Fixed Income

A return to multi-strategy management

Investment Management Research

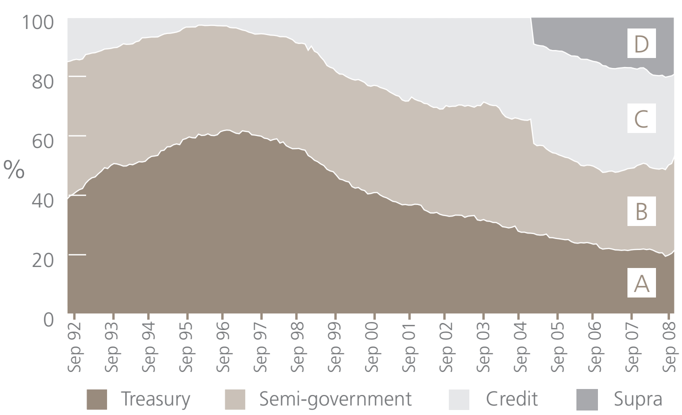
Summary

- **2008 will probably be a year that many investors would rather forget, with the global credit crisis erupting, causing global share markets to fall sharply, the world's largest economies to slip into recession and the demise of numerous global financial institutions.**
- **As a consequence of the crisis and various packages employed by governments to rescue the global financial system, multiple-strategy fixed income products have returned to favour after a nearly a decade of sitting in the wilderness.**
- **Pure credit funds have lost their appeal and may return again, but credit is more likely to be used as one strategy within a fund rather than the single strategy.**
- **Currently there are attractive investment opportunities for credit but only for selective high-quality issuers.**
- **The global credit crisis has re-affirmed that diversification and a focus on risk still remain the key rules when investing.**

Growth in credit markets

Over the last decade, we have witnessed incredible growth in credit which in hindsight was clearly unsustainable. In Australia, this growth can be illustrated by the change in the composition of the UBSA Composite Bond Index, with a sharp decline in the weighting of Commonwealth Government bonds (as indicated by 'A' in chart 1) replaced by a rise in the weighting of credit including banks and corporations ('C'), and highly-rated sovereign and supranational issuers and securities issued by banks, guaranteed by a domestic or foreign government ('D').

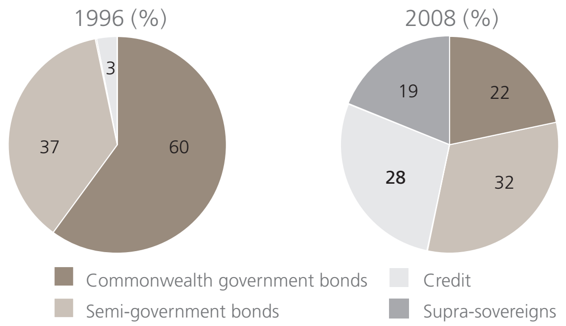
Chart 1: Percentage change in composition of the Australian fixed income market



Source: UBS

In 1996, Commonwealth and semi-government debt represented around 97% of the benchmark index; Commonwealth debt accounted for around 60% and semi-government debt accounted for 37%, while credit made up the balance. In November 2008, the composition had changed significantly, with Commonwealth debt falling to around 22% of the index, semi-government debt falling to 32%, credit rising to 28% and sovereign and supranational issuers accounting for around 19%.

Chart 2: Australian fixed income market breakdown 1996–2008



Source: UBS

The decline in the issuance of Commonwealth bonds can largely be explained by the reduction in the Federal Government's budget deficit to a significant surplus and becoming debt free. Meanwhile corporate bond issuance increased as corporations opted to use debt financing over equity, taking advantage of the cheaper source of funding in a low interest rate environment and replacing the government in supplying paper to the market.

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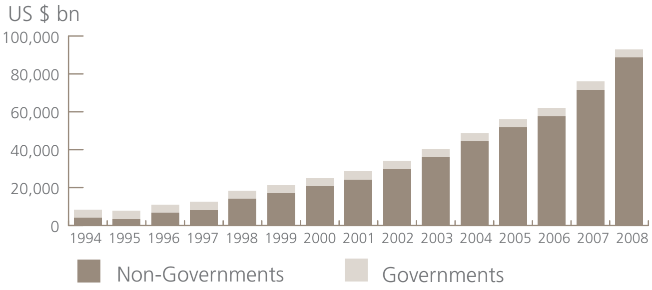
On a global basis, the growth in credit is more startling. Total debt issuance for the 12 months to June 2008 was US$89 trillion, of which US$88.6 trillion was non-government securities (see chart 3) – that represents a 350% increase since 2000.

