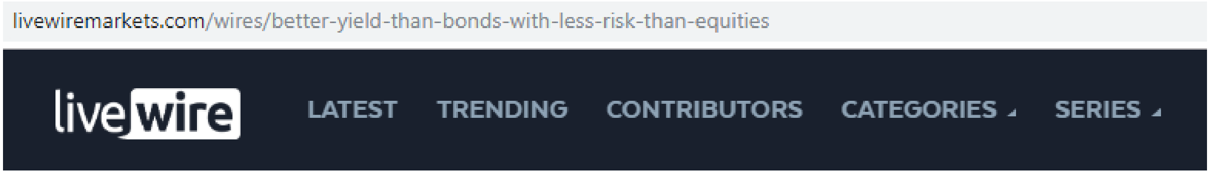
livewiremarkets.com/wires/better-yield-than-bonds-with-less-risk-than-equities

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Better yields than bonds (with less risk than equities)

RICHARD QUIN

Bentham Asset Management

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Investors are facing a common challenge: falling cash rates make it hard to earn a real return above inflation. Record-low yields on asset classes like cash (term deposits) and traditional fixed interest (government bonds) provide little investment income, while attempting to target similar returns from previous years may force investors to allocate into risker asset classes such as equities, just as those markets are reaching new peaks.

The question of "which asset class to move to?" has become tougher to answer. A useful, defensive yield asset that is often overlooked may provide the solution – **credit markets**. Credit can provide a real yield above inflation and has defensive characteristics which are well-suited to a slow-growth environment.

Credit offers higher regular income than cash/fixed interest, with lower risk (volatility) than equities.

Risks with fixed income and equities

The risks to **fixed income** have fundamentally changed. We've seen volatility in fixed income (long-duration government bonds) markets pick up markedly. Just as yields have been falling, duration has extended in most fixed income indices – amplifying the pain of any retracement. While fixed income portfolios have enjoyed windfall gains over the past year (as interest rate markets across the globe aggressively priced in additional rate cuts), going forward it will be very hard to repeat this performance. There is little room to cut further from here, and today's record-low yields and record-high interest rate duration in government bonds creates the potential for negative returns if rates instead normalise.

Fixed income's defensive characteristics are also in question. The low-to-negative long-term correlation between fixed income and equities has been the foundation for adopting government bonds as a diversifier (or insurance) in balanced portfolios. Over shorter periods, this correlation can be unstable and can even be positive, particularly in Australia. We have recently observed equity markets rallying on an increased expectation of lower rates. It is not out of the question that if we see a reversal of expectations towards higher rates, you will see both government bonds and equities sell off. Low duration (floating rate) credit may be one of the few asset classes to perform positively in a rising interest rate environment.

The outlook for **equities and equity income has softened as well**. Investors may feel some reluctance to allocate more to equities at current levels. Developed markets are trading at historical peaks, while at the same time a number of geopolitical issues such as Brexit remain.

Domestically, recent reporting from the Australian major banks have disclosed slower lending growth and weaker outlooks, paired with fresh capital raisings and cuts to dividends. The results have been share price weakness and a resetting of investor expectations about future returns.

So how to invest given this backdrop?

In Bentham's view, you're not being rewarded for taking term risk in government bonds at present. The upside is limited (given the lower bounds of negative rates), and the downside could be large.

Bentham is positioned with low interest rate duration now – we just won’t buy where we don't see fundamental value. Where we plan to generate a real yield is from credit. We believe investors are being fairly compensated for credit risk right now, but not for interest rate risk.

While the performance of **credit markets** has been muted over the past year with credit spreads widening in some key sectors, our expectation is that credit markets will outperform fixed income over the next 3-5 years, providing regular income for investors, with lower volatility than equity markets.

Credit sits between fixed income and equities along the risk spectrum. As an “intermediate asset class”, credit offers higher regular income than cash/fixed interest, with lower risk (volatility) than equities.

Lending to large established domestic and overseas corporates can be a very useful way for investors to generate an above-inflation return – earning regular coupons (paid in priority before equity dividends), with many more protections and rights than an investment in the equity of those same companies.

The opportunity in credit

There are attractive spreads to be earned in credit markets. Headlines relating to credit markets being at ‘record tights’ refer to yields rather than credit spreads. Separating out the record-low interest rate component from the total credit yield highlights that credit spreads are providing an increasingly important contribution to achieving a positive real yield for investors.

