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Bond portfolios from the ground up

By adopting an absolute return approach investors can continue to access bond portfolios that can deliver attractive returns above cash whilst reducing volatility risks now present in bond benchmarks. The Franklin Australian Absolute Return Bond Fund actively seeks diversified sources of return whilst managing downside risk.

The rise of absolute return style funds in the market has led several managers to move away from traditional approaches. Some contemporary investment strategies can look and behave more like a hedge fund or diversified credit fund that takes a long only approach to some of the higher yielding parts of the bond market.

The Franklin Australian Absolute Return Bond Fund takes a different approach. Aiming to maintain a high average credit quality across the fund, it actively seeks to incorporate diversified sources of return and deliver regular monthly distributions. It still preserves the key traditional aspects of bond investing by delivering attractive returns above cash whilst managing downside risk carefully.

By targeting returns of 2-3% per annum before fees over the cycle, the fund is able to meet expectations for clients who want income from bonds with a much lower level of volatility.

Protecting client capital

The Australian bond market has changed significantly over the last decade. Yields across the asset class are much lower, duration or interest rate sensitivity has increased dramatically and the market features more and more international borrowers. In fact, over 50% of Australia's non-government debt now originates from offshore entities.

Franklin Templeton Investments believes it is important to reconstruct bond portfolios from the ground up, beginning with cash and then carefully selecting specific opportunities that make sense for Australian investors still looking for defensive returns with lower capital volatility.

Andrew Canobi[01], director Australian fixed income, says this means the correct benchmark is cash – which is a much lower risk benchmark than a traditional bond benchmark.

Canobi explains that to minimise volatility in the fund's strategy, the first and foremost thought should be directed at protecting clients' capital. This is principally done by only investing in securities and strategies that work to achieve the fund's end objective of stable, attractive returns above cash with manageable risk.

"This means that, generally, we avoid the very high risk parts of the credit market. On average the credit quality across our portfolio is in the 'A' category or higher," Canobi says.

"Secondly we have very diversified sources of return in our portfolio. Fixed income managers may engage in many strategies but when it's all said and done they add up to a small number of concentrated positions."

For example a manager that diversifies across investment grade, high yield and securitised credit effectively has a concentrated exposure to credit in one form or another. By contrast the fund will blend some positions in credit with, for example, small positions in interest rate markets and selectively even some currency positioning, Canobi says.

"We seek to add value from positions in select securities and sectors from the bottom up, primarily from the domestic market but also some international exposure, and finally we position the fund to take advantage of movements in particular interest rates, as well as some currency markets around the world."

The Franklin Australian Absolute Return Bond Fund also has the ability to actively and dynamically hedge against potential market risks. If it is concerned about rising interest rates, for example, then it can hedge its exposure. Additionally the fund can actively hedge credit risk by adopting strategies that help protect against weakness in that market. Canobi adds that is a way of being more market neutral at warranted times.

Where to take advantage

While the fund is cognisant of what is in benchmarks, it is not bound by them. After beginning the investment strategy in cash, every position thereafter is considered active.

Canobi says the fund can and does take an active approach to duration, meaning it can be long on government bonds when valuations are attractive, or it can also be positioned to take advantage of rising yields.

The quote

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"We can adopt interest rate risk if valuations are compelling. We can take positions in government bonds, both when yields are likely to fall and when they're likely to rise to add value for our clients," he says.

"We also adopt positions in non-government sectors such as corporate credit but, importantly, we generally stay at the high quality, liquid end of the spectrum. We avoid higher risk and less liquid sectors such as listed hybrids and RMBs."

He adds another capability in accessing additional sources of alpha is by introducing highly targeted investment views on select global fixed income markets. For example the fund has been and remains constructive on New Zealand government bonds "where valuations are attractive and further easing is expected from the RBNZ."

Managing historic low rates

A scenario that is easily envisaged, Canobi says, is a world where both and equity and bond markets decline in value by five or 10%.

Because the characteristics and risks of bonds – in a traditional sense – have changed dramatically over the last 5-10 years, the fund strongly believes its investors need to rethink their fixed income approach.

"The natural earning capacity for bonds is very low. So you're cushion against negative returns straight away is very low," Canobi explains.

"Yields have fallen significantly reducing the income potential of traditional approaches whilst duration or interest rate sensitivity has increased. This means to continue delivering returns similar to those in the past, already record low bond yields globally need to reach even more extreme lows."

He adds that by adopting an absolute return approach investors can continue to access bond portfolios that can deliver attractive returns above cash whilst reducing some of the volatility risks now present in bond benchmarks. **FS**