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James Alexander
head of fixed income, Nikko Asset Management Australia

Falling rates in recent years have caused a major shift in sentiment to the point that financial advisers are looking after portfolios that are 'underweight' fixed income due to individual client preferences.

But is this decision beneficial for their clients in the long-term?

This edition features a Q&A that can help advisers add value by providing what is, on the surface, a counter-intuitive response to the consensus outlook on bond markets.

In the Q&A, Nikko Asset Management Australia's head of fixed income James Alexander explains why he does not foresee a 'bond bubble' bursting and why being 'underweight' in fixed income might make sense in the short-term but can hold an investor back over the long-term.

Ultimately, financial advisers need to look at overall portfolio risk alongside their clients' expectations on returns – and that's when the right fixed income allocation brings its just rewards.

Michelle Baltazar
Director of Media & Publishing

Risk management: The role of fixed income

Q&A with **James Alexander,** head of fixed income, Nikko Asset Management Australia

Why do you think that many Australian investors' portfolios are underweight fixed income?

It's probably down to two factors – returns and familiarity. Most people understand equities – if a company performs well, they can benefit from share price growth and potentially dividends and if it performs poorly, shares can decrease in value and dividends can dry up. So, generally there is a better recognition of equities as an investment.

Fixed income could be viewed as the second cousin – it's an asset class that many people don't understand and view as complex and difficult to access. In addition, equities tend to provide higher long-term returns than bonds so if you are just thinking about returns and not concerned with overall portfolio risk, then you're probably thinking less about bonds.

Why would an investor consider maintaining a bond allocation in their investment portfolio?

Australians have traditionally invested in equities rather than bonds, but bonds are a valuable component in a diversified portfolio. Although equities can offer the potential for greater returns more quickly, they involve considerable volatility and the potential for capital losses. Bonds tend to perform relatively better in market downturns and when deflation is a major risk. It's when an investor thinks about their overall portfolio that an allocation to bonds should be a consideration since their generally negative correlation to equities means that when equity returns are poor you tend to see bond returns stronger, offsetting those losses on the equity portion.

It's that risk mitigation that bond portfolios offer. It's about smoothing returns over time so you don't get big negatives one month and a great positive the next month. Bonds provide more stable returns and reliable income than equities and also involve less capital risk since bond interest must be repaid before any dividends.

So in a nutshell, holding bonds within a portfolio can help balance returns, diversify risk and reduce overall volatility.

What do you think an investor should look for when choosing a fixed income fund to invest in?

I think there are two key things.

The first is the type of product and the role it will play in a portfolio. Investors need to make sure that the product is in line with their particular return objectives, tolerance for risk and investment time horizon. If you're looking for a conservative bond fund that provides steady returns, make sure that's what the fund is actually doing. In the search for yield in the current environment, some asset managers are investing more heavily in credit, often lower rated credit which offers higher returns. In our view, although this may provide returns in the short term, in times of market stress which cause illiquidity, it can lead to negative performance surprises. We saw that during the GFC, when some funds, which could and did allocate large portions of their portfolio to credit, gave their investors a nasty shock. Instead of the fixed income portion of their portfolio doing its job and being the outperformer during that time, funds that were very overweight credit performed badly and in some cases actually delivered negative returns during that period.

So, it's important to consider what an investor wants from fixed income and choose a fund accordingly. If it's a non-core holding and the investor is looking for a higher return and is prepared to take on extra risk, then a fund that is able to invest in riskier securities could be appropriate. But if the investor is looking for a core holding, then they want a conservative true-to-label fund that won't give them any nasty surprises at a time they can least afford them.

The second key factor is to ensure the product is managed by an experienced and stable investment team. Fixed income markets are complex and require years of experience to fully understand and navigate. Managers will use a variety of strategies, such as duration and yield curve positioning, sector rotation and credit to enhance returns. This means that they can adjust portfolios to take advantage of opportunities in all parts of the fixed income market in all market conditions.

The quote

Experience also means having to make tough decisions – you don't want a manager that follows the herd.

Experience also means having to make tough decisions – you don't want a manager that follows the herd. An experienced manager will clearly communicate their perspective on the market even if it isn't widely shared and they are investing contrary to many of their peers. Look for an investment team that is prepared to be transparent with investors and be able to fully articulate the reasons for their investment positions.

With prices surging to record highs in recent years, is there a 'bond bubble' that is going to burst?

We don't think so. The way we would define a bubble is excessive prices that can't be justified by the information that you have. That's not the case with bonds. We are currently seeing sub-trend GDP growth globally and very low inflation (bordering on deflation in some countries), which is being further subdued by very low commodity prices. When bond yields are low, inflation tends to be low so it is unsurprising that bonds are outperforming at the moment – it's consistent with what has occurred historically.

The biggest risk for bonds would be an unexpected increase in inflation. However, inflation is subdued globally, even in the US where growth has started to pick up. In our view, there is nothing on the horizon that suggests this will change in the short term, with many central banks still talking about increasing quantitative easing or lowering interest rates. Given this very low yield environment and our expectations for it to continue for some time, we don't expect Australian 10-year bond yields to increase significantly over the next year. **FS**

Watch the interview on www.FSiTV.com

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