Chart 3: Annual global debt issuance 1994–2008



Source: Bank of International Settlements

Drivers of growth

The most dominant contributor to the rapid growth in the Australian credit market was the stable, low interest rate environment. During the 1990s smaller and less frequent changes to interest rates, relatively low nominal rates and inverted yield curves (whereby cash rates were higher than longer-dated bond rates), made traditional government fixed rate bond funds less attractive to investors. This was particularly the case for Australia's ageing population, with retirees and pre-retirees increasingly seeking higher-yielding 'so called' defensive products to deliver regular long-term income.

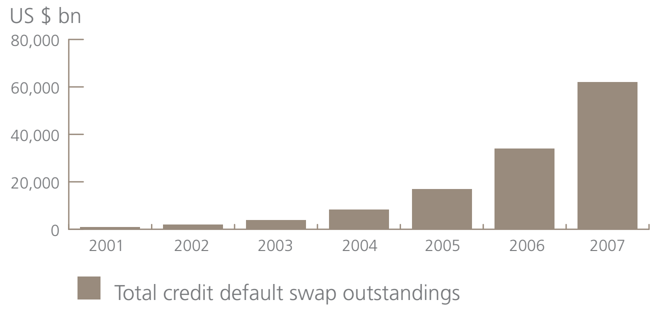
Low levels of default on corporate debt and the relative stability of credit spreads allowed investors to access 'cash-style' funds that seemed to provide a higher yield than traditional fixed income and cash products with little or no increase in perceived risk.

Australia's burgeoning superannuation market also played a role. Fund managers under pressure to deliver outperformance, coupled with an increasingly negative view on the ability of many fixed income managers to add value through duration strategies (due to stable interest rates) further exacerbated the move into credit-only and credit-dominated funds.

The increase in demand for credit assets pushed spreads to low levels with little regard to the risk characteristics of each issuer. Spreads between credit and government bonds narrowed from 200 basis points in 2005 to just 30 basis points on average in 2006. This together with low interest rates allowed banks and investors (including hedge funds) to borrow at historically low levels to invest in new loans and credit securities – further increasing their leverage and driving spreads even lower.

This increase in leverage was also a global phenomenon, as illustrated in chart 4, with the value of credit default swaps outstanding rising from US$2 trillion in 2001 to over US$60 trillion in 2009. This represents nearly twice the size of the world's share markets. Credit default swaps (CDS) are insurance-like contracts that promise to cover losses on certain securities in the event of a default. The buyer of the credit default insurance pays premiums over a period of time in return for the comfort in knowing that losses will be covered if a default happens. These contracts in theory are meant to operate like a house insurance policy however the reality was quite different. Unlike an insurance policy the credit swap market was not regulated and the amount of CDS on issue often far outweighed any underlying issuance as they were increasingly used for speculation rather than hedging purposes. They became very popular in a low default environment because there was minimal cash outlay required to gain exposure to the underlying security and they gave investors the ability to short credit securities with minimal transaction costs.

Chart 4: Total credit default swap outstandings 2001–2007



Source: ISDA Market Survey

As returns on credit securities declined, margins between traditional cash and fixed income products also narrowed leading investors to chase higher yielding (and considerably) riskier securities to maintain this yield differential. Assets of ever decreasing quality were packaged up (securitised) into new securities often with credit ratings considerably above that of the underlying assets and sold to investors as higher yielding alternatives to similar-rated traditional fixed income products. Investors in these products, some of which were unsophisticated investors, were often not aware of who the underlying borrowers were and indeed their credit-worthiness.

2007 – the year it all went wrong

The failure in the US of what were supposed to be highly-rated, low risk securities became the catalyst for what became the 'US sub-prime mortgage crisis' and the trigger for the global credit meltdown, collapse in equity and home prices and the subsequent economic slowdown.

The sub-prime mortgage crisis was the result of a combination of credit being too easy, lending standards being too lax, and fraudulent lending practices. Mortgage brokers and bank employees motivated to increase their bonuses and commissions in many instances lent money to those who couldn't afford to repay the mortgage and telling the borrowers they could sell the property for a profit later when property prices increase. These loans were largely variable rate mortgages on teaser rates as low as 3% p.a. for one or two years, which significantly increased after the honeymoon period finished to levels above 7% p.a.

The end of the honeymoon period for loans written in 2005/06 started the initial wave of defaults. Interest rates globally began to increase and borrowers, already struggling to meet existing payments, began to default on their loans. In late 2006 and early 2007 loans made under even poorer credit standards began to default, even while on the teaser rates and often without a single payment ever having been made. Delinquencies forced sales of properties in a market already over-supplied, triggering a rate of decline in house prices in the US not seen since the Great Depression. These effects subsequently spilled over into housing markets in Europe and the UK with a similar devastating impact.

This then led to an almost instant collapse in the market's confidence in all securitised assets (with no distinction being made between good assets and bad) which in turn started a declining asset price spiral in almost all global security markets.

