

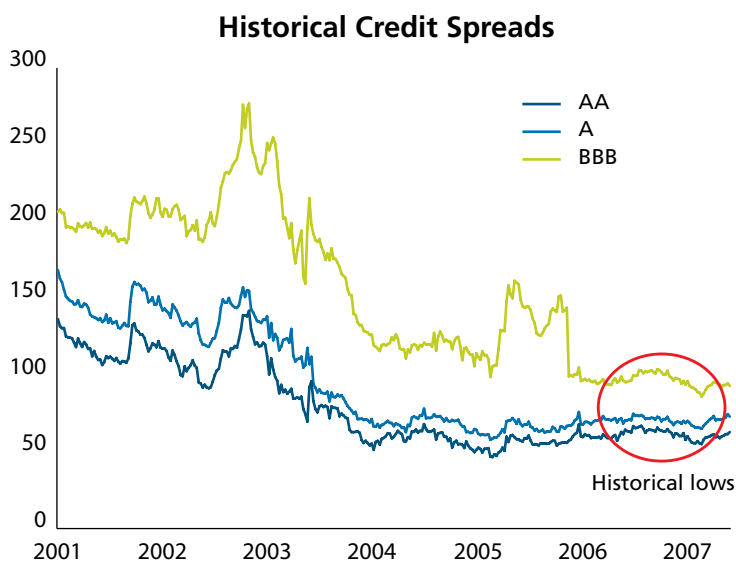
Will core bond managers cause a second round of pain?

Global bond fund managers did not save me in 2008

Bonds have always been considered a defensive asset class. When equities and risk assets start to underperform, bonds are then supposed to act as a hedge for client's investments. Equities and risk assets generally post negative returns when either:

- *Economic growth slows down;*
- *Fear that the earnings expectations in the markets may not materialise; or*
- *There is too much debt and leverage on company's balance sheets and the assets that are held against them are not worth the paper they are written on (i.e. what is happening in the world today).*

Unfortunately in 2008 when equity markets fell some 40%, very few bond managers provided positive returns to their clients. Why? To answer this properly, we must wind the clocks back a few years. In 2006 there was a glut of easy money floating around. Everyone, from superannuation funds to sovereign wealth funds, was flush with cash. Equity markets were reaching new highs and bond yields had been normalised as the Fed raised rates from 1% to 5.25%. The world was living well beyond its means, money was cheap and credit spreads were at historical lows.



Aside from the overleveraged banks and sub-prime crisis, something very significant happened in the bond market.

In 2006 bond fund managers were finding it difficult to outperform their respective benchmarks as rates reached normal levels (not stimulative at 1% or restrictive at 8%). The only way to outperform was to chase higher yields by buying credit, mortgages or other esoteric investments. On average, any bond rated BBB or higher was only trading a measly 30-50 basis points over government bonds. Credit was hugely mis-priced (the market ignored leverage for a year or two), yet managers were investing in any sort of spread product they could find.

In hindsight this was a mug's game. Bond managers were getting tricked into a no-win situation, all while trying to outperform benchmarks by half a percent. Many turned a blind eye to the effect of the new 'financial engineering' created by the investment banks. This innovative engineering allowed fund managers to leverage up the low spreads they were investing in to unjustifiable levels in order to produce the historical annual excess returns that fund managers (and investors) were used to. New products such as CDOs (collateralised debt obligations), CLOs (collateralised loan obligations) and credit derivatives were invented to produce excess returns in a low return environment. We all know the result; the market proved that there is no free lunch.

During this time, fund managers realised they had to be clever in order to produce excess returns. They had to either use leverage or go down the credit spectrum to collect the fees. Some of them did both. Not only did they lever up their portfolios, but they also invested in low quality credit. Bond fund managers encroached into the space of their equity brethren as their risk and return characteristics started to behave more like equities than bonds.

As bond fund managers moved out the credit spectrum to pick up yield, they also added equity-like risk to their defensive portfolios. This included, but was not limited to emerging market debt, low-rated mortgages, convertibles, high yield, commodities, and stock futures. In many cases, the commodities and stock futures were backed not with cash as collateral but with credit. This equity-like risk strategy produced great returns in the bull market. But, it came to a screeching halt in 2007 and 2008 as the market repriced risk to more appropriate levels.

Government-only benchmarked managers did well

The bond fund managers that well in 2008 were managers that held traditional government bonds, as the fall in interest rates and flight to quality allowed government bonds – the safest of instruments – to put in a whopping 15% returns for the year. Any bond fund manager that held credit, mortgages, or emerging market debt instead of government bonds in their portfolio underperformed significantly relative to their government-only managers, as credit spreads widened and money markets shut down.

So where has this left the investor? Pensioners took a beating in 2008. Property prices fell, share markets produced negative returns, and the only 'safe' part of the portfolio failed to protect them in the downturn.

So can government bonds return another 15% return in 2009?

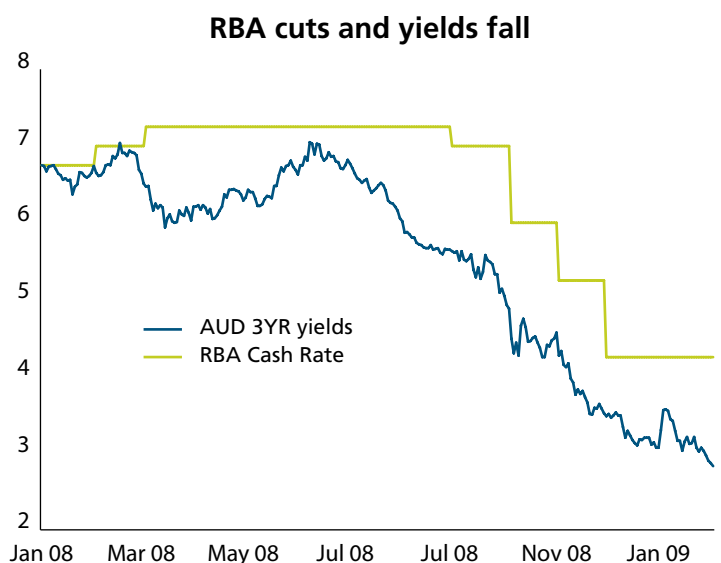
The answer is a resounding no!!

