FIXED INCOME
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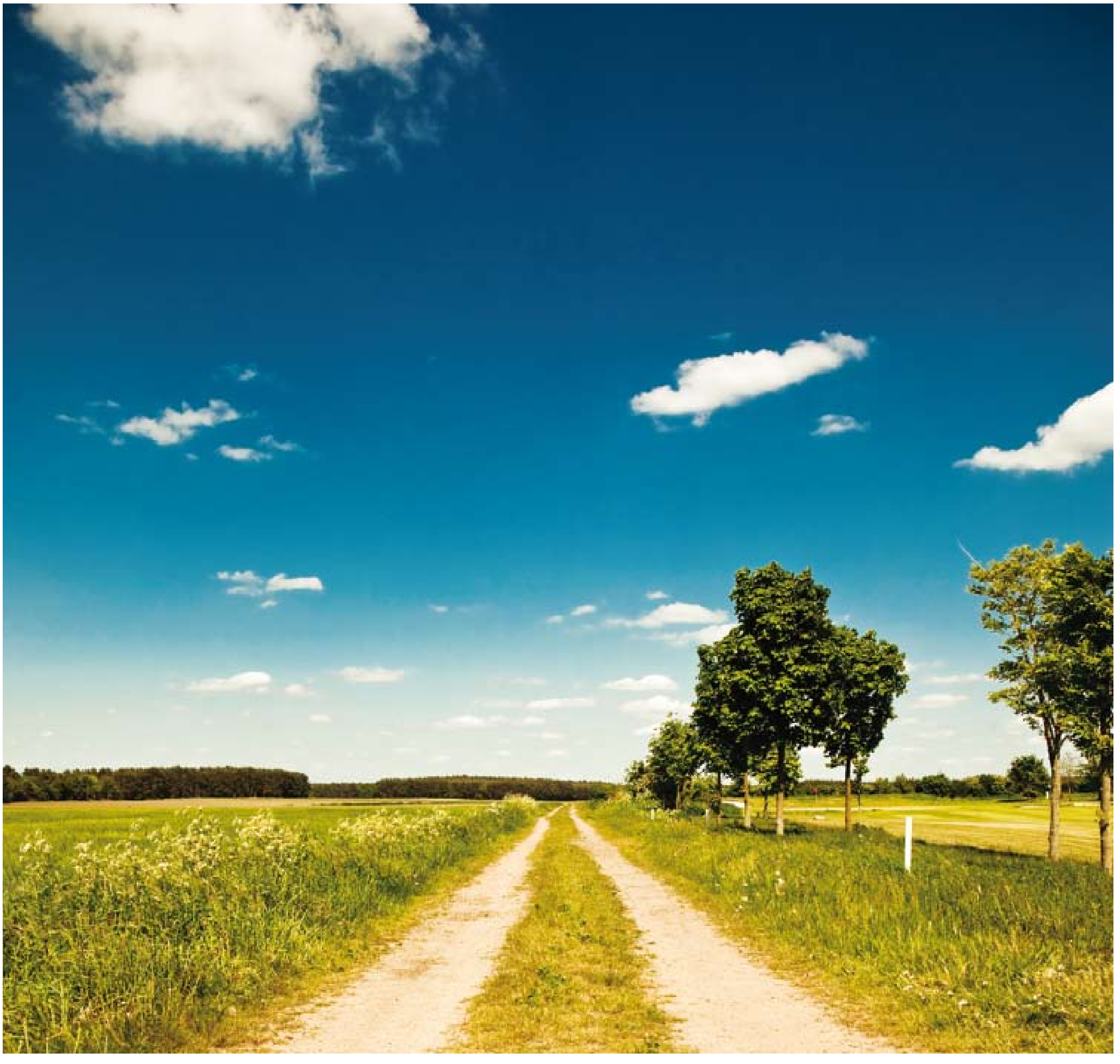

Investors and fund managers alike were taught some big lessons following the meltdown in credit markets a year ago. Christine St Anne *looks at how the crisis has driven a return to a more traditional approach to the asset class.*

Image: iStock Photo

International pop icon Madonna Ciccone recently revealed an insight into her investment portfolio.