The problem escalated in 2008

As default rates in the underlying mortgages of securitised products (which were often used as collateral for margin loans) increased, hedge funds, many of which had leveraged their funds by up to 15 to 20 times, received margin calls. To fund these, they needed to sell these or other credit securities causing prices and investor returns to fall. Investors began to withdraw their cash as returns plummeted, funds were often forced to sell their better performing credit assets to cover outflows as markets for the securitised products became illiquid – there were no buyers at any price.

As defaults in sub-prime mortgages reached unprecedented levels and contagion spread to other markets, holders of even super-senior tranches began to suffer ratings downgrades and actual credit losses.

Eventually, as losses began to mount and capital reserves began to decline, several smaller European and US banks collapsed along with two of the five largest US investment banks, Bear Stearns (ultimately purchased for a fraction of its former net value by JP Morgan) and Lehman Brothers. The collapse of Lehman Brothers and the subsequent failure to find a buyer for the organisation triggered a savage decline in equity and credit prices worldwide and worsened the global economic slowdown already in train.

Credit and capital markets seized up completely with banks either unable or unwilling to lend to one another and access to securities markets closed to borrowers as investors sought out the relative safety of government-issued debt and shunned anything considered slightly risky.

Many governments globally were forced to inject capital into their banking systems, guarantee retail bank deposits and eventually most bank wholesale issuance to prevent a complete failure of the banking and financial system. Short-term interest rates globally have been slashed to historical lows and governments have been forced to buy securities in an attempt to provide liquidity, maintain orderly markets and try and reduce the level of credit spreads, particularly to corporate and consumer borrowers. In Australia, the Reserve Bank of Australia (RBA) reversed six years of monetary policy tightening in four months, taking the official cash rate to a record equalling low of 4.25% in December 2008.

Future of the fixed income market

The fixed income market has fundamentally changed for the foreseeable future – both in terms of its composition and the way it functions. Issuance of corporate and securitised debt has now completely disappeared in the Australian market and will most likely be replaced by direct bank lending in the short term.

Governments globally have been forced to start issuing larger amounts of debt again to support their capital injection and securities purchase programs. In Australia, the Government announced fiscal spending of $26 billion (or 2.2% of GDP) in the final quarter of 2008. This, together with the slowdown in the economy may turn its $22 billion surplus to a deficit by as early as 2008/09.

Government regulation and intervention in the banking and securities markets is expected to increase as governments move to protect taxpayers' funds used to provide financial support to the banking sector. Government intervention in markets generally leads to market inefficiencies and mispricing, presenting opportunities for fixed income managers to exploit.

Pure credit funds are unlikely to be viable under these conditions due to a lack of diversity in new supply and due to investor demand for liquidity and their aversion to risk. Confidence has been shaken and trust has diminished. However, it's important to be aware that fixed income moves in cycles. Credit will return to favour again – but it will take some considerable time given the magnitude of this crisis.

In the meantime however there will be opportunities to invest in individual high quality credit securities and the current spreads on credit means there is exceptional value on certain securities. The current spread on Residential Mortgage Backed Securities (RMBS) for example, has widened from around 14 basis points above the bank bill index to around 400 basis points. With fair value for these securities estimated at around 60 basis points above the index, there are buying opportunities to be found.

The flight to the safety of government bonds saw the Australian fixed income market deliver a 15% annual return last year, its highest annual return since 1995. These returns are not sustainable, they reflect a huge one-off correction in bond yields due to the large fall in the cash rate – and it is unlikely the cash rate will decline another three hundred basis points. The increased supply of government bonds should also put pressure on bond yields as investors demand a higher term premium to ingest a larger amount of government bonds as such returns of around the long-term average of 5%–6% p.a. are more realistic.

Multi-strategy approach to investing pays off

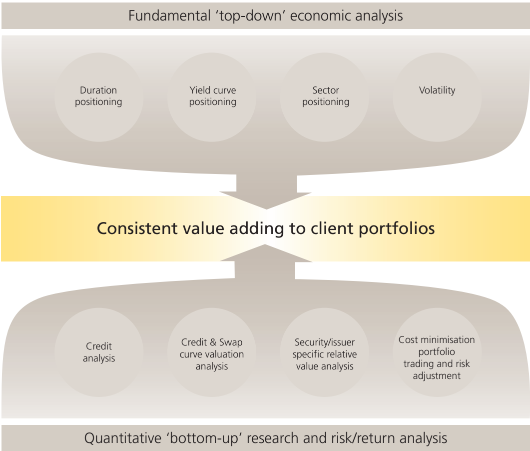
One of the key messages from this crisis is the importance of risk management and diversification – two fundamental investment principles that unfortunately seemed to be forgotten by many investors over the past few years.

These two premises underpin the Tyndall fixed income team's investment approach. Their strategy is based on risk and reward – the team doesn't chase yield but concentrates heavily on liquidity and risk controls.

