BENTHAM
ASSET MANAGEMENT

Asset Allocation: Credit lost in the middle

Credit investments typically provide higher income than cash with less risk than equities – but continue to be, 'lost in the middle'.

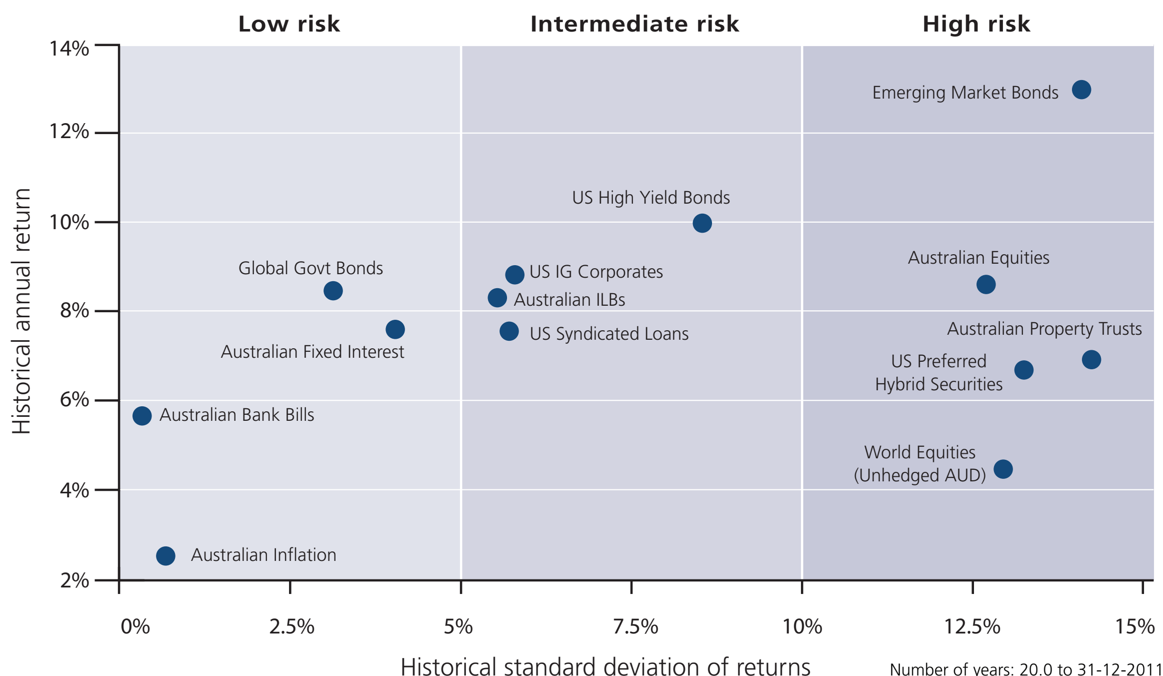
In the wake of the Global Financial Crisis (GFC), the asset allocation for many investors is 'barbelled' into two extremes. It is common to see portfolios with large weightings to low-risk cash and fixed interest at one end, and equities – predominantly Australian equities – at the other. In other words, these portfolios go from one risk extreme to the other, with nothing in the middle.

We believe this is a poor asset allocation strategy – especially in the current environment – one that will lead to sub-optimal returns, and one that (if it is not fixed) could leave investors worse-off in retirement.

The gaping hole in such portfolios ignores a safer and more predictable income-producing asset that sits in the middle ground of risk: namely, short-duration credit. We believe that the average retail investor – particularly, self-managed super funds (SMSFs) – almost completely ignore intermediate asset classes like credit in a portfolio. These intermediate assets provide a positive role within a portfolio in the current environment for investors who are looking to increase income and minimise capital volatility.

Forward looking asset class return profiles are likely to differ from the past. Government bond yields are low when compared with history despite a higher inflation risk. Sharemarket valuations seem reasonable when compared with history but growth drivers such as cheap leverage and high commodity prices may be absent going forward; credit market yields are currently much higher than historical levels.

Chart 1. Asset class historical nominal returns vs historical risk



Sources: Barclay's Capital, Bentham, BoA Merrill Lynch, Bloomberg, Credit Suisse, JP Morgan, Morgan Stanley and UBS.
Past performance is not a reliable indicator of future performance.

What have been the key drivers of historical returns for Australian investors?

Four main drivers of historical returns for Australian investors over the last 20 years have been:

1. Structural fall in inflation;
2. Financial deregulation;
3. Rising commodity prices; and
4. Domestic superannuation fund flows.

The primary driver of investment returns has been the **structural fall in inflation** from 9% to the Reserve Bank of Australia's long-term 'target' range of 2%-3%. This has been accompanied by a similar structural fall in inflation globally. In Australia, inflation as measured by the Consumer Price Index (CPI) has fallen from 9% in 1990 to 3.1% (as at December 2011). Over the 20-year period, the annualised inflation rate was a low 2.5%. In that time, the high initial yield offered by government bonds, the fall in inflation and recent swing to risk aversion has resulted in government bonds generating the most favourable risk-adjusted returns.

