Fixed Interest Funds Sector Wrap-Up

19 March 2012

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Executive Summary

Morningstar has completed qualitative research assessments of 44 fixed interest strategies offered to Australian investors. This Sector Wrap-Up provides an overview of our key observations and a summary of our Morningstar Analyst Ratings.™

Renewed interest in term deposits, hybrids, and annuities has been a major theme of late. We pose the question "why bother with fixed interest?", and find that the answer lies in the important role the asset class can play in investment portfolios. Term deposits, hybrids, and annuities all have shortcomings as defensive anchors, and we discuss why.

Active fixed interest fund managers often highlight the perceived faults of fixed interest benchmarks. Rather than getting bogged down in a debate about the relative merits and downsides of active and passive investing, we explore some of the key issues associated with being passively invested in the Australian and global bond indices, and discuss the key risks. We also critique the merits and drawbacks of local and global fixed interest investing. At its core, a global strategy offers a significantly expanded potential investment universe and accompanying diversification benefits, but also potentially greater risks such as disrupted income distributions.

Investors have been increasingly preoccupied with a strategy's income return, and confronted by a growing array of more flexible fixed interest options. We urge investors and advisers to always keep a total return rather than a yield-focused perspective. Beyond that, it's important to understand how a more flexible strategy fits within the context of an existing fixed interest allocation, to ensure that risk exposures are adequately diversified.

Our final port of call is an outline of our Morningstar Style Box™ for fixed interest funds. This useful graphic enables investors and advisers to quickly gauge a fixed interest portfolio's credit quality and duration, two important characteristics that determine how a strategy will perform and indicate how it could be deployed in a portfolio.

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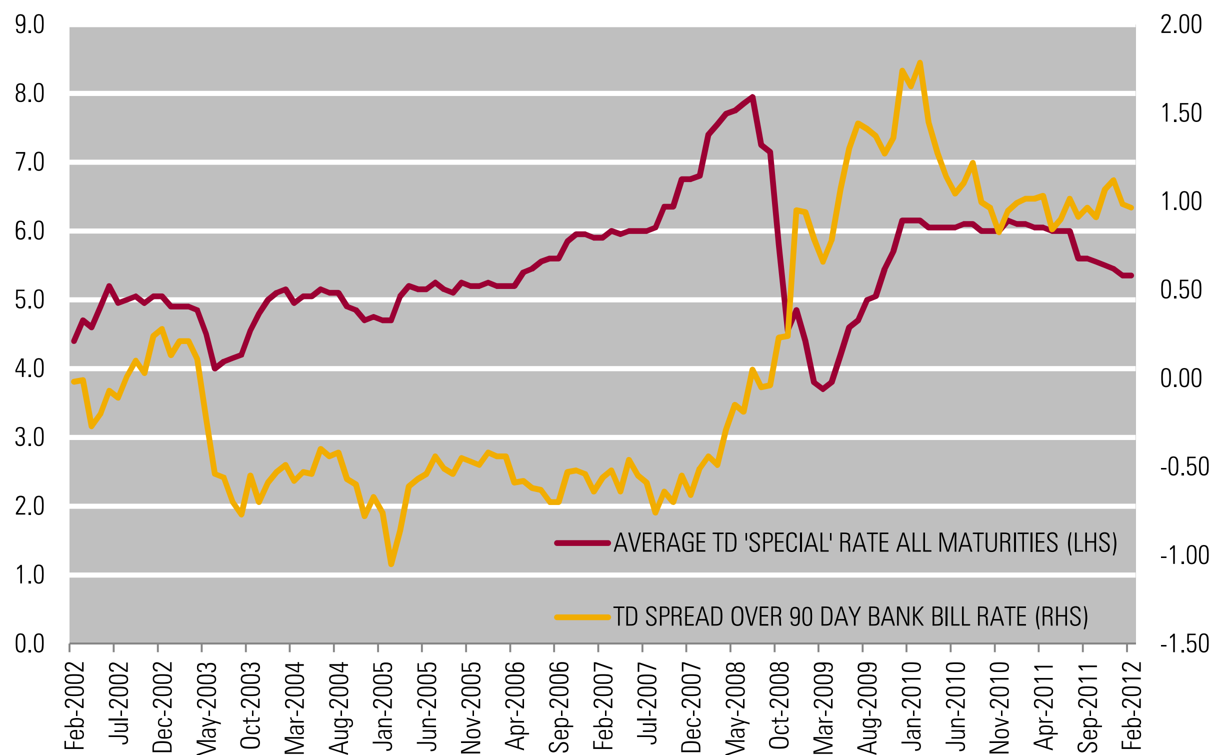
Why Invest in Fixed Interest?

Looking at the rates available on term deposits, it's easy to understand their attraction for investors, and to ask "why bother?" when it comes to a fixed interest investment. A government-guaranteed annual income of around five percent with assured capital stability on offer from many 12-month term deposits in March 2012 is undeniably attractive. Investors have also turned to hybrids and annuities, the former offering lofty income yields, and the latter to address the possibility of outliving one's assets (longevity risk). With this in mind, we will re-examine the role of a traditional fixed interest investment in the context of a high term deposit rate environment and the popularity of hybrids and annuities.

Term Deposits

Figure 1 below shows just how high these term deposit rates have been. The scarlet line shows term deposit rates, a weighted average of the five largest banks' 'special' rates across all available maturities. The orange line shows the spread these term deposits paid over 90-day bank bills (a wholesale cash rate available for institutional investors). The scarlet line shows that term deposit rates in 2010 – 11 were above historical levels over the past 10 years, with the exception of 2007 – 08. What's particularly eye-catching is the high premium term deposits have paid over bank bills since the peak of the 2008 financial crisis – term deposit rates were 100 basis points higher than bank bills in 2010 – 11. This spread has however fallen markedly since 2010.

Figure 1: Average 'Special' Term Deposit Rates and Spread Over 90-Day Bank Bill Rate, 2002 – 12



Source: Reserve Bank of Australia

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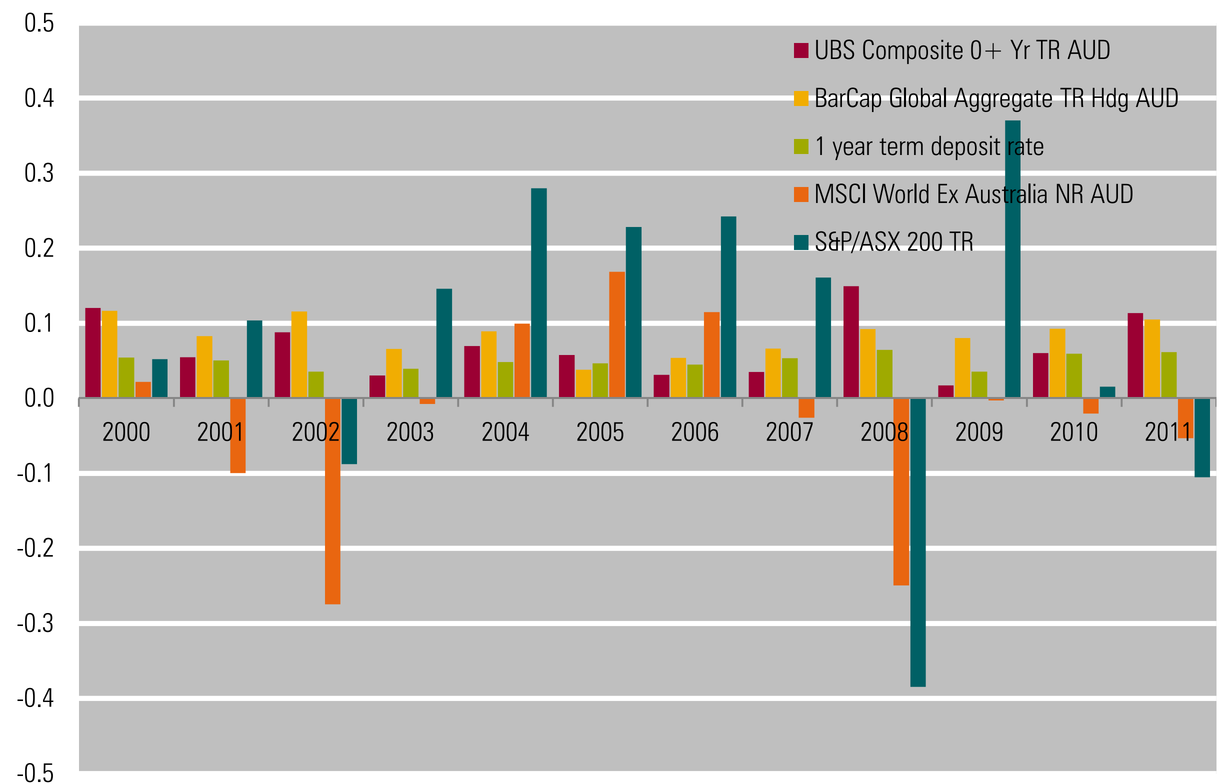
The instigator for these high term deposit rates was of course the volatility in wholesale lending markets emanating from the financial crisis of 2007 - 08. Australian banks responded by offering high term deposit rates to lure local savers, build up their retail deposit bases, and reduce their reliance on sometimes skittish and pricey wholesale funding. The banks have broadly succeeded in their endeavours. They have historically had little need to compete aggressively for retail deposits, as easy wholesale funding was a given. Term deposits have therefore paid little, if any, premium over the bank bill rate. These high term deposit rates should not be expected to persist forever, but while uncertainty over wholesale lending markets persists, the banks are likely to continue to lean heavily on retail funding.