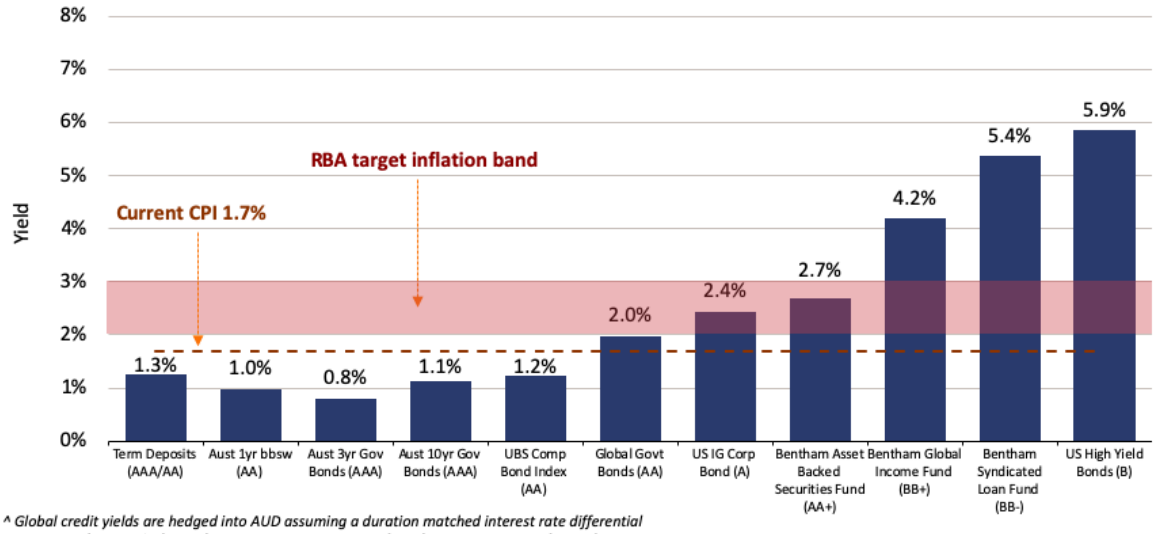
Bentham believes global credit market returns should continue to be supported by sound corporate fundamentals, with defaults remaining low in the near-term. Except for weakness in manufacturing and trade-exposed sectors caused by trade tensions, economic growth remains robust overall.

Corporate profit margins remain high but earnings growth has slowed, and US consumer data has held up. Underpinning this growth has been globally robust employment growth and a record low unemployment rate in the US. Credit markets relative to other asset classes are well-suited to low but positive economic growth.

A period of slow-but-still-positive growth is not ideal for equities (which are valued off growth numbers) but is not a headwind for credit. In the current environment, we are happy to lend to stable, profitable companies that are regularly paying coupons. With a flat yield curve, we are happy to be at the short end. We like floating rate exposures – minimising our interest rate duration exposure, and allowing us to participate in any normalisation of rates in the future.

Investors and their advisors should be realistic about their options for generating income. The below chart shows that yields on traditional cash and fixed income sectors now fall below the RBA target inflation band. Credit sectors, by comparison, are offering real yields.

Chart: Yields for Cash, Fixed Income & Credit



^ Global credit yields are hedged into AUD assuming a duration matched interest rate differential

Source: Barclays Capital, Bentham Asset Management, Bloomberg, Morgan Stanley and UBS

As at 31-10-2019

Two favoured sectors

For those looking for defensive positioning, Bentham favours **very high-grade asset-backed securities (ABS)**, as an alternative to long-duration investment-grade corporate or government debt.

AAA and AA tranches of global ABS are very remote from capital impairment. You might expect mark-to-market volatility in a down-market, but you don't expect permanent capital losses – these are defensive assets. Indeed, if you look at the structures in ABS, these securities tend to have an improving credit profile, as they naturally deleverage over their lifetime. We see high-grade ABS as some of the best relative value opportunities in credit at the moment.

Another floating rate sector Bentham finds interesting in this environment is the **US syndicated loan market**. Loans are one of the few asset classes to actually adapt to the low/negative interest rates environment, with LIBOR Floors becoming standard in documentation.

A “LIBOR floor” establishes a minimum value for LIBOR when setting the loan’s coupon of “LIBOR + Credit Spread”. LIBOR Floors are typically set at zero at the moment, protecting investors against a move into negative interest rates. Fundamentally, we like the senior, secured nature of loans as a sector, and believe current credit spreads are more than compensating investors for the anticipated default outlook.

Bentham’s approach to credit is to build a high degree of diversification into a portfolio – across issuers, sectors and even security type. The Bentham Global Income Fund, for example, currently has exposure to over 600 issuers. Bonds/loans are individually selected through bottom-up credit analysis and are primarily senior secured or asset-backed (i.e. priority positions in the capital structure).

Look beyond for new sources of income

Bentham invests in institutional quality asset classes that diversify risk while generating regular monthly or quarterly income for investors. Click **'follow'** below to hear more of our insights.

RICHARD QUIN View Profile

Managing Director

Bentham Asset Management

Richard Quin is the CEO, founding Partner, and Lead Portfolio Manager of Bentham Asset Management, a specialist global fixed interest and credit investment manager based in Sydney.