FINANCIAL REVIEW

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Is there room for international bonds in your portfolio?

While interest rate risk favours a "home bias", there's still a place for international fixed income in a balanced portfolio.

A missing piece of the passive funds puzzle has been found in the form of global fixed income ETFs.

by **Mark Story**

Australians have significantly less exposure to fixed income than investors around the world, but that hasn't stopped a wave of global companies issuing bonds in Australia in recent years. While 15 years ago 93 per cent of bond issuance came from institutions domiciled in Australia, today more than 20 per cent of the Australian composite bond index comprises issuers overseas.

Drill down beyond government issuance, and the encroachment of offshore issuers is even more pronounced, with Reserve Bank of Australia figures citing non-residents as the largest segment of the non-government bond market in Australia.

However, due to more protracted interest rate risk – where cash rates around the world are being held "lower for longer" – most retail investors and their institutional counterparts are more comfortable with less, not more, exposure to international government bonds.

It's not rocket science. International government bonds simply have an effective duration of around 7.3 years versus 4.62 years for Australian fixed income (the Australian Bloomberg Bond Index, comprising fixed rate bonds), where duration is short-hand for a change in the value of a bond index for the change in interest rates. If interest rates go down, investors in traditional fixed-rate bonds benefit, while the opposite is also true. When rates inevitably rise, prices of fixed-rate bonds can be expected to drop.

Within the current interest rate environment, institutions are wary of having too much in traditional fixed-rate bonds – particularly international government bonds – because an up-tick in rates isn't far away.

The big issue for investors, says Bentham Asset Management managing director Richard Quin, is that with interest rates remaining historically lower for longer, the risks to traditional fixed-rate bonds has changed, and they're simply not being rewarded for buying longer-dated bonds.

What this has also done, adds Quin, is force investors to rethink which sectors of global credit and fixed income markets are positioned to protect wealth in a rising-interest-rate environment. Successfully interpreting US Federal Reserve-speak is tantamount to stargazing, but by its own admission economic conditions are "ripe" for it to start raising its benchmark interest rate when it next meets, on December 15, he says.

Another important message for investors to understand, adds Quin, is that traditional, long-dated fixed-rate bonds – international or Aussie – carry interest rate risk in a rising-interest-rate environment. "This means that the returns investors historically achieved in this asset class are unlikely to be replicated in the near future."

Venture outside of traditional government bonds and he says there are many sectors which contain very little interest rate risk, for example floating-rate bonds, where the coupon on the bond increases as interest rates rise.

Bentham favours floating-rate global credit sectors, where investors are being rewarded with yield for taking on credit risk, while not taking on interest rate risk. Implementing this view, the largest allocation within Bentham's Global Income Fund – a multisector global fund with significant flexibility in allocation – is to floating-rate US corporate loans.

Quin expects floating-rate senior secured loans from international issuers to outperform cash and bonds over the year by enough to warrant the greater credit exposure, but he won't give specific numbers. He also reminds investors that credit assets give more protection than direct equities due to higher income and being higher up the capital structure.

In other words, if everything goes pear-shaped, you're not last in the queue to get your money out.

BENEFITS IN DIVERSITY

While there's an argument for both international and Australian bond issuers, BlackRock investment strategist Steve Miller says Australian investors still need to better recognise the diversity benefits that come from taking a "mix and match" approach.

"The right prism through which to view bond portfolio allocation is a lens of opportunity-set expansion," Miller says. "International issuers should complement the local bond [government or corporate] market rather than be a replacement to it."

Regardless of what they might think of Australian government bonds, he reminds investors that they're low risk (AAA-rated), and while offering less than 3 per cent yield over 10 years they are still performing significantly better than other sovereign bonds, especially in Europe where 60 per cent of issuers have negative yields.

However, when it comes to international credit securities, the shoe's on the other foot. Like it or not, Australia's fixed income paper is dominated by banks and a few industrials. By comparison, what international fixed income bonds offer local investors, says Morningstar senior analyst Alex Prineas, is the benefit of diversification they can't get locally.

