Fixed income allocations through different cycles

September 2019

ALTIUS ASSET MANAGEMENT

An allocation to fixed income through the cycle offers both ongoing income and diversification to growth assets. However, fixed income is not a homogenous asset class and there are various forms it can take and styles managers can employ:

Traditional bond funds (including passive) typically contain a largely static allocation to government, semi-government, supranational and corporate debt in line with a benchmark (typically the Bloomberg AusBond Composite 0+ Index). Investment limits are quite narrow so these funds tend to track the benchmark fairly closely with an interest rate duration between 5-6 years and spread duration between 1-2 years.

Credit funds invest entirely in corporate debt securities and are typically benchmarked against a floating rate index. These funds favour floating rate notes meaning they have little imbedded interest rate risk; however they have a higher sensitivity to credit spreads than traditional bond funds.

Absolute return bond funds are generally benchmarked against cash or a blended cash/bond benchmark. Investment limits for interest rate and spread duration risk are wide, allowing for positive absolute returns through the cycle and thus lower volatility than traditional bond funds.

Style	Advantages	Disadvantages
Traditional bond funds/passive	• Low cost • Provides biggest benefit in recessionary stage	• Interest rate risk grows as interest rates decrease • Reduced flexibility to add alpha
Credit funds (often includes global and sub-investment grade debt)	• Provides biggest benefit in economic recovery stage • Positive across most stages	• Correlated positively with growth assets • Higher cost
Absolute return bond funds (flexible duration and credit)	• Focus on capital preservation • Provides biggest benefit in overheating stage as rates rise • Not usually optimal but targets positive returns in all environments	• Higher cost • Unlikely to have optimal level of interest rate risk or credit risk

Dividing the business cycle into regimes, optimal investment styles exist for each regime:

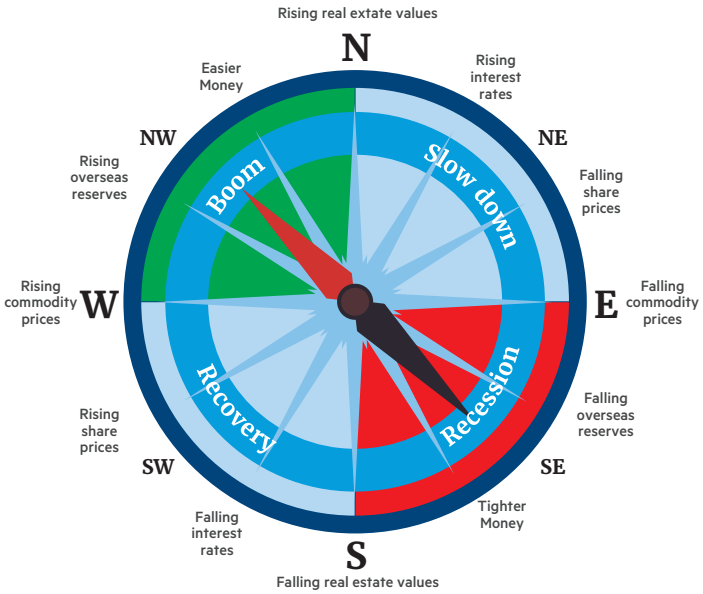
At north on the compass, the economy booms but hits capacity constraints, leading to inflationary pressures. Rising labour and material costs depress profit margins as well as inviting tighter monetary policy. Interest rates rise across the curve and credit spreads edge wider. Traditional bonds funds and equities correlate unhelpfully in this phase. An absolute return strategy is optimal in this regime due to flexible interest rate and spread duration settings. An astute manager can combine short duration with low spread duration to protect capital and even profit from interest rates rises and credit spread widening.

At east on the compass, tighter monetary policy and higher costs see a decline in corporate profits, less availability of credit and a contraction in economic activity. Central banks stop lifting interest rates. Long term Interest rates fall whilst credit spreads are still widening. Bonds and equities correlate negatively in this phase. Absolute return or traditional bond funds perform well provided they combine long duration with a modest allocation to credit.

At south on the compass, easier monetary policy allows deleveraging of corporate balance sheets and margin expansion, encouraging tighter credit spreads. Credit funds perform best in this early-cycle regime.

At west on the compass, we are well into recovery. This environment is conducive to strong credit growth and healthy corporate profitability with still accommodative monetary policy setting and interest rates and credit spreads are stable. Credit funds perform well as do traditional bond funds or absolute return funds provided they have an adequate allocation to credit.

Fixed income investment compass



Source: Altius Asset Management

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Chief Investment Officer

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Bill is well-known and highly regarded as a 33 year veteran in fixed interest asset management.

Prior to co-founding Altius in 2011, Bill was with Aberdeen Asset Management where he was head of Australian fixed income and chief executive officer. He also has worked as head of fixed income for Schroder Investment Management and Deutsche Asset Management. In his many investment roles, Bill has built successful fixed income businesses by developing proven investment processes and assembling strong investment teams.

Bill's career in investment and financial services began in 1984 with the Treasury Corporation of Victoria as a fixed income portfolio manager. He has a long working relationship with both Chris Dickman and Gavin Goodhand, formed over many years.

Bill holds a bachelor of economics from Monash University.

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