ADVANCE
ASSET MANAGEMENT

THE NEW DEFENSIVE: FIXED INTEREST INVESTING FOR PERIODS OF RISING INTEREST RATES

Defensive Yield Multi-Blend Fund

In the past, any rises in global interest rates signalled risks to the value of a traditional fixed interest portfolio.

The key aspect of this development in fixed interest investing is understanding the relationship between fixed interest and interest rates, and translating this into smart investment decisions and effective portfolio construction.

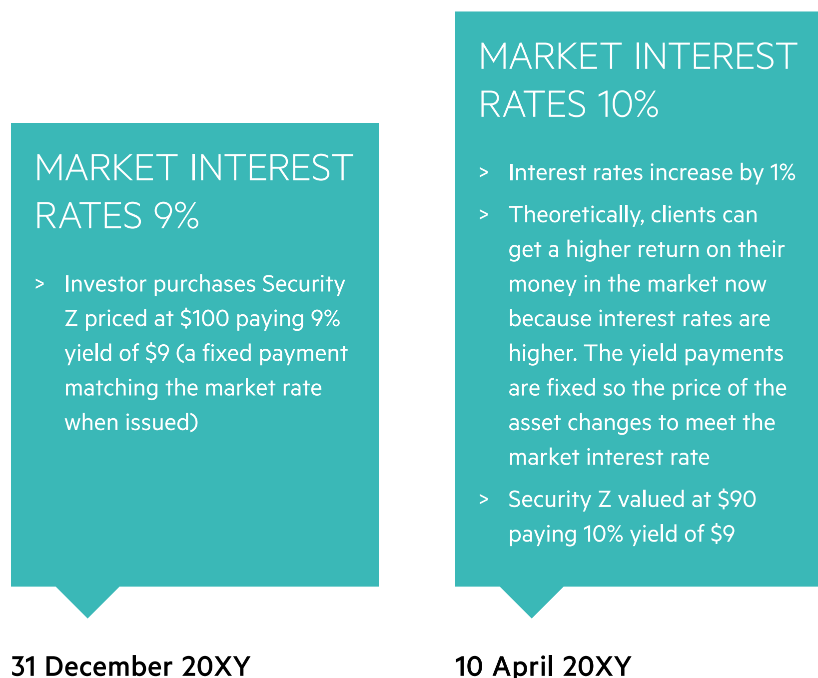
Conservative investors have long been attracted to fixed interest for its defensive qualities such as the potential to help to preserve value, diversify in periods of market volatility and provide income. These particular characteristics have meant it has typically been a key component of a diversified portfolio and made it a valuable haven during the latter stages of the Global Financial Crisis (GFC). During this period, interest rates fell to extremely low levels across the developed world.

However, interest rates are expected to normalise over the next few years. If interest rates rise, traditional fixed interest portfolios may see a corresponding fall in value due to the inverse relationship between interest rates and the price of fixed interest securities.

The issue

Rising rates and decreasing fixed interest asset prices – how the relationship works

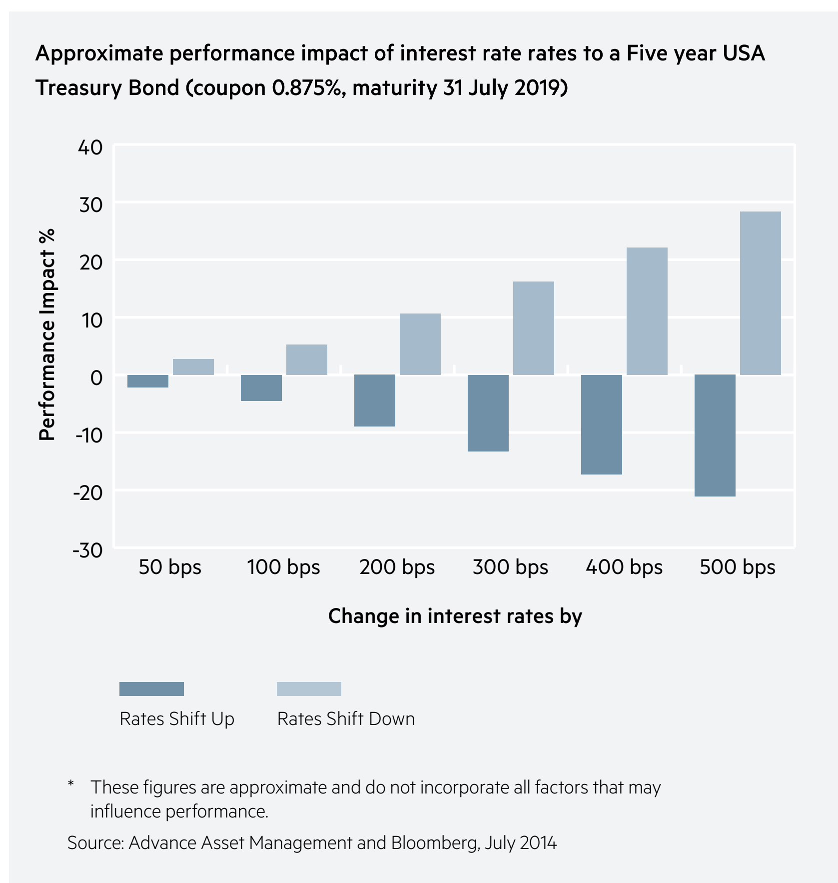
At the most basic level, investors are prepared to buy, or sell, fixed interest securities for prices based on the income (or yield) it produces compared with market interest rates. An example of how this might work is demonstrated below (ignoring factors such as time until maturity or income payment timings).