So why bother investing in fixed interest when a term deposit with capital stability delivers a healthy income stream? Essentially, it's all about the role investments play in a portfolio. A high-quality bond portfolio is the ideal 'insurance policy' when risky assets stumble, better even than a term deposit. This is because many (but not all) fixed interest strategies possess the important characteristic of interest rate duration. When interest rates fall, the value of a fixed interest portfolio rises. The bond portfolio is worth more because these securities pay higher coupon interest than what's on offer in the market. By contrast, although term deposits maintain capital stability, they're not marked-to-market, and so miss out on this revaluation effect. Additionally, maturing term deposits need to be reinvested at lower yields (rollover risk).

Why is duration important? Falling interest rates typically coincide with slowing economic growth and increased risk aversion. High-grade bonds providing a regular income stream are perceived as a 'safe haven', and are therefore more highly-valued. They effectively diversify a portfolio's exposure to risky asset classes, as their value typically rises when equities fall. Duration is not without risks, though – it increases a portfolio's sensitivity to interest rate changes, detrimentally so if interest rates rise. Nonetheless, duration gives to fixed interest diversifying qualities that supersede even term deposits. Figure 2 below illustrates this point. The graph shows the calendar year returns for the Australian and global fixed interest and equities indices as well as the average one-year term deposit rate from 2000 – 11.

Figure 2: Calendar Year Returns From Principal Asset Classes, 2000 - 11



Sources: Morningstar® Direct™, Reserve Bank of Australia

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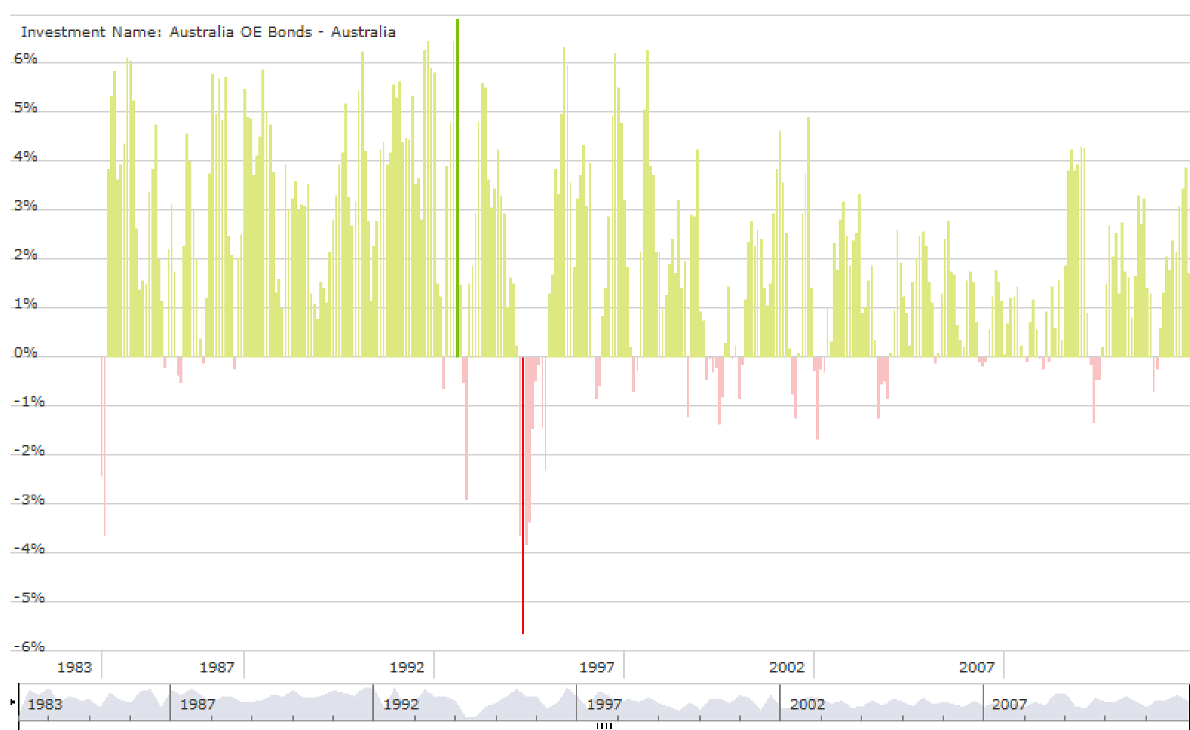
Figure 2 shows how much better both the UBS Composite and BarCap Global Aggregate Indices have performed compared to term deposits when equities have fallen. In the equities bear markets of 2002, 2008, and 2011, in each of these years the returns from the fixed interest indices far exceeded the yields on a one-year term deposit locked in at the start of the year. The story was the same in each year – concerns about slowing economic growth led to falling yields as markets expected monetary policy easing to stimulate economic activity. Falling yields are ripe for bonds, which provide the portfolio insurance that term deposits lack. (It's not all one-way traffic – at certain points in the cycle term deposits can outperform a vanilla fixed interest strategy, such as when Australian interest rates rose in 2006 – 07.)

There's one additional issue to consider. Marking-to-market means that a fixed interest portfolio's capital value rises and falls, unlike that of a term deposit. While this shouldn't be ignored, if the fund manager holds to maturity bonds which continue to pay their scheduled coupons, then the resulting vehicle will be stable and steadily generate income, even if its capital value fluctuates daily. Taking this a step further, Figure 3 below shows three-month returns from the funds in the Morningstar Australian Bonds category from 1983 - 2011. The graph shows that these high-quality fixed interest funds have suffered falls, but such dips are rare even over three-month intervals. The main outlier was in 1994, when Australian interest rates rose sharply in the second half of the year, causing significant marked-to-market capital losses.

Figure 3: Rolling Three-Month Returns from Australian Bonds Category, 1983 - 2011



Source: Morningstar® Direct™

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Hybrids

If term deposits have shortcomings as a primary defensive portfolio allocation, what about other widely-used options? In our view, hybrids are not suitable for this role, either, because they possess both debt and equity characteristics. Their popularity suggests otherwise. It's easy to see why – they have seductive income yields, some stability in earning a fixed interest rate, rank above equities in a company's capital structure (meaning that they have claim on assets before shareholders), and have the potential to convert to equity when the share price rises. Hybrid issues from companies such as **Woolworths** WOW and **Australia & New Zealand Banking Group** ANZ were accordingly snapped up by retail investors in 2011.

Nonetheless, we advise refraining from using hybrids as a core defensive portfolio allocation for several reasons. Firstly, history has shown that like equities, these securities tend to fall in value when growth slows. This often coincides with rising credit spreads, concerns about a company's ability to service its debt, and in a worst case scenario, deferred distributions. Investors in **PaperlinX** PPX and **Elders Limited** ELD hybrids suffered as these companies ceased paying their income distributions. Additionally, hybrids rank behind other bondholders, and so only have claims on a defaulting company's assets once the claims of other debtholders have been met. This significantly diminishes the hybrid's worth in times of stress, giving it more equity-like qualities. Issuers can also include unfavourable terms such as retaining the option to convert, or retiring the security before maturity to refinance at lower interest rates. Liquidity can also be problematic when risk aversion spikes – hybrids can be thinly traded, as was the case in 2008.

It's also noteworthy that fund managers are frequently far less enthusiastic about hybrids than retail investors. The managers of **Bentham Global Income** 10751, **Colonial First State Enhanced Yield** 12410, and **Schroder Credit Securities** 8922 cut their hybrid holdings dramatically from 2007 – 11, for instance. Although this was partially because of the lack of issuance, the fund managers saw better opportunities elsewhere. Indeed, fund managers' overwhelmingly negative view of the ANZ CPS3 issue was striking given its popularity with retail investors. Fund managers were unimpressed by what they perceived as the unfavourable terms, one of which enables **Australia & New Zealand Banking Group** ANZ to convert the securities to equity amid a sinking share price, as well as the sub-par yield compared to alternative securities of comparable risk.

We therefore urge investors and advisers not to treat hybrids as purely defensive debt. They can exhibit equity-like characteristics at the most inopportune times, and lack the safeguards of high-grade bonds. Hybrids are often also subject to an array of complex terms and conditions that can make them tricky to assess and value. No two hybrids are the same – while one may behave like a debt security, another could include terms that make it do anything but, which requires extra vigilance. Hybrids can play a role in a broader fixed interest allocation, but require careful and judicious use.

Annuities

Many investors also use annuities as a component of the defensive portion of their portfolio. While this is potentially a valid strategy, annuities should not be thought of as interchangeable with fixed interest funds – they are different products designed to achieve different objectives.

