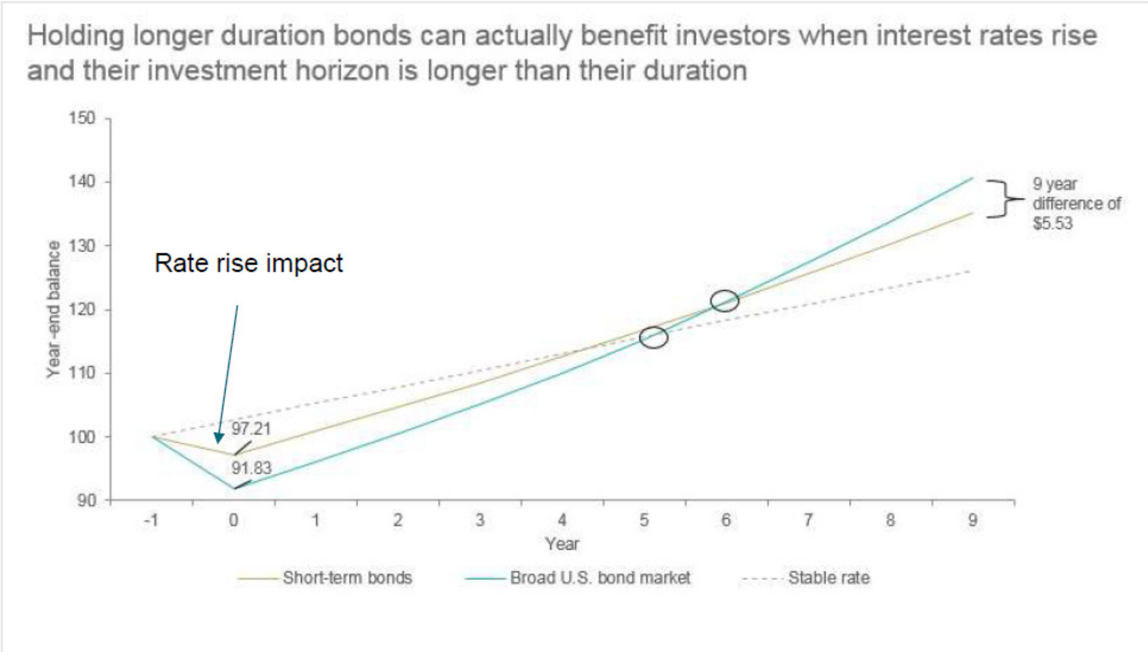
Reason being, not all bonds behave in the same way. If you have a cash rate rise of 100bp, that doesn’t mean all bonds, particular those on the longer maturity part of the curve will react the same.

Often what happens is the prospect of rising rates causes bond prices to either not move very much, or even rally. This happens because of the worry that a rate rise cycle will crimp economic growth and inflation in future.

So longer duration bonds are more of a long term predictor, which is partly why positive return profiles can be seen in a rising rate environment.

Benefits of retaining an allocation to longer dated bonds.

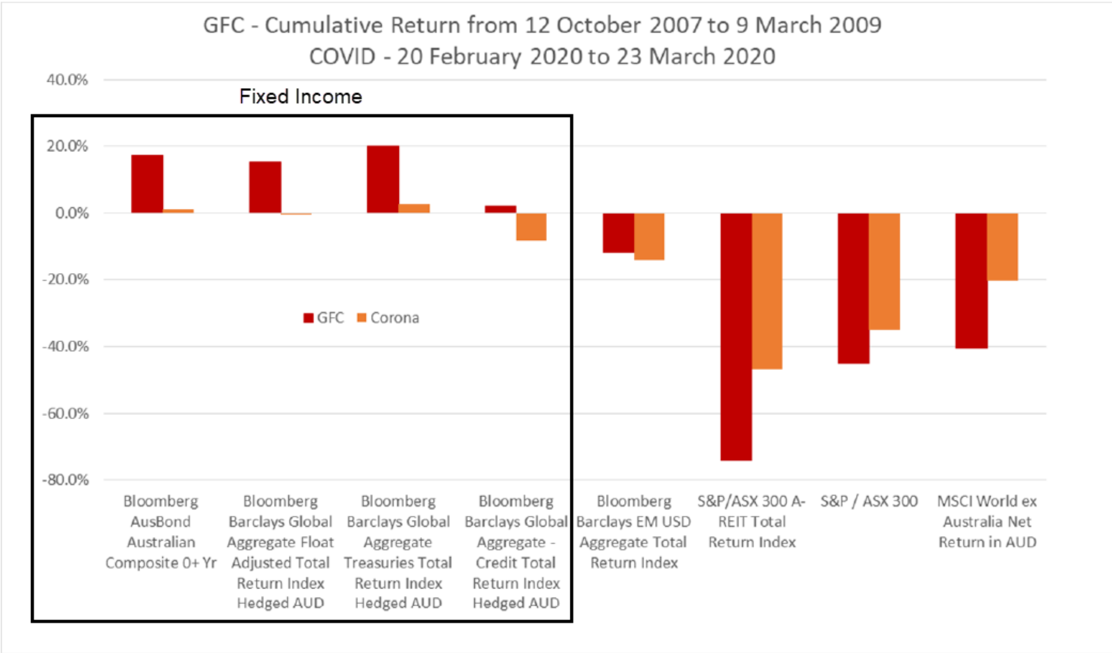
Investor timeframe is a crucial factor in choosing fixed income styles, especially for clients with an investment horizon longer than the portfolio duration.



Source: Vanguard from Bloomberg data

Rates are so low though, should I still hold them in my portfolio? Are Fixed Income strategies still relevant?

A clear advantage of bonds in a portfolio is that bonds held steady, with slight positive returns (excluding credit) in times of market distress. As illustrated in the below chart, they have held investor values, relative to equity, and REITs.



Source: Bloomberg

Holding bonds reduces portfolio volatility over time and is what it is designed to do.

Going forward, whilst returns expectations are going to be lower, which is just a factor of where interest rates are at the moment, the defensiveness quality to a portfolio doesn't change.

"But interest rates were still able to fall during that period of time"

This is true however low returns are the price that investors are going to have to pay to safeguard their portfolios from potential future large drawdowns, typically experienced in equity markets. So the role of bonds as a stable influence on a portfolio will continue into the future

There is no substitute for high quality, diversified fixed interest funds continuing to provide defensive characteristics, and diversity across maturities, and across sectors.

In this environment, costs matter even more since returns are already low. More of the returns can be retained through lower cost options, since fees will be eating away at a larger portion of total return.

Why not cash then?

Fixed interest remains a stronger diversifier in portfolio compared to cash.

If yields do go even lower, there is potential for capital gain. Whereas cash does not have this potential upside at all. Returns on high quality cash securities are close to zero so for investors with time frames of more than a few years there is a large opportunity cost from 'holding' cash.

Key Points and Takeaways

- High quality, diversified fixed interest funds continue to provide defensive characteristics.
- Investors need to be prepared for lower future returns.
- Costs matter!! Especially in this low return environment. Retain more returns through lower cost options.
- Active management can add value, however active managers still have to make correct investment decisions.