Of course, price accounts for more than just income offered. It is also based on other factors such as maturity, the frequency of income payments, the risk of the issuer and the perceived risk of holding the security. These factors all play a role in determining the price sensitivity of the security to a change in market interest rates. This is known as the security's "modified duration".

This same measure is used to calculate how the price of a fixed interest asset is affected by a change in interest rates by 1%. For example, if a fixed interest security's modified duration is calculated to be 5 years, then if interest rates rise by 1%, the price of the asset would fall by around 5%. On the reverse, if interest rates fall by 1%, the price of the asset will rise by around 5%.

A real example of this is illustrated below considering US Treasury Bonds with a modified duration of 5 years.



* These figures are approximate and do not incorporate all factors that may influence performance.

Source: Advance Asset Management and Bloomberg, July 2014

In a typical portfolio of fixed interest securities, the average duration of these securities is often calculated and reported to give a perspective of how the portfolio, and therefore an investor's capital, will be affected by interest rate movements.

The environment

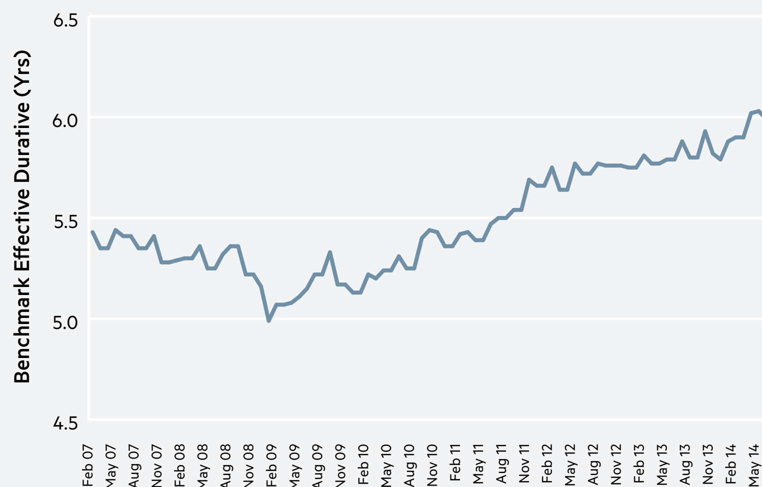
The unique market forces at play

Generally speaking, post the GFC, issuers have sought to take advantage of the cyclically low interest rates and lock these in over a longer period, so they have generally issued longer duration based securities.

The market changes in duration can be seen in global fixed interest indexes such as the Barclays Global Aggregate Bond Index, as illustrated below.

The key concern is that if interest rates rise, the capital value of portfolios may be affected in proportion to the duration of the portfolio.

Effective Duration of Benchmark Barclays Global Aggregate Hedged $AUD



Source: Bloomberg, July 2014

As traditional fixed interest portfolios tend to use global fixed interest indices for their benchmark and are restricted to these for their investable universe, these portfolios are also likely to demonstrate a similar change to their duration as the benchmark. This is where the benchmark changes in response to issuance of longer dated securities are not necessarily in the best interest of investors, particularly in rising interest rate periods.

As economies recover and central banks tighten monetary policy causing interest rates to again rise, the capital value of these portfolios may be dramatically affected in proportion to the duration. Any impact to a portfolio, even if temporary, is likely to be a concern for conservative investors, as well as those who may need to draw down their portfolio.

This increases the need for a more innovative and responsive approach within the fixed interest asset class.