Annuities address longevity risks. Many investors fear outliving their assets, and annuities provide a known income stream for the remainder of one's life. The certainty of income and capital, with a minimum amount of ongoing administration, is another appealing trait. Finally, annuities can also be incorporated effectively into tax-related planning strategies.

The rates available on shorter maturity annuities were not especially competitive with term deposits in early 2012 given their relative risks. Term deposits are backed by the bank, deposits up to A$250,000 carrying a further guarantee from the Australian Federal Government. The major banks and Australian Federal Government are rated AA- and AAA respectively by the principal credit ratings agencies, meaning that term deposits offered better returns with lower credit risks.

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Given these characteristics, are annuities a valid alternative to a defensive fixed interest strategy? In our opinion, they are not a substitute for a high-quality fixed interest investment. Duration sensitivity is a special characteristic of fixed interest funds, which is critical for building a well-diversified portfolio. Annuities may provide greater certainty of capital and income, but when equities are struggling and interest rates falling, high-quality, duration-sensitive vehicles should rise in value, all other things being equal. Conversely, the holder of an annuity will continue to receive the same payments – no bad thing – but nowhere near as beneficial when the remainder of their portfolio is falling in value. Additionally, while annuities are backed by a book of a regulated life company's assets, these may be invested in infrastructure, property, and other growth assets. Annuities can still warrant inclusion in a portfolio. Longevity risk is a meaningful reason for owning an annuity, and they can be integrated as part of an effective, well-balanced portfolio.

In conclusion, there may be valid reasons for the inclusion of term deposits, hybrids, and annuities in an investment portfolio. However, none of these should be relied upon as a defensive anchor. The lack of interest rate duration prevents term deposits and annuities from providing the 'insurance policy' effect many high-quality fixed interest strategies offer. And the risks and inherent complexities of hybrids are severe shortcomings that make them unsuitable for this role.

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Benchmarks – How Risky is Passive Investing?

Active fixed interest fund managers frequently cite the perceived faults of fixed interest benchmarks as a reason to avoid passive investing in this asset class. The argument is simple, especially globally – more indebted governments and companies comprise larger slices of a market, so it's risky and inefficient to merely replicate the index. Although this is an intuitive argument, it's worth digging a little deeper to understand the constituents of these indices, and to gauge whether index investing is as hazardous as claimed.

The UBS Composite and Barclays Global Aggregate Indices are both market capitalisation-weighted baskets of investment-grade securities. Both contain sovereign government, semi-government, supranational, and investment-grade corporate debt securities. Table 1 below shows some representative issuers in each of these sectors.

Table 1: Representative Issuers of a Sectoral Breakdown in a Fixed Interest Portfolio

Sector	Representative Issuers
Treasury	Australian Federal Government
Semi-Government	New South Wales State Government
Supranationals and Government Agencies	European Union
Financials	National Australia Bank
Non-Financial Corporates	Tabcorp Holdings

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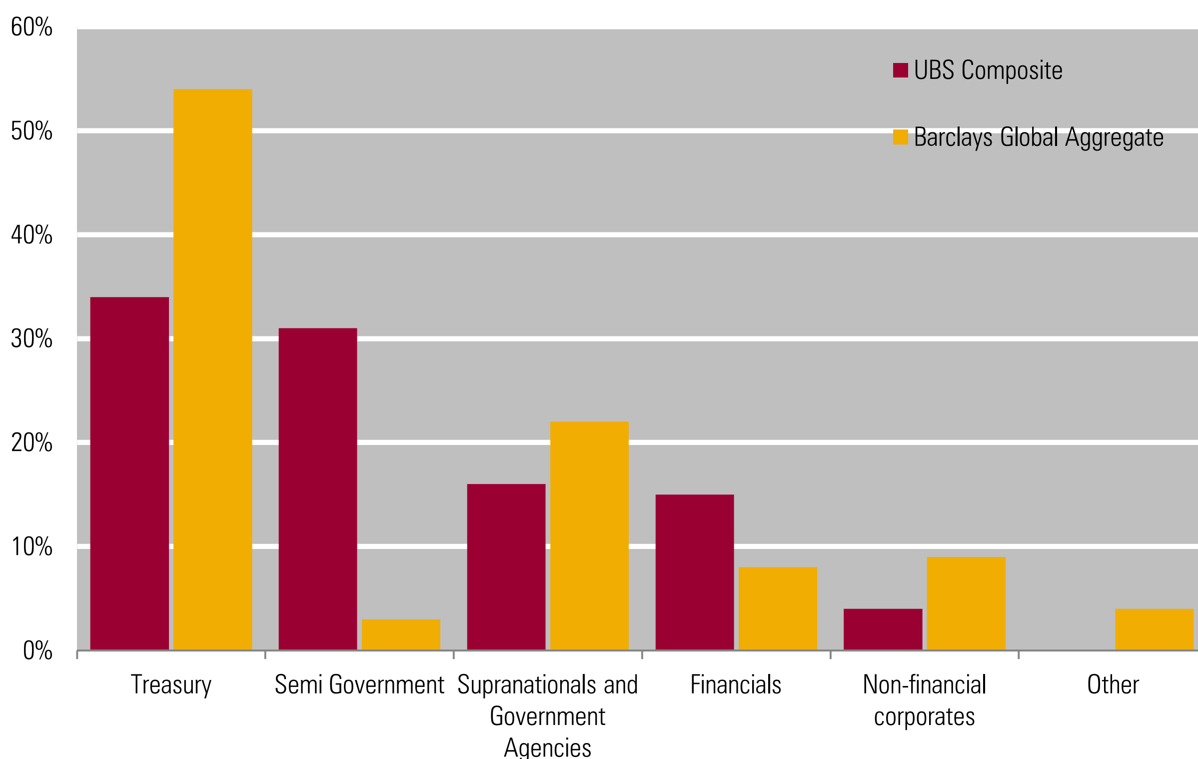
Moving on to the indices themselves, it's clear that sovereign government debt (denoted in Figure 4 below as 'Treasury') is a significant component for both indices, and especially so for the global benchmark. Another similarity is that debt issued by supranational bodies (comprising multiple member states such as the European Union) and government agencies is also significant to both indices. Semi-government issues – state or provincial debt – is a much larger component of the Australian bond index than for the global market. This is also the case for financial markets. Finally, non-financial corporate bonds are more prevalent in the global than in the Australian index.

Figure 4: Sectoral Breakdowns of UBS Composite Bond, Barclays Global Aggregate Indices at 12 December 2011



Source: Schroder Investment Management

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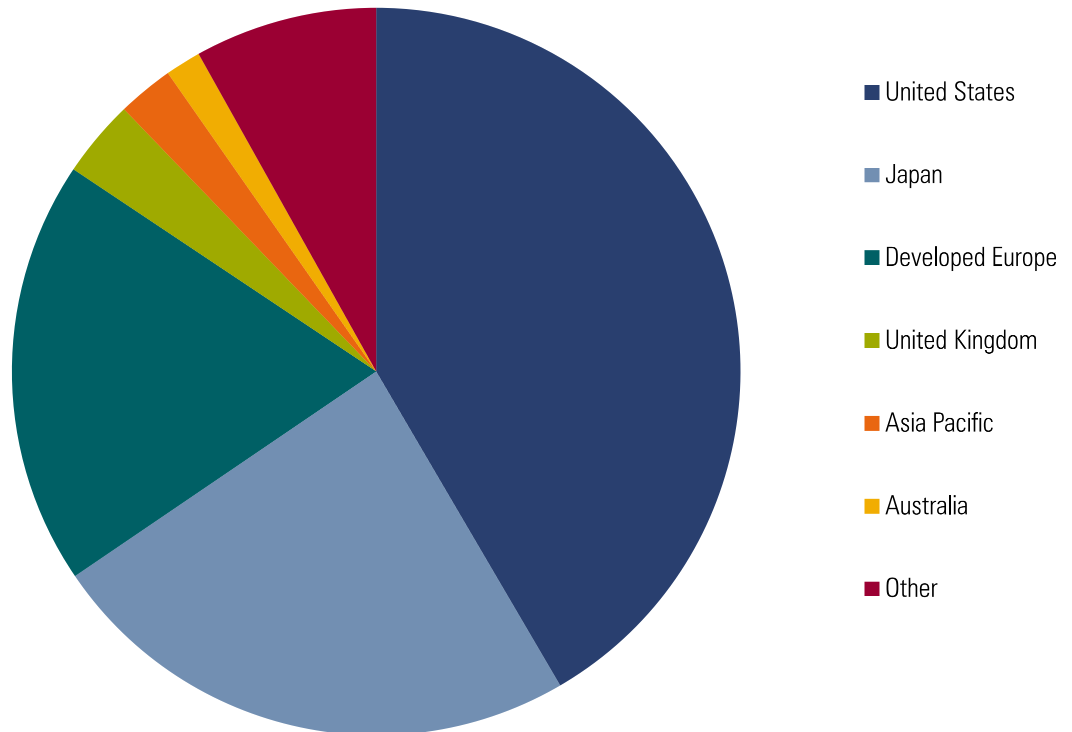
Figure 5 below shows the geographical breakdown of the Barclays Global Aggregate Index. The concentrated exposures of the United States, Europe, and Japan stand out. This is where the argument that active fund managers make about the dangers of passive investing finds most support. Around 84.0 percent of the index is in US, Japanese, and European debt (although it's not all sovereign debt), and these are the countries and region which have elicited the most concern about the sustainability of their budgets.

