

Fixed income allocations through different cycles

September 2019

An allocation to fixed income through the cycle offers both ongoing income and diversification to growth assets. However, fixed income is not a homogenous asset class and there are various forms it can take and styles managers can employ:

Traditional bond funds (including passive) typically contain a largely static allocation to government, semi-government, supranational and corporate debt in line with a benchmark (typically the Bloomberg AusBond Composite 0+ Index). Investment limits are quite narrow so these funds tend to track the benchmark fairly closely with an interest rate duration between 5-6 years and spread duration between 1-2 years.

Credit funds invest entirely in corporate debt securities and are typically benchmarked against a floating rate index. These funds favour floating rate notes meaning they have little imbedded interest rate risk; however they have a higher sensitivity to credit spreads than traditional bond funds.

Absolute return bond funds are generally benchmarked against cash or a blended cash/bond benchmark. Investment limits for interest rate and spread duration risk are wide, allowing for positive absolute returns through the cycle and thus lower volatility than traditional bond funds.

Style	Advantages	Disadvantages
Traditional bond funds/passive	<ul style="list-style-type: none"> Low cost Provides biggest benefit in recessionary stage 	<ul style="list-style-type: none"> Interest rate risk grows as interest rates decrease Reduced flexibility to add alpha
Credit funds (often includes global and sub-investment grade debt)	<ul style="list-style-type: none"> Provides biggest benefit in economic recovery stage Positive across most stages 	<ul style="list-style-type: none"> Correlated positively with growth assets Higher cost
Absolute return bond funds (flexible duration and credit)	<ul style="list-style-type: none"> Focus on capital preservation Provides biggest benefit in overheating stage as rates rise Not usually optimal but targets positive returns in all environments 	<ul style="list-style-type: none"> Higher cost Unlikely to have optimal level of interest rate risk or credit risk

Dividing the business cycle into regimes, optimal investment styles exist for each regime:

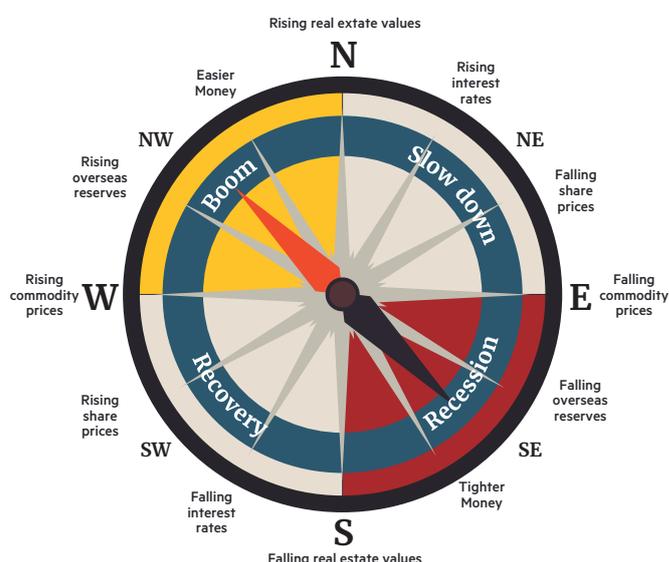
At north on the compass, the economy booms but hits capacity constraints, leading to inflationary pressures. Rising labour and material costs depress profit margins as well as inviting tighter monetary policy. Interest rates rise across the curve and credit spreads edge wider. Traditional bonds funds and equities correlate unhelpfully in this phase. An absolute return strategy is optimal in this regime due to flexible interest rate and spread duration settings. An astute manager can combine short duration with low spread duration to protect capital and even profit from interest rates rises and credit spread widening.

At east on the compass, tighter monetary policy and higher costs see a decline in corporate profits, less availability of credit and a contraction in economic activity. Central banks stop lifting interest rates. Long term Interest rates fall whilst credit spreads are still widening. Bonds and equities correlate negatively in this phase. Absolute return or traditional bond funds perform well provided they combine long duration with a modest allocation to credit.

At south on the compass, easier monetary policy allows deleveraging of corporate balance sheets and margin expansion, encouraging tighter credit spreads. Credit funds perform best in this early-cycle regime.

At west on the compass, we are well into recovery. This environment is conducive to strong credit growth and healthy corporate profitability with still accommodative monetary policy setting and interest rates and credit spreads are stable. Credit funds perform well as do traditional bond funds or absolute return funds provided they have an adequate allocation to credit.

Fixed income investment compass





BILL BOVINGDON
Chief Investment Officer, Cash and Fixed Interest

Bill has an enviable 33 year track record in fixed interest asset management.

Prior to co-founding Altius, Bill was the head of Australian fixed income and chief executive officer at Aberdeen Asset Management. He has also been head of fixed income for Schroder Investment Management and Deutsche Asset Management.

His achievements include building market leading fixed income businesses by overhauling investment processes and systems and developing investment staff.

Bill has a long working relationship with Senior Portfolio Managers Chris Dickman and Gavin Goodhand, formed over many years.

For further information, please contact your Australian Unity Business Development Manager:

Adam Kirk
Head of Intermediated Markets
M 0403 515 401

Aaron Hallifax
Business Development Manager Investments
VIC/TAS/SA/WA
M 0431 615 809

Dale Robertson
Business Development Manager Investments
NSW/ACT/QLD/SA
M 0413 503 490

For more information on the Altius Sustainable Bond Fund, please contact your financial adviser or our Investor Services

australianunity.com.au/wealth
investments@australianunity.com.au

Investor Services
T 13 29 39
Adviser Services
T 1800 649 033

Australian Unity
271 Spring Street,
Melbourne
VIC 3000

Important Information

This publication by Australian Unity Funds Management Limited ABN 60 071 497 115, AFS Licence No. 234454. Its contents are current to the date of publication only, and whilst all care has been taken in its preparation, AUFM accepts no liability for errors or omissions. The application of its contents of specific situations (including case studies and projections) will depend upon each particular circumstance. This publication has been prepared without taking into account the objectives or circumstances of any particular individual or entity. This information is intended for recipients in Australia only. Not to be reproduced without permission.