Reason 1:

The duration of a standard government benchmark (UBS) is around three years. So for every 1% drop in rates, you get a 3% capital gain.

As at 31 January 2009, the three year Australian government bond yielded 2.90%. The yield fell from nearly 7% in mid 2008, once the RBA realised that they had underestimated the severity of the global crisis and began cutting rates aggressively.

Rates in Australia will fall another 1 or 2% **only** if the global crisis intensifies. If this happens, kiss your equity returns good bye! The allocation to your



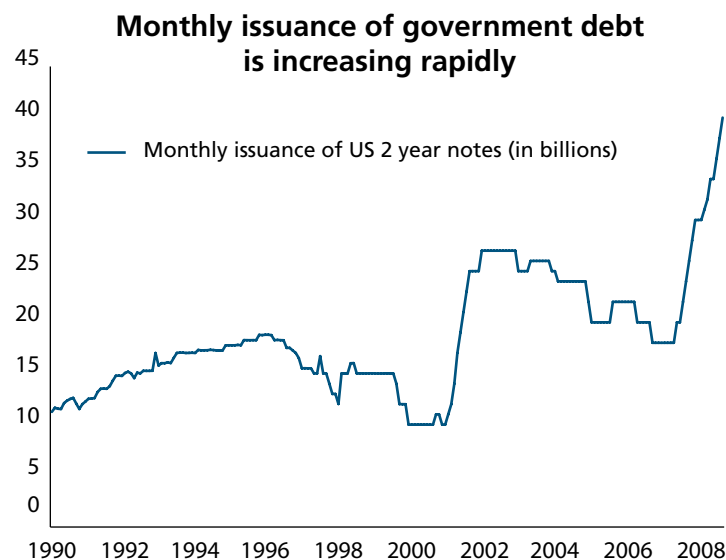
bond portfolio will not save the day. Let's assume the worse case scenario is correct and Australian 3 year yields fall 2% from current levels (2.90% to 0.90%). This will equate to 6% capital gains and 3% coupon income = Total return of 9% in a best case!

If we believe this scenario do we own enough bonds to protect us?

Reason 2:

Global governments are on a mission. The problems of 2008 are systemic and are no longer contained to an individual bank, company or country. Central Banks are reducing the cost of borrowing as quickly as they can (rates are headed to zero). Governments are spending as quickly as they can to build roads and bridges to nowhere, all to increase consumption, stop job losses, restore confidence and shore up the banking system.

Many of the large US investment banks (who relied on borrowing, leverage and owning assets) have closed their doors forever. The governments are the only ones with a large enough wallet to bail out the institutions. Governments are increasing their balance sheet, by selling government bonds and taking equity stakes in banks. The liability is being shifted away from the corporate/bank balance sheets to the government balance sheets.



Treasury markets rallied in 2008 as the crisis intensified and investors became extremely risk averse and moved to the safest of asset classes. Most recently, the US Federal Reserve has started to buy longer dated US treasuries to lower the level of interest rates, reduce mortgage rates (bail out the homeowner), and make other investments seem more attractive.

The risk in the next 12 months is that the market starts to demand a premium to fund treasuries. This could result in the bond bubble bursting and rates rising significantly. A traditional core bond manager (with a benchmark of 3-5 years duration) will most likely **not** reduce their duration to zero to protect against capital losses in a rising rate environment.

If US 10 year yields rise to 5%, a core bond portfolio that holds government debt will earn a coupon of 2.5%, but will suffer a capital loss of 2.5 x 5 years duration (10%) for a net loss of 7.5%. This is not unreasonable as excess supply (as government embarks on large budget deficits in order to bail out banks, quantitative easing, etc) is inflationary in the future. It is important to note that rates can rise without an equity market bounce as the market gets worried about supply and not economic recovery, which is traditionally the case.

Core bond fund managers could be in store for a second dose of underperformance, this time due to rising bond yields.

What is the prudent thing to do?

When markets get to extremes some simple tactical asset allocation decisions help save investor returns. Based on our analysis, it would be prudent to:

- Not own any government bonds as they are at historically low yields. That is unless you think the world will end up in a Japan-like scenario.
- Buy high quality, floating rate corporate debt so that investors get reset with higher coupons as rates rise.
- Buy some cheap protection for higher future inflation (inflation protection bonds).
- Reduce duration from nearly 5 years to nearly zero (possibly even short). Now is not the time to lock in yields for the future.
- Separate your fixed income risk into two categories:
 - Purely defensive – government and high quality corporate
 - Equity substitutes – emerging markets, high yield, structured credit, convertibles, and commodities
- Focus on achieving absolute returns while maintaining the true fundamental characteristics of a bond portfolio (capital preservation and income generation coupled with a defined risk management framework). Rather than being constrained by a benchmark, investors should concentrate on implementing greater flexibility within their portfolios so that the areas with the greatest value can be captured.

Keep things simple in life and investing!