Figure 5: Geographical Breakdown of Barclays Global Aggregate Index at 9 January 2012



Source: Colonial First State Global Asset Management

Credit Quality

The next issue is the credit quality of the respective indices. The bulk of the value of the securities represented by the UBS Composite Bond Index is AAA-rated. The Australian Federal Government and most states and territories hold AAA credit ratings. Supranational issuers also typically hold AAA ratings, while the four major Australian banks (**Australia & New Zealand Banking Group** ANZ, **Commonwealth Bank of Australia** CBA, **National Australia Bank** NAB, and **Westpac Banking Corporation** WBC) are all rated AA-. Consequently, the UBS Composite Bond Index is dominated by AAA- and AA-rated issuance.

The credit quality of the Barclays Global Aggregate Index is also quite high. Around half of the index is AAA-rated, and around a third classed as AA. This index's credit quality is nonetheless lower than the Australian benchmark, as many countries are not AAA-rated, and non-government institutions comprise a greater proportion of the global index. The extent to which this breakdown adequately captures ongoing sovereign credit risk also remains to be seen, in light of the downgrades to the credit ratings of Italy, Spain, and the United States in 2011.

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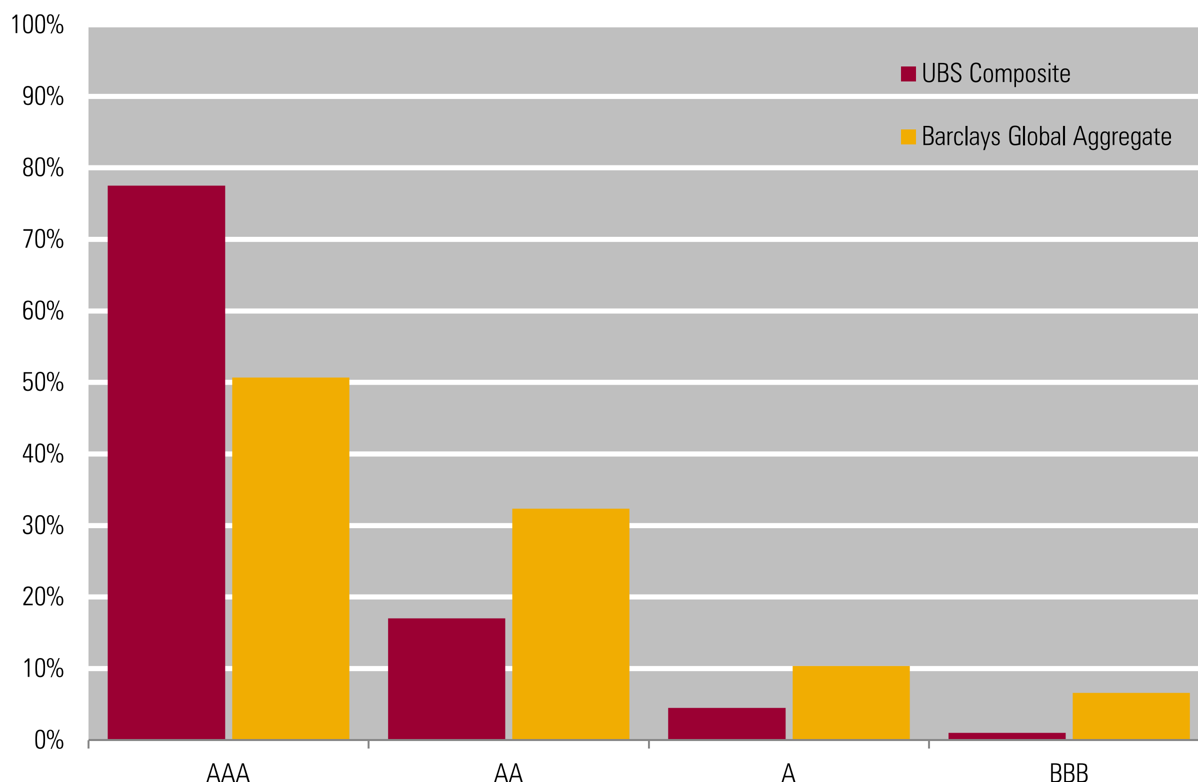
Figure 6: Credit Rating Breakdowns of UBS Composite Bond Index at 31 December 2011 and Barclays Global Aggregate Index at 9 January 2012



Sources: Vanguard Investments Australia and Colonial First State Global Asset Management

Interest Rate Duration

The duration of the UBS Composite Bond Index was 3.79 years at 31 December 2011, after having risen steadily over time. The reason for this is that duration fluctuates in line with the proportion of the index that is government debt. Governments generally issue longer-dated debt than companies, as governments' ability to service the debt is less vulnerable to cyclical variations. The Australian Federal Government has been issuing debt to fund budget deficits in the aftermath of the 2008 financial crisis. This debt has therefore been growing as a proportion of the UBS Composite Bond Index at the same time as many companies have been deleveraging. The Barclays Global Aggregate Index's duration of 5.8 years at 9 January 2012 was markedly longer than the Australian bond index. This is attributable in large part to the greater prevalence of government bonds as index constituents than is the case for the Australian index. The global bond index's duration has lengthened in recent years as governments have issued significantly greater volumes of debt.

We will now examine each index's duration combination. This decomposes these average duration figures into constituent bands, to show each index's sensitivity to changes in specific points of the yield curve. For instance, two bond portfolios could both have an average duration of five years, but one could be much more sensitive to changes in short-term interest rates. This would materialise in a high duration contribution within the 0 – 1 bracket. Figure 7 over shows that the global bond universe is skewed heavily to ultra-long duration securities. Global sovereign bonds are issued with much longer terms to maturity than in Australia, while paying lower coupon rates. By contrast, the Reserve Bank of Australia no longer issues debt with maturities beyond 10 years. The global bond index is therefore particularly sensitive to changes in the economic growth and inflationary expectations underpinning long-term bond yields.

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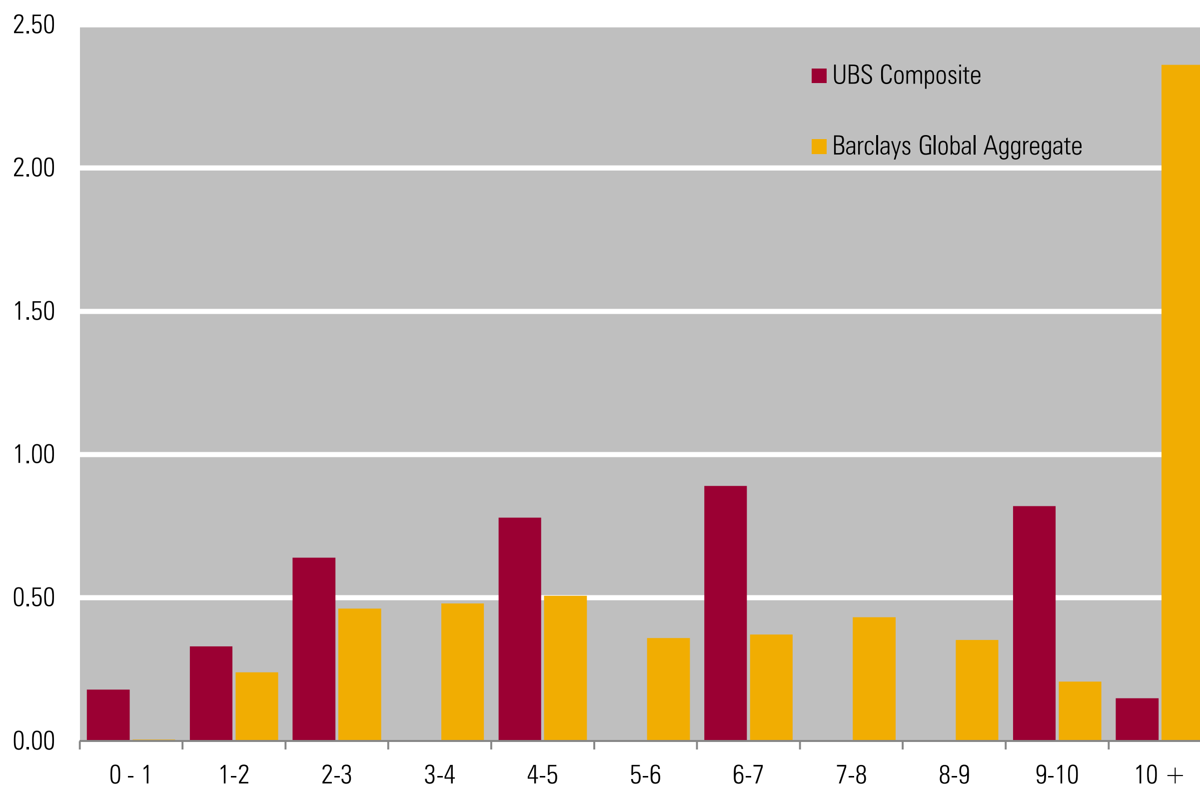
Figure 7: Duration Contributions of UBS Composite Bond Index at 31 December 2011 and Barclays Global Aggregate Index at 9 January 2012



Source: Colonial First State Global Asset Management

Finally, the universe of global debt securities is much deeper than the Australian bond market. The UBS Composite Bond Index comprises 386 debt securities totalling about A$754.0 billion in assets. This is dwarfed by the Barclays Global Aggregate Index, which contained 13,425 debt securities in January 2012 totalling about US$34.70 trillion in assets. The average yield to maturity in the Australian bond market of 4.61 percent is well above the 2.20 percent offshore.