As a case in point, with slightly more than $5 billion in issues this year to date, Australia's high-yield corporate market is still at only a third of issuances pre-GFC, which peaked at $15 billion. By comparison, the US high-yield primary market is worth around $US700 billion.

In addition to opening themselves up to a more diversified range of industry sectors with some offering high-quality ratings, in some cases close to AAA-, different covenants and shorter durations, Prineas says international credit securities also offer a significantly greater breadth of bond offerings and uncorrelated risk.

A large part of the international fixed income story, adds Elizabeth Moran at FIIG Securities, is the currency play. She says once investors are interested in fixed income, going overseas tends to be a natural progression, and there are good reasons to hold bonds in foreign currencies. "If you think the Australian dollar will fall, buying international bonds or credit securities should boost the underlying value," Moran says.

But with a growing number of global companies issuing Australian-dollar-denominated bonds locally – which could be incorporated into the local benchmark – and Australian companies, like QBE Insurance and Newcrest Mining issuing bonds in US dollars, Prineas says there's been a blurring of exactly what constitutes Australian fixed income.

Back in July global corporate giant Apple gave Australian investors unprecedented access to three bonds (fixed rate and floating) issued in Australian dollars paying between 2.85 and 3.7 per cent. Collectively, the $2.25 billion issue was the largest corporate bond deal in Australia's history, over double that of the $1 billion BHP Billiton issued in 2012.

With Apple's securities being AA+ rated by Standard & Poor's, Moran says this bond, along with other highly rated bonds issued by the Commonwealth and state governments and other low risk corporations, will be viewed as a "safe haven".

Having only ever issued bonds in US dollars previously, US technology giant Intel has followed Apple's lead and in late November debuted in Australia with an $800 million, two-tranche deal.

EXCHANGE-TRADED-FUNDS

While "single issue" offerings like Apple and Intel add to the diversity of offerings within Australia's international fixed income space, so too will three new exchange-traded funds (ETFs) focused on global fixed income that iShares Australia plans to launch this side of Christmas.

These include the iShares Corporate Bond ETF, benchmarked against the Barclays Global Aggregate Corporate Index; the iShares Global High Yield Bond ETF, benchmarked against the Markit iBoxx Global Developed Markets Liquid High Yield Capped Index; and the iShares JPMorgan US Dollar Emerging Markets Bond ETF, benchmarked against the JP Morgan EMBI Global Core Index. All are hedged for currency risk.

"They'll give investors access to the sort of higher yields or income they can no longer get with term deposits," says Jon Howie, head of iShares Australia.

Considering how difficult it's been for retail investors to get this level of exposure to many different regions, sectors, credit profiles and maturities, Howie expects strong interest in the three ETFs. He also expects strong uptake from self-managed super funds, which have a growing demand for low-cost fixed income assets.

Howie expects advisers to look to global fixed income as a core part of a truly diversified portfolio. "It allows access to global credit sold by brokers, listed on the ASX in Australian dollars, with [in some cases 2500 securities] offering greater diversity compared with Australian equities, and should attract investors keen to maintain certain levels of income," he says.

Vanguard Australia is also about to launch international fixed income ETFs. Launch dates for funds over global government and credit securities indices are not yet confirmed. Both funds will be unhedged.

Given that the market isn't far away from multidecade lows, Miller says chasing bond indices isn't where investors should be now.

UBS Global Asset Management head of fixed income for Asia Pacific Anne Anderson says assuming the pending change in policy direction by the US central bank generates greater volatility, there's even greater need to actively manage reinvestment risk. "It's hard for individual investors going into ETFs to control those exposures, and returns will reflect that," she says, "so they really need to go an active manager."

Whether any "lift-off" by the Fed mid-December is a seminal game-changer or not, Anderson suspects it will depend on the speed at which a rise in rates is implemented. "With central banks creating pricing inconsistencies by moving debt, there's greater need to actively manage a fixed income portfolio," Anderson says.

Given that it looks like a safe harbour within a risk-off environment, UBS is overweight Australian fixed income, with yields remaining high relative to other markets.