The second driver has been **financial deregulation**, which has allowed banks to improve profitability, to put more leverage into the system and consolidate the finance and funds management industries. This deregulation drove up bank share prices and general asset prices in conjunction with rising levels of debt on corporate and consumer balance sheets.

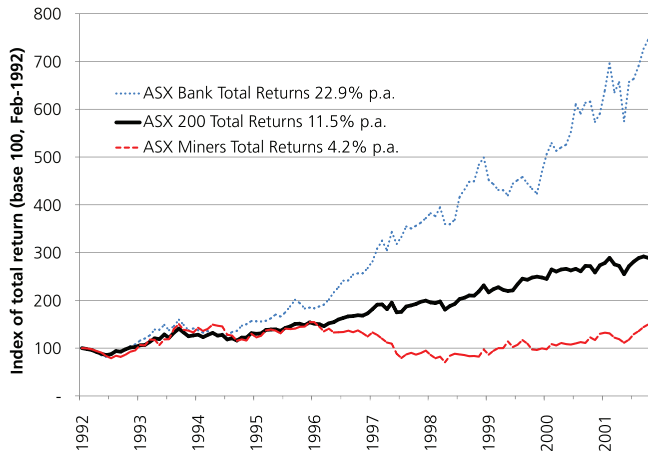
The third driver has been a commodity **'super cycle'**, driven by a combination of both rising demand for commodities from China and India and chronic mining industry under-investment. These demand/supply dynamics have lifted the prices for iron ore, coal and copper significantly. This boom has greatly benefited the market capitalisations of Australian mining companies and thus the Australian sharemarket, as well as driving both Australia's terms of trade and the Australian dollar to record levels.

The fourth driver has been the **creation of a local superannuation industry**. The introduction of compulsory superannuation in the form of the Super Guarantee (SG) Act in 1992 by the Keating Labor government ignited a growth of assets held by the super industry by more than seven-fold to over one trillion dollars. Australia's demographics around the

Chart 2. Long term bonds are at historical lows

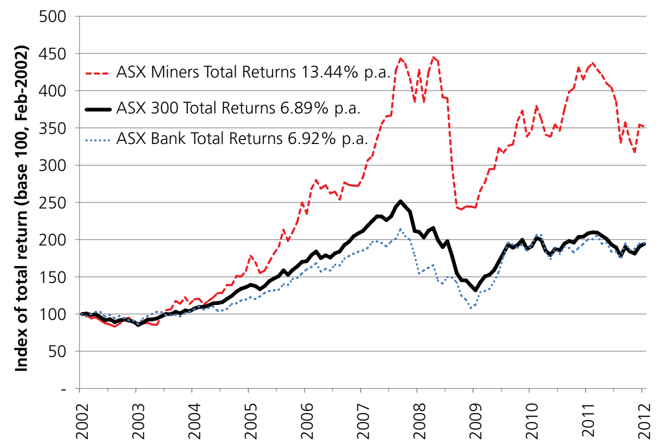
Source: Bloomberg and Bentham. From 1978 to 30 December 2011

Chart 3. Bank returns were strong through the 1990s



Source: Bloomberg and Bentham.

Chart 4. Miners have driven equity returns for the last 10 years



Source: Bloomberg and Bentham.

establishment of compulsory superannuation has led to portfolios that are appropriately skewed towards growth assets. This along with favourable tax treatment of dividends has created a local country investment bias into the Australian sharemarket.

What do the drivers of past returns look like going forward?

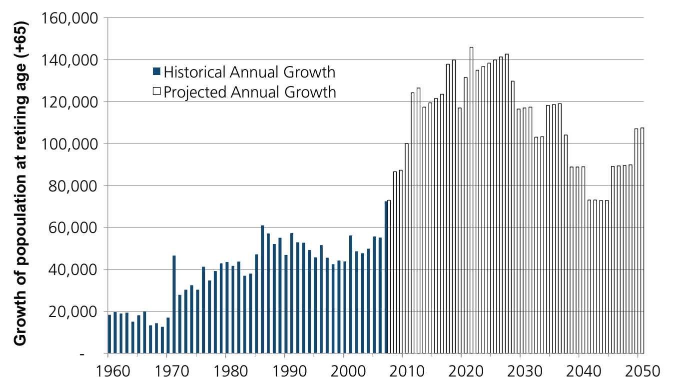
Inflation is unlikely to fall further, and should remain around the 2.5% level, with risk on the upside given the loose monetary policy employed globally. This dynamic is not favourable for future government bond returns, as evidenced by the prevailing low US government bond yields which are below 2%. There is a low probability of deflation, although it would have a large impact on markets, particularly those assets sensitive to growth.

