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Vivek Prabhu
head of fixed income
Perpetual Asset
Management

The search for real yield

At a time of record low interest rates and global uncertainty, fixed income isn't typically seen as an income-generating option – but it can be.

Very few investment managers can lay claim to having been prepared for the market turmoil seen as a result of the COVID-19 pandemic.

But, whether by coincidence or by design, Perpetual's head of fixed income Vivek Prabhu can.

Much of it, he says, comes down to the fact the fund is built around investor outcomes, rather than a need to "blindly follow a benchmark".

"By that, I mean it's designed to deliver bank bills plus 2% per annum before fees, so it's built around an actual outcome," he explains.

The actively managed Perpetual Diversified Income Fund invests in a range of quality debt securities across a variety of sectors and maturities, with the aim to deliver regular income and the potential for above cash rate returns.

In selecting those investments, Prabhu and his team screen out risks using filters that help to identify the companies with strong balance sheets, predictable earnings, that demonstrate industry leadership and low susceptibility to regulatory or event risk.

As portfolio manager of the fund, Prabhu was ready when the downturn hit; about 18 months prior he had started de-risking the portfolio and increasing exposure to top-rated securities.

"Typically, over the 15-year history of the fund, I've turned the portfolio over roughly two times per annum, which gives you an idea of how high quality and liquid the portfolio is," he says.

"The lead up to COVID and after COVID was no different."

From September 2018 onwards Prabhu set about increasing the portfolio's exposure to AAA securities. At the outset, AAA securities accounted for about 20% of the portfolio and, by the time COVID hit, sat above 50%.

"To put that into context, during the depths of the GFC we only had about a 40% exposure to AAA assets," Prabhu says.

Following the downturn, in last year's June quarter alone, Prabhu turned over about 90% of the portfolio. He cut the AAA exposure to less than 25% and allocated instead to longer dated banks, financials and corporates, typically BBB rated or towards the lower end of investment grade.

"I point that out because, unlike the Global Financial Crisis when it took central banks, regulators and governments the best part of 10 months to implement their policy responses," he explains.

"During COVID-19 the same players had their GFC playbook from which to draw on and they implemented those responses within a matter of weeks. So, as an investor, if you didn't act quickly, you missed the opportunity."

That's when credit spreads started to come back in, with Prabhu saying they're now tighter than pre-COVID levels and, in some cases, tighter than those seen pre-GFC.

And it paid off. In the year to March 31, the fund returned 8.85% when the index saw just 0.11%. In fact, the fund has consistently outperformed the Bloomberg AusBond Bank Bill Index since inception.

As a result, Prabhu has profited from many of the positions taken during the June quarter last year. Over 40% of the portfolio is now in AAA bonds and the BBB exposure has been slashed to almost 20%.

We are much more defensively positioned now, Prabhu says.

That works for investors too, with Prabhu saying the fund is ideal for the defensive component of investors' portfolios.

That said, the fund also has several advantages when compared to traditional defensive assets like cash, term deposits and fixed rate bonds.

Prabhu says a key advantage is that unlike with term deposits and fixed rate bonds, investors in the Diversified Income Fund aren't locked into a fixed rate of return.

Taking it one step further, the fund's strategy acts as a hedge against inflation. This is because it's a floating rate fund with underlying securities that reset to prevailing market interest rates on a monthly or quarterly basis.

"As the cash rate begins to rise, the income generated by the portfolio rises and that's why it acts as a good hedge against inflation," Prabhu explains.

However, because of the index that it's benchmarked to, there's very little interest rate risk or duration.

"That bank bill benchmark has 0.1 years of interest rate duration, compared to a fixed rate bond fund which would currently have over five and a half years of interest rate duration," he says.

"From a capital stability point of view, you're not exposed to capital volatility as a result of changes in market interest rates."

Much of the success seen by Prabhu and his team in recent times came from foreign denominated holdings, which contributed strongly to the fund's returns.

Credit is a global market, he says, and the fund is capable of buying bonds in both Australian dollars and international currencies. However, the fund is not able to take on any currency risk, meaning that when the team does buy foreign denominated bonds, it's hedged back to Aussie dollar currency risk and the local floating rate interest risk.

"From time to time, particularly during times of volatility, we'll see opportunities in foreign denominated bonds where the credit spreads available are much wider than the equivalent Aussie dollar credit," Prabhu says.

"COVID was no different."

As an example, Prabhu cites a recent investment the fund made.

"During that period, we bought a Commonwealth Bank senior US dollar bond, which is AAA rated. And even after all the hedging costs, the credit premium or credit spread I was able to collect was almost double that of the equivalent Aussie dollar CBA bond," he says.

Now, Prabhu and his team are looking ahead to identify opportunities to be maximised in the respective domestic and global economic recoveries.

"Credit spreads have come in a long way since the initial COVID period, particularly because we've seen that response from central banks, regulators and governments which has been supportive of equity markets and credit spreads," he explains.

Having said that, credit spreads can remain tight for a long time, Prabhu says, adding that he is reminded of the period from 2004 to 2007 "when they were low and tight for a long period of time".

Looking at the credit fundamentals, the asset class is buoyed by accommodative policies from central banks, such as ongoing quantitative easing and fiscal stimulus implemented by the world's governments.

The improving global economic outlook is also encouraging, particularly as the roll-out of COVID-19 vaccines the world over gains traction.

"For these reasons it makes sense to remain fully invested albeit in a more defensive fashion," Prabhu says.

The Perpetual Diversified Income Fund is available for financial advisers to access on a range of platforms, including BT Panorama, HUB24, MyNorth, Netwealth, and Perpetual WealthFocus. FS

The quote

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Watch the video on www.fsitv.com