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How to get more from your defensive asset allocation

What exactly is a defensive asset? The answer to this depends on who you ask.

For some people the priority is liquidity so just holding cash might make sense. For others it means having limited performance volatility so perhaps you could consider a term deposit. And for others it might mean protecting your portfolio if equities are selling off, which might mean you want a lot of interest rate exposure so perhaps buying some longer dated government bonds might make sense. It would be nice if there was one solution that accomplished all of these goals simultaneously, but that may be a hard to find.

The table below summarises a few of the more traditional defensive asset allocation (DAA) choices and some of the pros and cons of each.

Another option which may be worth considering in your DAA strategy is a low duration absolute return bond fund. These funds try to balance a range of investor objectives. In our opinion, the best ones offer the following attributes:

Absolute return focus: An absolute return focus means the manager is trying to generate positive returns in most market environments. Contrast this with an approach where a benchmark is provided and the fund outperforms that benchmark but still loses money for investors. That should not be considered a good outcome.

Unconstrained: Many traditional fixed income funds are managed against a stated benchmark. Managers should be held accountable for their performance, so benchmarking them makes intuitive sense. Unfortunately all fixed income benchmarks have limitations. The fixed income markets are large and diverse. There is no one index that does a good job of reflecting the range of investment opportunities. In addition, it's easy for managers to outperform their index by taking greater credit risk than represented in the underlying index. Unfortunately, that practice is all too common.

Limited interest rate risk: Interest rates remain close to multiple century lows. It seems unlikely they will stay there forever. It might be prudent to avoid taking excessive interest rate risk at this point in the cycle. Bond portfolios with interest rate duration greater than two years might be worth reconsidering in the current environment.

However, there are times when a long interest rate duration is appropriate so it's also worthwhile for the manager to have the flexibility to extend duration when needed. On a related point, long duration bonds are often touted as a good hedge for equity risk, but those correlations are far from reliable and often break down for long periods.

Very high average credit quality: Most funds will disclose an average rating which is usually the weighted average rating of all the securities held in the portfolio. The S&P rating scale is as follows: AAA, AA+, AA, AA-, A+, A, A-, BBB+, BBB, BBB-. In our opinion, funds worthy of consideration for your core DAA should have a weighted average rating of at least "A" or better. Anything below that would likely introduce too much volatility.

Another note of caution, be wary of funds that do not disclose their weighted average rating. It could mean they are taking more credit risk than they should to boost their returns.

Option	Pros	Cons
Cash	Liquidity, limited interest rate risk	Very low returns
Term Deposits	Higher return than cash, limited interest rate risk	Low returns, not great liquidity as most are sold with notice periods
Government Bonds	Low default risk	Significant interest rate risk in a rising rate environment
Listed Corporate Bonds	Ease of execution	Difficult to construct sufficiently diversified portfolios and/or material interest rate risk in a rising rate environment
Traditional Fixed Income Funds	Active management, better levels of diversification	Many can have material interest rate risk in a rising rate environment and/or a limited range of assets to choose from
ETFs	Ease of execution	Many can have material interest rate risk in a rising rate environment and/or be poorly diversified
Listed Hybrids	High Yielding	Meaningful equity like risk

Ever read a fixed income article that was so dense you end up abandoning it halfway? Our latest featured article is a refreshing departure from this.

On the contrary, Mark Mitchell, founder and portfolio manager of fixed income specialist Daintree Capital has provided an easy-to-digest checklist of what investment attributes investors need to look out for when it comes to their defensive asset allocation strategy.

Of course the article is still about fixed income so it's not devoid of industry jargon entirely. But it's a fantastic starting point to understand the merits of an absolute return bond fund without gouging your eyes out. Read this article and watch my video interview for more.

Michelle Baltazar
Director of Media & Publishing

The quote

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Active management: Passive management might make sense in some parts of your portfolio, but it's our view that it's not a particularly good option in fixed income. Most passive fixed income strategies either follow an index with meaningful duration risk (which we believe doesn't make a lot of sense in this environment) or are poorly diversified. Only through active management can managers look for the most attractive assets and hedge out unwanted risks.

Diversification: Most active bond funds have a reasonable level of diversification but not all of them. Any strategy which has less than 50 different issuers in the portfolio is potentially taking too much single issuer risk.

While most issuers rated investment grade should be considered safe and have a low chance of defaulting, unforeseen things do occur from time to time.

If a portfolio has too much exposure to a name that defaults, it could destroy the performance of the fund for years. Bonds have an asymmetrical risk payoff structure meaning there is little upside (especially in investment grade bonds) but lots of downside risks. This means diversification in a bond portfolio makes a lot of sense. Running concentrated bond portfolios usually does not.

Other key priorities for absolute return funds include limited equity risk, high liquidity, ability to look globally for assets, regular income, low volatility and multiple sources of returns.

Absolute return bond funds are not a panacea. They still have a range of risks and require a skilled experienced manager to make use of a large range of investment options while effectively managing the risks. But even if you assume this to be the case, there will still be risk. The question obviously becomes do the benefits outweigh the risks.

Asset allocation is never an easy process and there aren't many free lunches in investing, but given the relative benefits and additional return potential a low duration absolute return bond fund may warrant consideration for your core defensive asset allocation strategy. FS

Disclaimer: Please note that these are the views of the writer and not necessarily the views of Daintree. This article does not take into account your investment objectives, particular needs or financial situation.

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