The upshot of all this is that passive investors in Australian fixed interest are heavily-exposed to Australian government, semi-government, and supranational issuers, with a substantial serve of financials. The significant financials weighting could be problematic if wholesale lending markets were to be disrupted or the Australian residential property market took a hit, because of the banks' exposure to this segment of the economy. Non-financial corporate debt is a small fraction of the Australian bonds on issue. As it stands, the majority of the Australian debt market is high-grade, reflecting Australia's relatively robust finances. The index's lengthening duration means that a passively-managed fixed interest portfolio's value is increasingly sensitive to changes in market interest rates, adversely so if they rise.

Passive global bond investors get a high credit quality investment, although not to the same extent as an Australian-only vehicle. Sovereign government bond issues are a major component of the global debt index, and within this sleeve, several heavily-indebted nations are major issuers. While this grabs many headlines, it's important to understand that a global fixed interest indexer is much more susceptible to moves in bond yields than a purely benchmark-neutral Australian offering. A passive global fixed interest investment does, however, provide a much broader universe of sectors and issuers than a purely Australian fixed interest vehicle.

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Onshore and Offshore Fixed Interest Investing

The previous section showed how the Australian fixed interest market is of higher credit quality, more concentrated in government and financials debt, and has lower sensitivity to changes in interest rates than the global debt market. While investors and advisers are bombarded with news about the gloomy global macroeconomic outlook, Australia appears to be a comparative haven. Given this context, it's worth reconsidering the relative merits of global and Australian fixed interest investing.

The Case For Global Investing

Diversity is the principal reason for investing offshore. As noted previously, the Australian bond market is comparatively shallow, and is skewed heavily towards government and financial services company debt. Investors seeking exposure to corporate debt need in our view to look both on- and offshore. Additionally, Australia is unlikely to be immune from a major disruption to the global banking system, which would lead to falls in the value of bank debt as spreads widened. This is a pertinent issue given the banking sector's sizeable footprint in the Australian debt market. Finally, investors with offshore debt exposure may be able to better mitigate the effects of rising Australian bond yields, especially if interest rates are falling overseas.

Fund managers may also find more mispriced investment opportunities offshore. **Bentham Global Income** 10751, for example, rose 58.31 percent in 2009, more than clawing back the previous year's 33.31 percent fall. The strong performance in 2009 was attributable to Bentham's holdings in syndicated loans and securitised debt – such a result would not have been possible in an Australian-only fixed interest vehicle. Global fixed interest funds' diversification across issuers and sectors can also reduce concentration risks relative to Australian-only strategies. A broader investment palette may, however, include more lower-quality and complex fare, amplifying credit and liquidity risks.

Emerging markets debt is a prime example of the broader risk and return opportunities of investing globally. Emerging market debt is undoubtedly several notches behind developed market standards – a significant portion remains domiciled in $US, many developing world debt issues are rated sub-investment grade by credit ratings agencies, capital controls are common, and investor behaviour can be skittish. All of this suggests that investment in emerging market debt should be undertaken sparingly. Still, many emerging market nations' balance sheets are in better shape than their developed counterparts, and credit quality has by and large improved significantly. Modernising countries require greater amounts of capital for financing, enabling fixed interest investors to participate in their ongoing development.

Investors dismayed by the low headline yields many overseas government debt securities offer should understand that this may understate what an Australian investor actually earns. This tricky concept relates to currency hedging and the high yields on Australian government bonds by international standards. In essence, an Australian investor buying a US Treasury bond will not simply earn the two percent coupon after hedging the currency risk. This is because the $US/$A forward rate will trade at a discount to the spot rate to incorporate the Australian market's higher interest rate. Australians will therefore earn a hedged return closer to the domestic risk-free rate than to the US rate.

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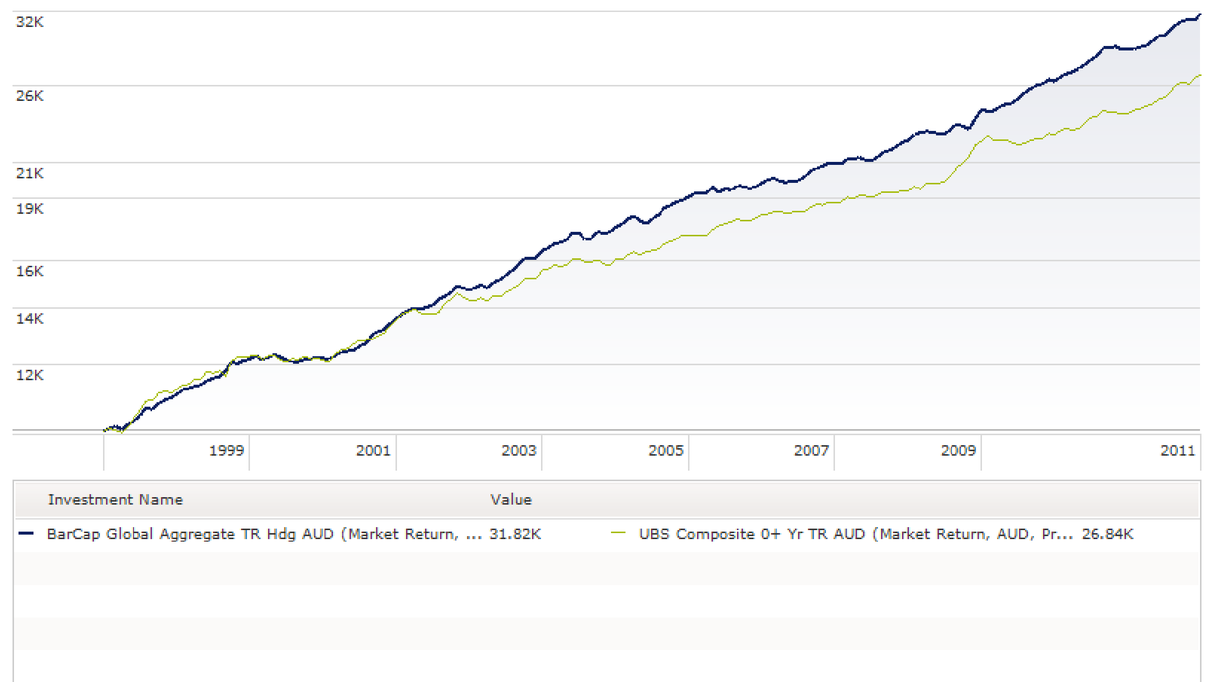
The Drawbacks of Global Investing

The spectre of heavily-indebted countries looms large. Fixed interest investing at its simplest is about earning coupons and return of capital. It's easy to consider the Australian bond market's comparatively high credit quality as a much safer environment for the bondholder. A major sovereign default would also put pressure on the assumption that developed market global government bonds can continue to perform the stable, defensive function they have long fulfilled.

The falls in interest rates to near-zero levels in countries such as the United States and the United Kingdom have several implications. As rates cannot fall below zero, extremely low yields complicate a global bond portfolio's ability to provide an 'insurance policy' when equities tumble. This additionally leads to an unfavourably imbalanced payoff profile. Investors will still benefit if rates fall further, but in the major economies they are already near zero. In the meantime, a marginal increase in yields can severely hinder a bond's value, because of these securities' long duration and low coupons. Australian bondholders also face this risk, but to a lesser extent – the asymmetry of the payoff is less unfavourable, because of the lower interest rate duration and higher yields. Many fund managers have consequently positioned their portfolios to be short duration to reduce the impact of rising interest rates. PIMCO is one very notable exception. The firm reversed course and adopted a benchmark-neutral to long duration position across several of its strategies in 2011 in anticipation of a prolonged period of subdued economic growth and resulting interest rates.

Global bond managers concerned about the potential for rising interest rates can reduce the duration of their portfolios. One of the most aggressive at doing so recently has been Michael Hasenstab, portfolio manager of **Franklin Templeton Multisector Bond** 17390. As well as shunning US Treasuries, Hasenstab has tilted the strategy towards countries he believes exhibit much more sustainable debt characteristics, notably in the emerging markets. This is one way for a global bond fund manager to fight the twin difficulties of rising interest rates and unfavourable macroeconomic fundamentals, but it requires very strong conviction and the investment flexibility to adopt such positions. The fall in interest rates globally has amply rewarded bond investors for more than a decade. The Barclays Global Aggregate Index far outpaced the UBS Composite Bond Index from 1997 – 2011 (Figure 8).