According to the Material Girl, the two asset classes that steeled her portfolio against the global financial crisis (GFC) were property and fixed income.

Madonna's fixed income portfolio was only exposed to government securities. Investment experts may have an issue with a lack of diversification and market correlation, but the superstar still remains on top of the wealth ladder while many banking chiefs and captains of industry have faltered.

It is of course a flippant comparison, but while her fixed income portfolio sought safety in more traditional debt assets, other investors were hungry for yield. Subsequently, fixed income portfolios were exposed to high-yielding structured securities. Such portfolios came under stress post the GFC, with many unable to weather the storm.

"The global financial crisis brought everyone back to basics. Across the industry, people are rethinking what they want their fixed income to be," Watson Wyatt senior investment consultant Tony Arnold says.

Morningstar consultant Sallyanne Cook says people simply got burnt on structured products such as collateralised debt obligations (CDO).

Such products entailed complex structures that were intended to protect investors from any defaults.

But as history now tells us, Australian firms such as Basis Capital and Absolute Capital folded following the collapse of their CDO portfolios, while many local government councils in New South Wales are currently locked in a lawsuit over claims of CDO miss-selling.

A NEW LANDSCAPE

Cook says the lessons learned from the credit crisis will have an impact on how new products will be structured.

"There was just not enough credit analysis done on underlying securities. There were no questions on how will these structures perform under extreme conditions," she says.

"On the structuring side there is going to be reduced leverage. Going forward portfolio managers will have greater scrutiny on the underlying portfolio."

Ultimately investors were looking for high-generating returns, according to Arnold.

"Investors wanted to drive their portfolios harder and that's where some funds ran into difficulty," he says.

For the $2.8 billion West Australian fund Westcheme the GFC certainly posed some challenges.

The CDOs the fund invested in were effectively wiped out in value following the crisis.

"While the CDOs looked good when we bought into them in 2003 with double-digit returns, by 2007 we decided to stop investing in them," Westscheme chief executive Howard Rosario says.

"Our analysis showed that the sub-prime market in the United States had started feeding into these products."

For Rosario what exacerbated the demise of the CDOs was the rating agencies.

"We didn't expect S&P (Standard & Poor's) to change their ratings [on the CDO structures]. This forced investors in the higher tranches to sell down their positions. So we didn't get caught up so much from the credit defaults as by the rating agencies," he says.

The experience provided some lessons for the fund.

"Investing in CDOs really demonstrated to us the importance of understanding the inter-connectiveness of market issues. In this case it was the state of the housing prices. Buying CDOs managed by different managers was not effective diversification because in the end the common theme was the housing prices in the US," Rosario says.

"In the end having the number of managers did not protect us from that downturn."

Following its experience with the GFC, Westscheme has reduced its drawdown exposure.

It also means a return to safer assets for the fund.

Following a recent overhaul of its investment strategy, Westscheme will now invest in fixed income, an asset class the fund has ignored for a decade.

Five per cent of the fund's portfolio will be held in fixed income. The increased allocation comes at the expense of listed equities.

Rosario says the fund will invest in Australian and overseas fixed income.

The issue now for Rosario is finding a manager that offers traditional fixed income assets.

"It is very hard to get a manager that only manages government bonds. We are looking for normal fixed income managers that give us returns against a conventional benchmark," he says.

But even conventional bond managers have had some rethinking to do.

Global bond manager PIMCO was exposed to Lehman Brothers. When the firm collapsed on 15 November 2008, the firm held its ground.

"What happened with Lehman Brothers was clearly a policy mistake. In hindsight, the events highlight this," PIMCO head of portfolio management Rob Mead says.

"We did have some exposure to Lehman. However, we did not change our approach based on the one event as we saw this event as a mistake that would not be repeated. The collapse of Lehman was not a core event

SALLYANNE COOK
reduced leverage

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MARK FLANAGAN
Shenkman Capital Management

MADONNA
credit bubble

that you should be building your portfolios around."