The team believes in a balanced approach to fixed income, rather than one single strategy, allowing them to take advantage of opportunities in all parts of the fixed income markets. They combine 'top-down' macro portfolio positioning, with fundamental 'bottom-up' credit research (as illustrated in chart 5 on the following page) and adjust the allocation between strategies to best reflect conditions.

The team identifies the current conditions, how they are likely to change and the risks of this outcome not eventuating to determine how best to exploit the market using a variety of strategies prevalent at the time and expectations of changes in the future. The ability to use duration, curve positioning, sector rotation and other trading strategies ensures that excess returns can be generated from multiple sources in all market conditions.

Chart 5: Tyndall's multi-strategy approach to fixed income



Source: Tyndall Investment Management Limited

With this approach, Tyndall's highly experienced seven-member team has historically adopted a cautious approach to investing in credit, maintaining that if risk wasn't being adequately priced in (i.e. an investor wasn't being compensated for the extra risk), then they wouldn't invest in that security. Credit on the surface looks like it provides superior returns to other fixed income products however, much of the excess spread in credit securities is a function of the additional risk (default and liquidity) inherent in credit-risky assets. Credit may provide excess returns, but only when this spread is above fair value (i.e. above the level required to compensate an investor for the additional risk).

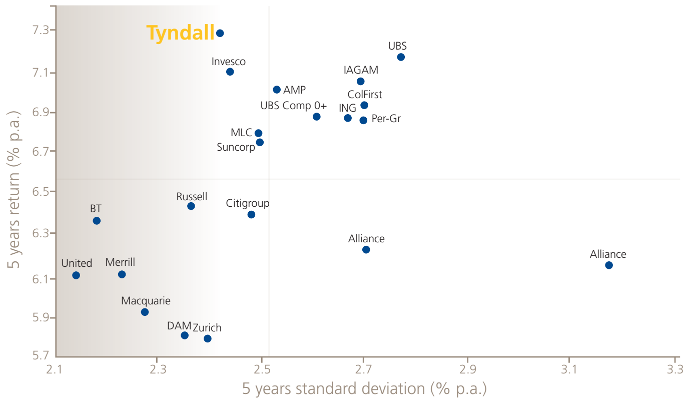
Central to their process is the belief that fixed rate credit is superior to floating rate credit (which is prevalent in most credit-style funds such as income and enhanced cash). Generally the conditions where credit does poorly are during times of economic stress, this is also when interest rates are likely to be lowered to stimulate an economy. This provides a natural offset for fixed rate credit securities that cannot be achieved with floating rate bonds. A fixed rate bond's price increases as market yields decline, however for a floating rate bond the price is relatively unaffected by a decline in rates, although coupon income will decline.

This investment approach has been consistently applied by the team for many years and their investors have been duly rewarded. They have a long and established track record in delivering top quartile fixed income performance in the Australian and international markets. It has also been the recipient of a number of high profile industry awards, most recently *Money* magazine's Best of the Best award for 2009 for fixed income.

Consistency in delivering excess returns within a moderated risk strategy is fundamental to the team's philosophy. Over the five-year period to 30 November 2008, the Tyndall Australian Bond Fund exhibited a superior risk adjusted return, delivering significant outperformance with less risk than most other funds in the Intech Australian Bonds (Specialist) survey (as illustrated in chart 6).

Chart 6: Consistent returns with lower risk

Standard deviation vs return - Australian Bonds (Specialist)
30 November 2008



Source: Intech Investment Consultants

A well-diversified portfolio has been the key to the team's success. The majority of investments in Tyndall's fixed income funds are highly-rated Australian banks, sovereign and supranational, semi-government and Commonwealth Government bonds. Generally the team purchases credit securities with a shorter maturity profile and a more conservative rating profile however there may be times in an economic cycle where the reward for moving down the credit spectrum outweighs the risks. As credit spreads narrow these securities are re-assessed and sold at the targeted credit spread level.

Conclusion

Whilst credit securities have provided excess returns in a fixed income portfolio over the last decade, the events of the past 18 months have highlighted the potential risk that credit can add to an investment portfolio. Investing in selective credit securities as part of a diversification strategy can however allow a portfolio to benefit from spread contraction as well as earn extra running yield. An integral part of investing in credit is the fund manager's ability to assess credit quality and monitor credit risk exposure, selectively diversify across the credit rating spectrum/sector/geographic exposure, and avoid securities that don't meet these objectives.

Historically Tyndall has derived the majority of its performance from duration management, however going forward it expects to increasingly draw more of its performance from credit. This reflects the strengthening of its credit capability and also its belief that the current spreads offer investment opportunities for certain high-quality credit securities.

Prepared by Tyndall Investment Management Limited
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