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Jeremy studied maths but has more than 20 years' experience in publishing, where he writes about financial planning and investing.

Specialists worth their weight in gold

Assembling a robust fixed-income exposure is a complicated but important business and should be dealt with carefully, writes **Jeremy Chunn**.

If cultural cringe is a real phenomenon, why don't Australians have more fixed income in their portfolios? Around the world the average allocation to bonds last year was 29 per cent, according to Towers Watson. But Australian super funds have 13 per cent invested in the asset class.

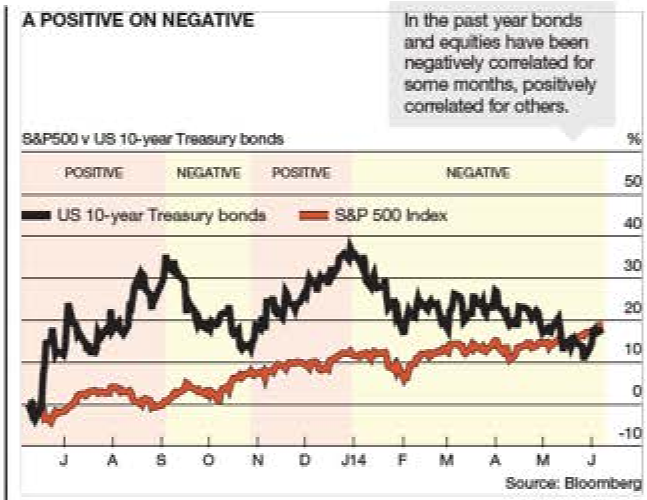
Investors overseas are also packing out the passive route to bond ownership. For the 16 months to April, fixed-income exchange traded funds attracted about 27 per cent of flows to ETFs. Here they attracted 4 per cent.

Bonds, fixed income, credit – call it what you like, it's an international fashion we just don't want to follow.

Australian investors are "habitually under-invested" in fixed income, says Altius Asset Management chief investment officer Bill Bovingdon. A heavy bias towards good old Aussie equities is just so hard to break when you've become hooked on big, franked dividends and historical outperformance against the developed economies.

But that's the whole point: a good bond portfolio should absorb shocks when the market drops. A really good one should go up when shares go down – the magical charm of negative correlation.

Lots of Australian investors who think they're doing the right thing by including bonds in their portfolios are getting it horribly wrong, Bovingdon says.



"In the self-managed super fund area we have such a huge exposure to the banks, and that tends to be where people are going to get their fixed income as well," he says.

"They're buying banks, hybrids, subordinated debt, senior debt, term deposits – and then their equity portfolio is full of banks as well. It's really generating a whole degree of one-way bets."

The real reason investors overseas hold more bonds than we do may have something to do with the size of the market and yields on offer. Yes, it comes with risk, but a good manager will diversify most of that away.

Bentham Asset Management CEO Richard Quin says a slow and steady education on bonds is required. "There's good evidence that if you create a fully diversified credit investment and hedge it back into Australian dollars that it actually complements a portfolio quite a lot," he says.

Bentham follows this strategy for institutional investors, managing portfolios of high-yield bonds and loans.

Corporate debt in the US is growing at 10 per cent a year, as companies take advantage of cheap money. This doesn't mean bonds offer low yields, Quin says, as credit spreads are "not especially cheap".

Income from equities is no substitute for a fixed income asset. "You don't know with any certainty what the price of the equity asset will be … and people are underestimating that risk."

Credit markets can offer the same yield with lower volatility. And yet the topic of bonds when raised with investors is so often met with an opaque stare. "We've been puzzled by it, to be honest," he says. "It's really only since the Second World War people have developed this equity cult."

It's not possible to access high-yielding parts of the bond market in Australia. "And you need it," says Bovingdon. "If you're going to get into sub-investment grade you need hundreds of names to get a proper payoff from the characteristics of the asset class without giving yourself exposure to unwanted default risk."

As we head towards the next market crash, and there will always be a next one, Quin reminds us that the credit markets took 1.5 years to recover after 2008, whereas equities took 4.5 years to claw back losses.

"It goes to the fact you have a legal claim on the company, and a legal requirement to be paid a coupon."