



There's always a place for fixed income

By Roger Bridges, Head of Fixed Income

The current sharp and protracted share market downturn and the Government guarantee saw an increase in popularity in cash and term deposits last year. However, with Australian cash rates now hovering at 49-year lows and likely to head lower, this attraction has waned, with fixed income becoming the new saviour. However, have investors left it too late?

Lower cash rates, falling inflation and slowing economic growth helped produce returns of around 15% in Australian fixed income in 2008¹. This was the highest annual calendar year return since 1995 when it returned 18.6%. After seven years of average returns of around 5% p.a., this was a very pleasing and somewhat welcome reward for investors in fixed income and balanced funds – and some compensation for what was otherwise a disastrous year.

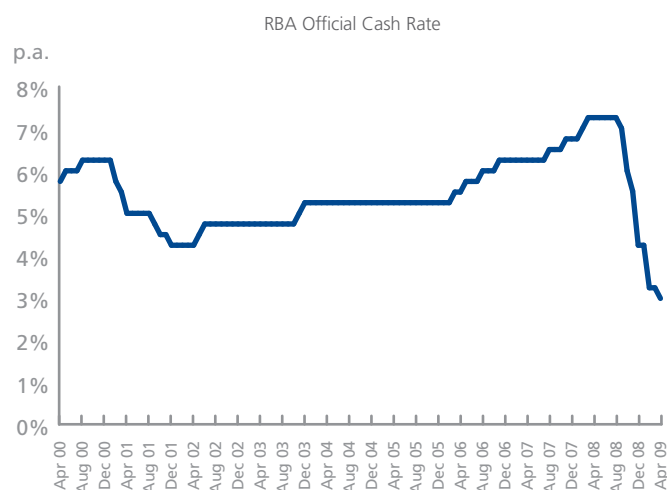
The returns were due largely to dramatic cuts in official cash rates – from 7.25% p.a. in September to 4.25% p.a. in December (and subsequently 3.0% p.a. in April, see chart 1). Lower cash rates on the back of slowing growth and lessening concerns about inflation generally mean lower bond yields and hence higher bond prices. A repeat of last year's returns is unlikely in 2009 given the magnitude of the rate cuts in 2008 – there's not much more room to move. 15% p.a. returns in this asset class are not the norm these days either – sustained low interest rates and targeted inflation bands have ensured an end to that. Returns in the near term are more likely to be driven by the traditional source – income.

Fixed income in perspective

While we are unlikely to see a repeat of 2008's bond rally in 2009, we believe that bonds should still deliver higher returns than cash in 2009, and what's more they should be positive returns. We believe returns of around

6% p.a. should be achievable in 2009 and with less volatility than equities. Over the past 20 years, Australian fixed income has delivered considerably less volatility than Australian equities (see chart 2 on the following page), with a highest calendar year return of 25% p.a. (1991) and lowest calendar year return of -5% p.a. (1994). This compares with 45% p.a. (1993) and -38% p.a. (2008) for Australian equities. Of course these returns are commensurate with the level of risk for each asset class.

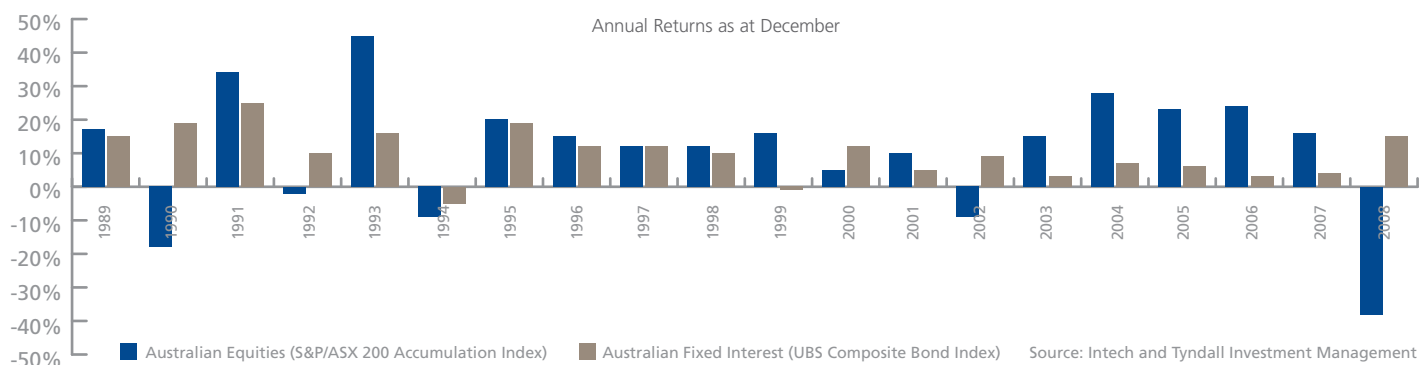
Chart 1: Interest rates at 49-year lows



Source: Reserve Bank of Australia

¹ UBS Composite Bond Index, source: Intech

Chart 2: Australian Bonds vs Equities 1989 – 2008



	Australian Equities	Australian Fixed Interest
Highest calendar year return	45% (1993)	25% (1991)
Lowest calendar year return	-38% (2008)	-5% (1994)
Periods of negative returns	5 (1 in every 4 years)	2 (1 in every 10 years)

Variation in returns from one year to the next is important, but perhaps of more interest to an investor is the number of times a sector has delivered negative returns. Over the same 20-year period, Australian fixed income recorded two negative calendar year returns (1994 and 1999), whilst Australian equities experienced five negative calendar year returns (1990, 1992, 1994, 2002 and 2008). This represents a 1 in every 10 year chance of a negative return for fixed income versus a one in every four year chance for Australian equities.