Figure 8: Barclays Global Aggregate and UBS Composite Indices, Growth of A$10,000 From 1997 - 2011



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As attractive as global bond returns have been relative to their Australian counterparts, we caution investors and advisers about extrapolating past performance into the future. Global bonds have outperformed because interest rates worldwide have fallen much more than they have in Australia. A major and unforeseen slowdown in global growth would be necessary to enable global bonds to continue their solid run. This is not impossible, given the continuing European sovereign debt woes, but in such an event we would not expect the Australian economy to remain immune. Such a scenario would also be favourable for Australian bonds, especially given that the country's sovereign debt is one of the few default risk-free investments offering an above-average yield. Finally, a significant component of global bond returns for Australian investors has been a result of currency hedging, a situation which depends on interest rate differentials between countries persisting.

While Australian investors have enjoyed the benefits from higher hedged global bond returns, currency hedging has one major drawback – disruptions to income distributions. When the $A falls rapidly in value, currency hedging losses need to be funded. Fund managers can do so using interest earned or liquidating a portion of the portfolio. Distributions can be affected in either case. Indeed, **Vanguard International Credit Securities Index** 9152 and **Legg Mason Global Multi Sector Bond** 15127 both failed to pay an income distribution in 2009, while **PIMCO EQT Global Bond** 10883's 0.23 percent income return was a fraction of its 20.0 percent total return, all because the $A fell dramatically in late 2008.

Investment in a global fixed interest strategy greatly expands an Australian investor's investment universe, especially in the provision of access to non-financial corporate debt. The flipside is that investors may be taking on more credit or liquidity risks, depending on the strategy selected, or experience disruptions to their income distributions. The existence of low headline yields is not a reason to avoid global fixed interest, but the asset class is particularly vulnerable to a rise in interest rates.

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Investing for Income and Index-Agnostic Vehicles

The substantially larger cohort of retirees, mortgage funds with capital restrictions, and uncertainty over ongoing term deposit rates has prompted many investors to re-examine their income needs. This is understandable, given the painful losses from many equities allocations. Investors should, however, adopt a total return and portfolio perspective, rather than simply focusing on fulfilling a specific income need. Higher yields mean more credit and liquidity risks. It's easy to overlook these risks when yields are enticing, as many investors in retail hybrids can attest.

We're also conscious of a degree of unnecessary product proliferation. Always a risk when there's a hot trend, some fund managers may see this as an opportunity for asset-gathering. Several strategies have been launched since 2007, including a trio of minimally constrained approaches – **Kapstream Absolute Return Income** 17256, **Perennial Tactical Income** 17406, and **PIMCO EQT Australian Focus** 17158.

Their fund managers all tout an ability to deliver a superior and consistent income stream. Investment merit remains our central concern. These strategies each pass muster, but only PIMCO's vehicle has a demonstrable edge in our view, courtesy of the intellectual firepower involved. Nonetheless, many investors desire a steady and consistent income stream. There are some important issues to consider. The first is specific to global fixed interest offerings with currency hedging. As we mentioned earlier, hedging can severely disrupt income distributions when the $A falls sharply.

Another concern is how suited the underlying securities are to meeting liquidity needs and providing regular distributions while maintaining capital stability. For instance, many investors did not comprehend mortgage funds' lack of liquidity when heading for the exits in late 2008. Among fixed interest funds, **AMP Capital Enhanced Yield** 10632's plethora of private debt instruments came unstuck when credit dried up, while **BlackRock Monthly Income** 11602 held far more concentrated bank credit risks than was suitable for a vehicle promoted as providing a steady income return with low capital volatility.

Credit specialists can attain a higher income objective. Strategies such as **Colonial First State Global Credit Income** 10872, **Macquarie Income Opportunities** 10715, **Perpetual Diversified Income** 13443, **Schroder Credit Securities** 8922, and **UBS Diversified Credit** 8855 all invest in non-government debt securities, typically with minimal capital valuation sensitivity to interest rate changes. The potentially higher total returns are however accompanied by vulnerability to widening credit spreads, which may result in returns which are more highly-correlated to equities than a fund incorporating both sovereign and credit instruments.

The strategies with fewer benchmark-related restrictions than a traditional fixed interest option include the aforementioned offerings from Kapstream, Perennial, and PIMCO. **Colonial First State Enhanced Yield** 12410, **Goldman Sachs Income Plus** 5024, **PM Capital Enhanced Yield** 8049, and **Vianova Strategic Fixed Interest** 14371 are among the more seasoned strategies. Each can rotate meaningfully between sectors, adjust duration, or hold cash. PIMCO has switched between government and credit allocations significantly; Kapstream, PM Capital, and Vianova have moved into cash at times of stress; and Perennial has shifted its interest rate duration dramatically. Colonial First State and Goldman Sachs can both select from a wide-ranging menu of investments including listed infrastructure and property for the former, and equity option overlays for the latter.

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How successful then have these vehicles been at tactically orienting their portfolios? Table 2 below shows these strategies' trailing returns over multiple time periods to 29 February 2012 compared to the UBS Composite, Barclays Global Aggregate, and Reserve Bank of Australia Accepted Bills indices. As the table shows, the results have been mixed. Most strategies have surpassed the bank bill rate over longer timeframes, but have fallen behind the Barclays and UBS indices. This includes funds such as **Kapstream Absolute Return Income** 17256 and **PM Capital Enhanced Yield** 8049, which attempted to protect their portfolios by lifting their cash allocations in 2008. The reason for this widespread below-index performance was having below-index duration when yields have broadly fallen through time. This has overtaken the effects of any tactical shifts such as expanding cash holdings in an attempt to preserve capital.

Table 2: Trailing Returns From Index-Agnostic Fixed Interest Strategies to 29 February 2012

Fund/Index Name	Ticker	1 Year %	3 Years %pa	5 Years %pa	10 Years %pa
Colonial First State Enhanced Yield	12410	4.61	9.78	4.92	N.Ap.
Goldman Sachs Income Plus	5024	3.52	9.45	4.45	6.76
Kapstream Absolute Return Income	17256	5.28	6.03	N.Ap.	N.Ap.
Perennial Tactical Income	17406	5.71	N.Ap.	N.Ap.	N.Ap.
PIMCO EQT Australian Focus	17158	6.54	7.84	N.Ap.	N.Ap.
PM Capital Enhanced Yield	8049	4.02	7.89	5.43	N.Ap.
Vianova Strategic Fixed Interest	14371	8.41	5.91	6.91	N.Ap.
BarCap Global Aggregate TR Hedged AUD Index		12.06	10.15	8.87	8.04
UBS Composite 0+ Years TR AUD Index		9.81	6.22	7.03	6.39
RBA Bank Accepted Bills 90 Days		4.77	4.37	5.25	5.33

Source: Morningstar® Direct™

Relaxing the constraints of indices would appear to hold some appeal, but we suggest caution. These strategies may not be positioned at a given point in time to capitalise on falling interest rates should equities stumble, which is when investors need this quality. Indeed, all of these funds trailed the UBS Composite Index substantially during 2011. This is not to say that their returns were poor, or inconsistent with how the strategies were designed. Rather, investors and advisers should have a clear idea of what they are setting out to achieve before selecting such a vehicle. If looking for a portfolio that will be at its best when risky assets fall, a strategy with interest rate duration is the most appropriate. An unconstrained offering may be suitable as a steady income generator.

Even then, it's still critical to gauge a portfolio's holdings and management style and how it fits within an existing fixed interest allocation. Benchmark-agnostic yield-focused vehicles may not necessarily be the answer for a well-balanced portfolio to perform through a full market cycle. Investors may, for instance, be duplicating their credit and lack of sovereign debt exposure if they already hold a specialist credit strategy, increasing their correlation with equities, and unwittingly creating a riskier portfolio.

Diversification is as always essential. Investors can obtain an all-in-one exposure to both Australian and offshore fixed interest markets through a range of strategies in our Bonds – Global/Australia category. Even so, some of these may be particularly exposed to Australian fixed interest – **Colonial First State Diversified Fixed Interest** 4712 and **Macquarie Diversified Fixed Interest** 9839 have consistently had 70.0 and 80.0 percent of their portfolios respectively invested in Australian debt. Consequently, they may be at greater risk than some of their peers if the Australian fixed interest market experiences difficulties. Our research reports help discern the particular characteristics of all these strategies and help advisers and investors make more informed decisions about strategies' characteristics.

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Understanding and Using the Fixed Interest Style Box

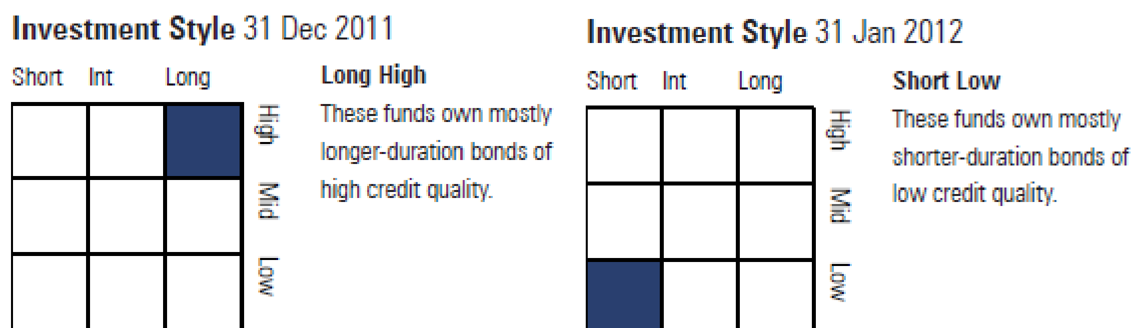
The Morningstar Style Box™ is a useful graphic which enables investors and advisers to quickly gauge a fixed interest portfolio's credit quality and duration. These are two important characteristics which determine how a strategy will perform, and consequently suggest how it should be deployed in a portfolio.