Nevertheless, Mead says the fixed income sector could be in for a rethink in terms of how the asset class now generates its alpha.

"There is now more scope than ever to create alpha within fixed income asset classes. Credit spreads are now reflecting underlying credit risks. The ability to do bottom-up research and understand the types of securities investors are buying can make a big difference to whether you are an outperformer," he says.

The types of securities preferred by PIMCO currently are high-quality corporate bonds.

And post Lehman Brothers, Mead says financial stocks are still performing well.

"I still see a lot of value in that sector," he says.

FISCAL OPPORTUNITIES

Opportunities in government debt have also emerged on the back of large fiscal stimulus packages launched by governments around the world.

"Two other markets have now reopened," Arnold says.

"With fund managers offering government-guaranteed cash rates, investors have access to the short-dated debt markets."

The Australian Office of Financial Management has also hinted about the possibility of launching a government-guaranteed inflation-linked market, he says.

"This will be a new form of debt that will attract investors with long-term liabilities," he says.

For Mead, the government's participation in the debt market is a good thing.

"The Australian domestic bond market was shrinking and it became less important than other sectors. We think it is a good thing that the market is now growing. It means that the market itself is larger and more investable," he says.

With a return to safety, the key question for the debt markets is the future for distressed debt.

RETHINKING HIGH YIELD

Cook says there is still a role for low investment-grade credit.

"At the end of the day there will always be an appetite for high yield. A lot of people are still interested in the high-yield market. There will always be a market for companies that need to refinance," she says.

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>
> HOWARD ROSARIO
> *Westscheme*

New York-based manager Shenkman Capital Management has been managing high yield for more than 24 years, and survived the credit bloodbath of 2008.

"Some people look at high-yield debt as too much risk. In our view, this type of credit is still attractive at spreads of nearly 1000 basis points over US Treasuries," Shenkman executive vice president Mark Flanagan says.

Flanagan says most credit markets have recovered a substantial portion of 2008 losses.

Indeed, Bloomberg research shows a number of high-yield indexes have clawed back some huge losses.

The Lipper High Current Yield Index reported a 25.86 per cent negative return in 2008. Similarly the Merrill Lynch US High Yield Index posted a 26.39 per cent fall.

By 2009, the year-to-date figures for 2009 were substantially different, with the indices reporting a 21.96 per cent and 29.37 per cent return respectively.

"The high-yield asset class, which was a leading indicator going into the credit crisis, is proving to be a leading indicator in the current market recovery," Flanagan says.

Nevertheless, memories of the default levels during the crisis are still fresh in people's minds and for Arnold there is still a big default cycle to go through.

Flanagan says, however, that investors get better protection with high yield through high-yield covenants.

"Although high yield has a higher default rate than investment grade, investment-grade bonds do not typically afford investors the covenant protection inherent within many high-yield bonds," he says.

These covenants place leverage limits on a company's balance sheet, restrict the company's ability to sell its assets and safeguard investors in the event of a leveraged buyout.

Following the global financial crisis there will still be a role for high-yield debt and structured products.

"Structured credit in its most aggressive from is very unlikely to make a comeback. However, clean, well-structured and unlevered residential mortgage-backed securities and other high-quality asset-backed securities will continue to fill an important place in the global funding mix," Mead says.

Cook believes the legislative landscape is in need of an overhaul if another credit crisis is to be prevented.

"While the banks have tightened their lending standards [and] the US Treasury has come back and tightened up its lending requirements, the big question now is will the global authorities set new rules and regulations to avert another credit crisis?" she says.

For Mead it is about finding the balance.

"Global authorities are focused on improving the capital structures of financial institutions, but at the same time they want to ensure that creditworthy borrowers continue to have access to credit to ensure that economic growth does not stall," he says.

"Fining the balance between de-risking the financial system and choking off risk appetite will be a key variable going forward in terms of potential global growth."