Fixed income took a back seat in recent years as many investors (particularly retirees and pre-retirees) chased higher yielding (and unfortunately considerably more risky) credit securities. Packaged up and sold as 'safe' investments, investors have discovered that the old adage, 'higher returns means higher risk' is actually true.

Regular and known income

This serves to focus the mind on the key role that fixed income plays in a portfolio; while equities are designed to primarily provide capital growth (with some potential for income), fixed income is designed to primarily provide a regular and known income stream (with some potential for capital growth). For instance, of the 6.5% p.a. average return (after fees) over the past five years for the Tyndall Australian Bond Fund (TABF) for the period to 31 March 2009, 5.8% was income and 0.7% was growth. A 6% income stream each year is pretty handy particularly in today's low interest rate environment.

Fixed income is also a valuable diversifier in an investor's portfolio, particularly during sharp share market downturns as shown in chart 2 (i.e. 1990, 2002 and 2008).

So in sum, the global financial crisis has firmly highlighted the role that fixed income plays in a portfolio, it can provide:

- Regular income
- Greater capital preservation
- Portfolio diversification
- Lower volatility
- Less negative annual returns than equities.

Outlook for fixed income market

We believe cash rates are likely to end at between 2.0% and 3.0% in this cycle. Yield curves have steepened due to increased government issuance and the fear of higher inflation. We however feel that the inflation story is likely to be an issue for 2011, rather than a near-term problem. We don't expect the RBA to begin tightening interest rates until unemployment shows signs of plateauing or falling – and this is not likely until at least 2010 or possibly 2011.

The increasing steepness of the risk-free curve is making fixed income a much more attractive proposition for investors than it has in the last 15 years. Previously with low real yields and no real pricing for term risk, investors were basically attracted to cash products. As a result there was a trend for investors to enhance their cash returns by taking on more credit risk.

However times have changed with cash rates at record low rates and the prospect that they will remain so in the near future. Additionally the market is now truly pricing for term risk, making 10-year bonds, which are offering around 5.5%, an attractive investment option to cash which is at 3%. The return of government bond supply to the market means investors are now being rewarded for taking on term risk. In other words, fixed income has returned to being a truly viable alternative asset class.

Credit to play increasing role in returns

We expect that just as credit led the sell-off in asset prices it will also lead any sustained improvement in global financial markets. We expect considerable volatility in all markets to continue for some months.

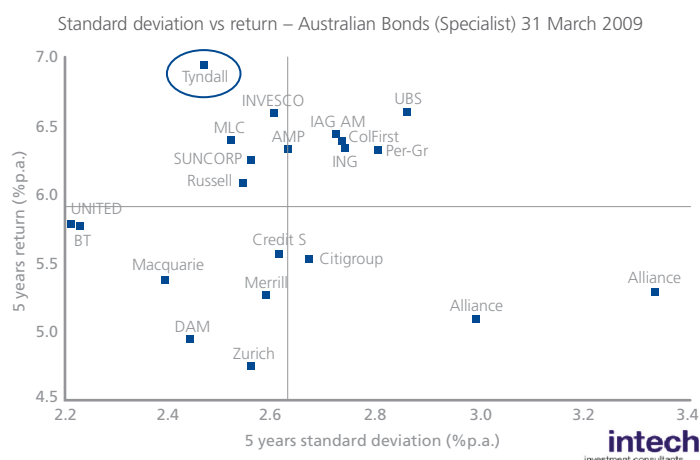
Historically Tyndall has derived the majority of its performance from macro strategies i.e. positioning the portfolios around our expectations for interest rates and the yield curve. However going forward we expect to increasingly draw more of our performance from highly-rated credit securities that offer fixed interest yields. This reflects the strengthening of our credit capability and also our belief that the current spreads offer investment opportunities for certain high-quality credit securities.

Diversification and risk paramount

The global financial crisis has highlighted the importance of risk management and diversification – two fundamental investment principles that underpin Tyndall's fixed income investment approach. Our team's strategy is based on risk and reward – preferring not to chase yield but concentrating heavily on liquidity and risk controls.

Consistency in delivering excess returns within a moderated risk strategy is fundamental to the team's philosophy. Over the five-year period to 31 March 2009, 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 (see chart 3).

Chart 3: Consistent returns with lower risk



We believe in a balanced approach to fixed income, rather than one single strategy, allowing us to take advantage of opportunities in all parts of the fixed income markets. We identify current conditions, how they are likely to change and the risks of this outcome not eventuating to determine how to best 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.

For more information on the Tyndall Australian Bond Fund, our investment process or for a copy of our research paper 'A return to multi-strategy management' please visit our website www.tyndall.com.au

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