Secondly, financial re-regulation of the global banking system will lead to de-leveraging. These impending changes will impose more stringent capital and liquidity requirements that will curtail the size of bank balance sheets and equity returns. It is likely there will be less credit availability and it will be more expensive.

Thirdly, high commodity prices are likely to eventually produce a supply response through the introduction of additional capacity. This supply response may eventually lead to lower prices for the major commodities and possibly a lower Australian dollar. You can still believe in the massive impact of China's continuing economic growth but the above may happen. In other words, even a 'super cycle' is still a cycle.

Finally, domestic superannuation fund flows will continue to grow, but the investment focus of the super industry will become more income-oriented as the 'baby boomers' move from the wealth-accumulation phase to drawing-down on that wealth to provide income in their retirement – in which state they are less likely to risk capital.

Chart 5. Baby boomers leading to strong growth in post-retirement population



Source: Australian Bureau of Statistics

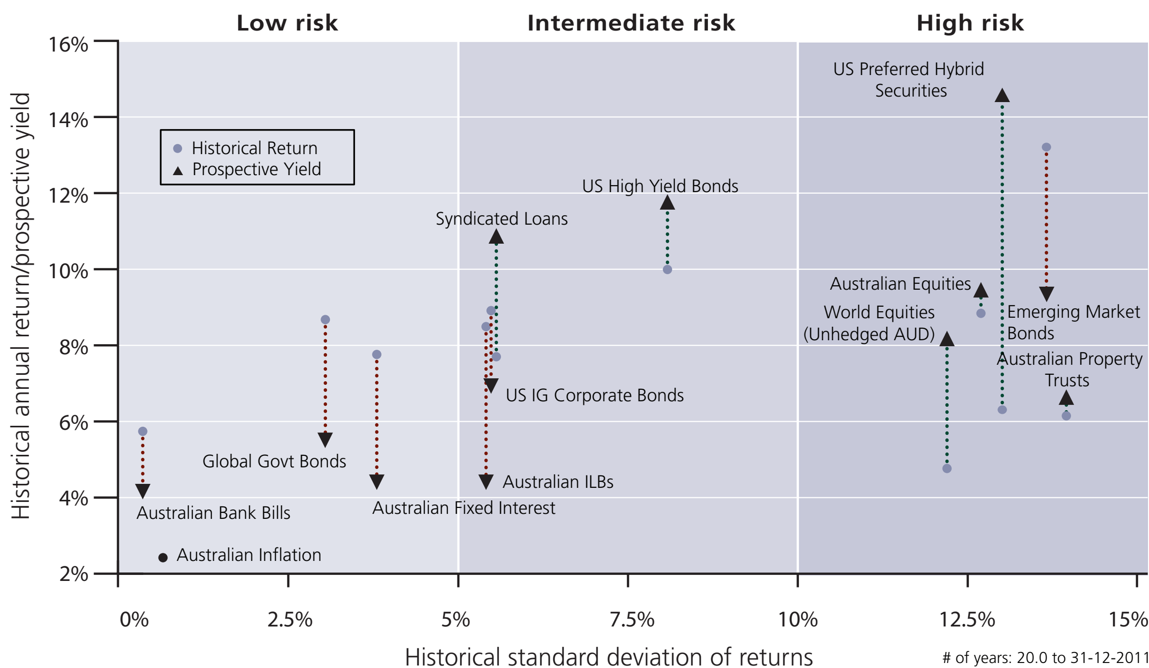
Yield gap highlights relative value of credit markets

Government bond yields are low relative to historical data even though the risks are higher. Equity yields (the inversion of the price-to-earnings ratio) are reasonable but future sharemarket returns are dependent on the realisation of growth which is less likely to occur in deleveraging markets. Credit market yields are higher than historical returns, which bodes well for credit investors but is likely to dampen sharemarket valuations.

Conclusion

As more Australians approach retirement, income is becoming an increasingly prominent consideration for most investors. Given the case that we have outlined for the critical drivers of returns for Australian investment portfolios over the medium term, we believe that short-duration credit is poised to come into its own as a safer and more predictable source of income – and one with less risk than equity thereby protecting capital. It is a pity it tends to be lost in the middle.

Chart 6. Historical returns and prospective yields versus historical risk^*



^ Sources: Barclay's Capital, Bentham, BoA Merrill Lynch, Bloomberg, Credit Suisse, JP Morgan, Morgan Stanley and UBS.
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Investors should add their estimate of growth to the equity earning yields to compare returns.

*Prospective fixed interest yields are hedged into AUD assuming an estimated duration matched interest rate differential. The Australian Equities and World Equities (unhedged) yields represent the Bloomberg estimated earnings yield. The historical standard deviation shown for these equity asset classes is based on the total return for the relevant index. Actual returns will comprise of both income and capital movements and as a result could vary substantially from those shown above. The outcomes shown above may be affected by known or unknown risks and uncertainties that cannot presently be identified. Accordingly actual outcomes may differ from those shown above.

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