The Style Box for fixed interest funds plots a portfolio's weighted average credit quality and interest rate duration. Credit quality is shown along the vertical axis, high credit quality at the top and low quality at the bottom. Duration increases across the Style Box grid from left to right.

This is a useful depiction because in times of stress, portfolios with higher average credit quality and longer duration are best-placed to succeed. These would be situated in the upper middle or top right of the Style Box. This is typically the domain of index-aware strategies that invest in both sovereign debt and credit, such as **Vanguard International Fixed Interest Index** 6428. Conversely, fund managers are more inclined to assume credit risk and keep duration low when they expect more benign conditions. This is where credit-focused strategies often appear – **Schroder Credit Securities** 8922 (Figure 9) and **UBS Diversified Credit** 8855 are two such examples. Unsurprisingly, strategies with more flexible mandates are scattered across the Style Box, although many held short to moderate duration positions in 2011 because of fears about rising interest rates, which proved unfounded. For example, **Franklin Templeton Multisector Bond** 17390 has held significant high-yield emerging markets exposure, positioning it towards the bottom of the Style Box, while the more conservatively-positioned **Vianova Strategic Fixed Interest** 14371 is near the top.

A higher credit quality vehicle with intermediate to longer duration is more likely to fulfil the 'insurance policy' role we've mentioned previously – one which we believe should form the core of a fixed interest allocation. A lower credit quality portfolio potentially provides a greater total return, and could better handle rising interest rates if it lacks duration. The catch is that these can be more highly-correlated to risky assets, which is problematic in a downturn. Consequently, portfolios at the bottom of the Style Box, including vehicles that can be tactically oriented in this way, are in our view best deployed in a supporting capacity.

Figure 9: Fixed Interest Style Boxes for Vanguard International Fixed Interest Index and Schroder Credit Securities, 31 December 2011 and 31 January 2012



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Changes to Morningstar Analyst Ratings

We take a medium- to long-term outlook when determining qualitative recommendations. Our views about the merits of investment strategies move over time on the basis of manager-specific factors such as investment team composition, changes to investment process, and our degree of relative conviction.

We upgraded one strategy during this sector review, **Schroder Fixed Income** 10862 designated Bronze as a result of the firm having bolstered its size and experience, under Simon Doyle's effective leadership.

We also initiated coverage of seven strategies. **Perennial Fixed Interest** 5666 and **PIMCO EQT Australian Focus** 17158 attained Morningstar Analyst Ratings™ of Silver and Bronze respectively. Perennial's inexpensive offering is managed by a seasoned and stable team, while we consider PIMCO's firm-wide depth of knowledge to be its principal competitive advantage. The remaining five strategies were all designated Neutral – **Goldman Sachs Core Plus Australian Fixed Income** 15828, **Goldman Sachs Income Plus** 5024, **Kapstream Absolute Return Income** 17256, **Legg Mason Global Multi Sector Bond** 15127, and **Perennial Tactical Income** 17406.

Additionally, we ceased coverage with this review of **All Star KFM Income** 15584, **Challenger High Yield** 8970 (terminated in 2011), **Putnam Worldwide Income** 14562, and **Vianova Core Plus** 15586 (terminated in 2011).

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Morningstar Medallists

Investment strategies with Morningstar Analyst Ratings™ of Gold, Silver, or Bronze carry the tag Morningstar Medallists. These are the strategies that in our opinion truly stand out, and share common traits including a capable and stable team, robust processes, and an ability to deliver in a variety of market conditions.

We designated 25 of the 44 fixed interest strategies we assessed Morningstar Medallists (Table 3 below). Three achieved the highest possible Analyst Ratings of Gold: **PIMCO EQT Diversified Fixed Interest** 10882, **PIMCO EQT Global Bond** 10883, and **Tyndall Australian Bond** 10858. Few can match the combined intellect and skill of Bill Gross and his colleagues at PIMCO. Staff stability and a simple, consistently-applied process are the hallmarks of Tyndall's fixed interest investing which elevate it above its rivals. Eight strategies attained Silver, and we designated a further 14 Bronze.

Table 3: Morningstar Medallists – Fixed Interest Strategies

Ticker	Fund Manager/Strategy	Morningstar Analyst Rating™
10882	PIMCO EQT Diversified Fixed Interest	Gold
10883	PIMCO EQT Global Bond	Gold
10858	Tyndall Australian Bond	Gold
17390	Franklin Templeton Multisector Bond	Silver
9839	Macquarie Diversified Fixed Interest	Silver
10715	Macquarie Income Opportunities	Silver
5666	Perennial Fixed Interest	Silver
10881	PIMCO EQT Australian Bond	Silver
4487	Vanguard Australian Fixed Interest Index	Silver
6432	Vanguard Index Diversified Bond	Silver
14371	Vianova Strategic Fixed Interest	Silver
11173	Advance International Fixed Interest Multi-Blend	Bronze
10751	Bentham Global Income	Bronze
4712	Colonial First State Diversified Fixed Interest	Bronze
12410	Colonial First State Enhanced Yield	Bronze
10872	Colonial First State Global Credit Income	Bronze
8406	Dimensional Five-Year Diversified Fixed Interest	Bronze
17158	PIMCO EQT Australian Focus	Bronze
8049	PM Capital Enhanced Yield	Bronze
8922	Schroder Credit Securities	Bronze
10862	Schroder Fixed Income	Bronze
2579	UBS Australian Bond	Bronze
4866	UBS Diversified Fixed Income	Bronze
9152	Vanguard International Credit Securities Index	Bronze
6428	Vanguard International Fixed Interest Index	Bronze

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Appendix 1: Basic Data

Fund Manager/Strategy	Ticker	Morningstar Analyst Rating™	Analyst	Benchmark	Duration Limit Yrs	Expd Tracking Error %pa
Aberdeen Australian Fixed Income	3219	Neutral	Tim Wong, CFA	UBS Composite Bond	Index +/-1.5	1.0 – 2.0
Aberdeen Diversified Fixed Income	14322	Neutral	Tim Wong, CFA	UBS Composite Bond (50.0%)/Barclays Global Aggregate Hedged $A (50.0%)	Index +/-1.5	1.0 – 2.0
Advance International Fixed Interest Multi-Blend	11173	Bronze	Alex Prineas	Barclays Global Aggregate ($A Hedged)	Max. +/-2.5 in each underlying fund	1.0 – 3.0
AMP Capital Australian Corporate Bond	5335	Neutral	Alex Prineas	UBS Credit 0+ Years	Index +/- 1.5	0.90
AMP Capital Enhanced Yield	10632	Under Review	Tim Wong, CFA	Reserve Bank of Australia Cash Rate	0.2	1.68
Bentham Global Income	10751	Bronze	Tim Wong, CFA	UBSA Bank Bill (50.0%)/UBSA Composite Bond (50.0%)	No limit	1.50 – 4.50
BlackRock Monthly Income	11602	Neutral	Mark Laidlaw	UBS Bank Bill	Not targeted (credit only, interest rate duration is less than 365 days)	Not targeted
BT Fixed Interest	2950	Neutral	Tim Wong, CFA	UBS Composite Bond	+/-2	1.0 – 3.0
Colonial First State Diversified Fixed Interest	4712	Bronze	Tim Wong, CFA	UBS Composite Bond	+/-3.5	2.0 – 3.0
Colonial First State Enhanced Yield	12410	Bronze	Tim Wong, CFA	Reserve Bank of Australia Cash Rate	-1 to +2	1.50 – 2.50
Colonial First State FirstChoice Fixed Interest	11292	Neutral	Tom Whitelaw	50/50 UBS Australian Corporate Bond/Citigroup World Broad Investment Grade $A Hedged	N.Ap.	3.0
Colonial First State Global Credit Income	10872	Bronze	Tim Wong, CFA	UBS Australian Bank Bill	+/-0.25	2.0 – 3.0
Dimensional Five-Year Diversified Fixed Interest	8406	Bronze	Alex Prineas	Benchmark-unaware	5	N.Ap.
Dimensional Short Term Fixed Interest	5839	Neutral	Alex Prineas	UBS Bank Bill 0+ Years	2	N.Ap.
Dimensional Two-Year Diversified Fixed Interest	13305	Neutral	Alex Prineas	Benchmark-unaware	2	N.Ap.
Franklin Templeton Multisector Bond	17390	Silver	Tim Wong, CFA	Barclays Capital Multiverse ($A Hedged)	Not targeted	4.0 – 7.0
Goldman Sachs Core Plus Australian Fixed Income	15828	Neutral	Tim Wong, CFA	UBS Composite Bond	None applied	2.0 – 3.0
Goldman Sachs Income Plus	5024	Neutral	Tim Wong, CFA	UBS Bank Bill	N.Ap.	N.Ap.
Kapstream Absolute Return Income	17256	Neutral	Mark Laidlaw	Reserve Bank of Australia Cash Rate	-6.0 to 6.0	Not targeted
Legg Mason Global Multi Sector Bond	15127	Neutral	Mark Laidlaw	50.0% BarCap Global Aggregate, 25.0% JP Morgan EMBI+, 25.0% BarCap US High Yield 2% (all hedged)	0 - 12	3.0
Macquarie Diversified Fixed Interest	9839	Silver	Tim Wong, CFA	UBS Composite Bond	+/-2	1.50
Macquarie Income Opportunities	10715	Silver	Tim Wong, CFA	UBS Bank Bill Index	1	1.50

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Fund Manager/Strategy	Ticker	Morningstar Analyst Rating™	Analyst	Benchmark	Duration Limit Yrs	Expd Tracking Error %pa
MLC Diversified Debt	16244	Neutral	Mark Laidlaw	BarCap Global Aggregate Hedged (50.0%)/UBS Australian Composite Bond (50.0%)	Not targeted	1.50
MLC Horizon 1 Bond	13402	Neutral	Mark Laidlaw	UBS Bank Bill (30.0%), UBS Australian Composite Bond (42.0%), BarCap Global Aggregate Hedged (28.0%)	Not targeted	1.50
OnePath Diversified Fixed Interest	7697	Under Review	Julian Robertson	UBS Composite Bond	+/-2	Index +/-1.50
Perennial Fixed Interest	5666	Silver	Mark Laidlaw	UBS Composite Bond	+/-1.5	0.60
Perennial Tactical Income	17406	Neutral	Mark Laidlaw	50.0% UBS Bank Bill/50.0% UBS Composite Bond	+1.5	0.60
Perpetual Diversified Income	13443	Neutral	Tom Whitelaw	UBS Australia Bank Bill	+/-0.50	1.50
PIMCO EQT Australian Bond	10881	Silver	Alex Prineas	UBS Composite Bond	2 – 5	2.0
PIMCO EQT Australian Focus	17158	Bronze	Alex Prineas	50.0% UBS Composite Bond/50.0% UBS Bank Bill	2 – 2.5	2.0
PIMCO EQT Diversified Fixed Interest	10882	Gold	Alex Prineas	BarCap Global Aggregate Hedged $A (50.0%) /UBS Australian Composite Bond (50.0%)	3 – 7	3.0
PIMCO EQT Global Bond	10883	Gold	Alex Prineas	BarCap Global Aggregate Index Hedged $A	3 – 7	2.0
PM Capital Enhanced Yield	8049	Bronze	Mark Laidlaw	Reserve Bank of Australia Cash Rate	1	N.Ap.
Schroder Credit Securities	8922	Bronze	Tom Whitelaw	Reserve Bank of Australia Cash Rate	0 – 2	Not targeted
Schroder Fixed Income	10862	Bronze	Tom Whitelaw	UBS Composite Bond	+/-2.5	0.50 – 1.50
Tyndall Australian Bond	10858	Gold	Mark Laidlaw	UBS Australian Composite Bond (All Maturities)	1	Not targeted
UBS Australian Bond	2579	Bronze	Tim Wong, CFA	UBS Composite Bond	Not targeted	0.70 – 1.0
UBS Diversified Credit	8855	Neutral	Tim Wong, CFA	None stated	Not targeted	1.0
UBS Diversified Fixed Income	4866	Bronze	Tim Wong, CFA	50.0% UBS Australia Composite Bond/50.0% Barclays Global Aggregate ($A Hedged)	+/-3	1.0
Vanguard Australian Fixed Interest Index	4487	Silver	Chris Douglas	UBS Australian Composite Bond	Matches index	0.10 or below
Vanguard Index Diversified Bond	6432	Silver	Chris Douglas	UBS Australian Composite Bond (40.0%)/BarCap Global Aggregate $A (60.0%)	Matches index	0.66
Vanguard International Credit Securities Index	9152	Bronze	Chris Douglas	BarCap Global Aggregate Government-related and Corporate Hedged $A	Matches index	0.25
Vanguard International Fixed Interest Index	6428	Bronze	Chris Douglas	Barclays Capital Global Treasury Hedged $A	Matches index	0.20 or below
Vianova Strategic Fixed Interest	14371	Silver	Chris Douglas	UBS Composite Bond	-0.75 to +6.0	Not targeted, historically <2.0

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Appendix 2: People

Fund Manager/Strategy	Ticker	Lead Manager(s)	Date Appointed	Years Exp	Team Size	Avg Yrs Exp	Avg Yrs Tenure
Aberdeen Australian Fixed Income	3219	Victor Rodriguez	2009	18	9	10	5
Aberdeen Diversified Fixed Income	14322	Victor Rodriguez	2009	18	9	10	5
Advance International Fixed Interest Multi-Blend	11173	Ron Mehmet	2010	27	5	27	4
AMP Capital Australian Corporate Bond	5335	Jeff Brunton	2008	20	10	10	4
AMP Capital Enhanced Yield	10632	Jeff Brunton	2008	20	8	16	6
Bentham Global Income	10751	Richard Quin	1997	21	3	13	2
BlackRock Monthly Income	11602	Stephen Miller	2002	27	5	19	6
BT Fixed Interest	2950	Vimal Gor	2010	17	7	13	6
Colonial First State Diversified Fixed Interest	4712	Warren Bird	2001	32	15	18	8
Colonial First State Enhanced Yield	12410	Warren Bird, Rudi Minbatiwala	2005, 2005	32, 11	9	16	8
Colonial First State FirstChoice Fixed Interest	11292	Scott Tully	2002	23	7	16	7
Colonial First State Global Credit Income	10872	Tony Adams	2001	25	10	15	5
Dimensional Five-Year Diversified Fixed Interest	8406	Steve Garth	2003	9	5	8	8
Dimensional Short Term Fixed Interest	5839	Steve Garth	2003	9	5	8	8
Dimensional Two-Year Diversified Fixed Interest	13305	Steve Garth	2005	9	5	8	8
Franklin Templeton Multisector Bond	17390	Michael Hasenstab	2003	16	22	15	9
Goldman Sachs Core Plus Aust Fixed Income	15828	Subash Pillai	2006	15	5	17	11
Goldman Sachs Income Plus	5024	Subash Pillai	2010	15	7	16	9
Kapstream Wholesale Absolute Return Income	17256	Kumar Palghat	2007	24	7	16	4
Legg Mason Global Multi Sector Bond	15127	Ian Edmonds	2007	21	19	22	10
Macquarie Diversified Fixed Interest	9839	Graham McDevitt	2010	26	30	11	7
Macquarie Income Opportunities	10715	Brett Lewthwaite	2010	16	30	11	7

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Fund Manager/Strategy	Ticker	Lead Manager(s)	Date Appointed	Years Exp	Team Size	Avg Yrs Exp	Avg Yrs Tenure
MLC Diversified Debt	16244	Stuart Piper	2008	32	2	21	6
MLC Horizon 1 Bond	13402	Stuart Piper	2008	32	2	21	6
OnePath Diversified Fixed Interest	7697	Greg Michel	2007	28	7	16	7
Perennial Fixed Interest	5666	Glenn Feben	2002	31	6	24	13
Perennial Tactical Income	17406	Glenn Feben	2009	31	6	24	13
Perpetual Diversified Income	13443	Vivek Prabhu	2004	19	4	19	6
PIMCO EQT Australian Bond	10881	Robert Mead	2008	21	4	17	7
PIMCO EQT Australian Focus	17158	Robert Mead	2009	21	4	17	7
PIMCO EQT Diversified Fixed Interest	10882	Bill Gross, Robert Mead	2009, 2008	40, 21	62	24	16
PIMCO EQT Global Bond	10883	Bill Gross	2009	40	62	24	16
PM Capital Enhanced Yield	8049	Jarod Dawson	2004	13	5	15	5
Schroder Credit Securities	8922	Mihkel Kase	2003	16	9	17	4
Schroder Fixed Income	10862	Simon Doyle	2003	24	9	13	4
Tyndall Australian Bond	10858	Anita Daum	2008	10	9	16	6
UBS Australian Bond	2579	Anne Anderson, Warren Tease	1993, 2005	28, 25	9	15	7
UBS Diversified Credit	8855	Tim van Klaveren	2011	21	9	15	7
UBS Diversified Fixed Income	4866	Warren Tease	2005	25	9	15	7
Vanguard Australian Fixed Interest Index	4487	Stephen Howard	2010	10	6	15	5
Vanguard Index Diversified Bond	6432	Stephen Howard	2010	10	6	15	5
Vanguard International Credit Securities Index	9152	Stephen Howard	2010	10	6	15	5
Vanguard International Fixed Interest Index	6428	Stephen Howard	2010	10	6	15	5
Vianova Strategic Fixed Interest	14371	Michael Schneider	2005	22	4	16	5

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