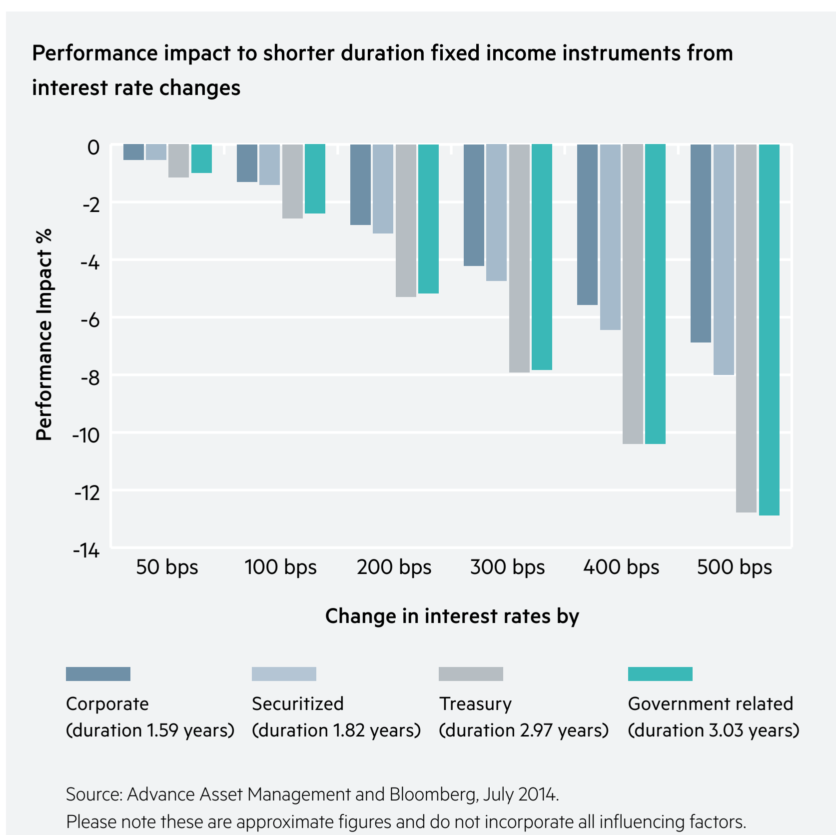
The solution

Manage the risks of a traditional fixed interest portfolio by using active management, shorter duration securities and an alternative benchmark

1 Incorporating an allocation that uses a broader investable universe and actively considers duration in the market can help to minimise potential losses.

2 Focusing on shorter duration securities, as well as money market instruments means lower price sensitivity to movements in interest rates and in turn, less impact to the overall value of a fixed interest portfolio. It also offers improved flexibility to adjust positions as a result of the shorter duration (investors are not locked in for long periods) and hence greater liquidity. This means short-term investments can be made that specifically take advantage of changes in interest rates.

See the following graph for an illustration of the impact on 3-year Treasury bonds compared with 5 year and 10 year Treasury securities.



Source: Advance Asset Management and Bloomberg, July 2014.
Please note these are approximate figures and do not incorporate all influencing factors.

The solution (continued)

An alternative benchmark such as the Bloomberg AusBond Bank Bill Index℠, rather than a global fixed interest index like the Barclays Global Aggregate Bond Index, can offer the following potential benefits to a portfolio.

> Flexibility to use shorter duration securities and in turn, the option for shorter average duration to help to preserve capital from interest rate rises.

> Lower market volatility than traditional fixed interest portfolios.

> Cash benchmarks are absolute return in nature so can help to enhance returns when compared to traditional fixed interest portfolios.

TYPES OF SHORTER DURATION SECURITIES

The types of bonds and instruments that offer short duration and flexibility in a portfolio include:

> Bank bills

> Floating-rate bonds

> Negotiable Certificate of Deposit

How Advance can help

A multi-manager approach can provide additional protection from volatility

Taking a multi-manager approach can offer a range of potential benefits.

> Mitigation of individual manager risk, in turn enabling more consistent returns and lower volatility.

> Diversification of investment styles across asset classes.

> Access to different markets and in turn, different securities.

> Access to specialist global managers that may not be typically available to Australian investors.

Advance's specific approach to multi-manager investments offers even more potential benefits.

> Incorporates proprietary macro-economic research to shape the investment selection and combinations used in the multi-manager funds.

> A rigorous industry-recognised approach to manager selection.

> The use of a mandates means beneficial ownership of the securities within the pool rather than owning units in a trust. This ensures greater liquidity for investors and enhanced security should the underlying manager face any problems.

> High quality risk management systems.

> Methodical and thorough ongoing review of individual managers and the overall multi-manager strategy.

> Independent governance approach supported by being part of a large banking institution.

How Advance can help (continued)

In essence, fixed interest can continue to play a role in a diversified portfolio regardless of the point in the market cycle if duration is managed actively and tactically. We do this by broadening the opportunity set with subsequently less focus on typical fixed interest benchmarks to offer greater flexibility when managing market conditions and in turn, in periods of rising interest rates while still offering the potential for income to investors.

Using shorter duration fixed interest securities and a benchmark such as the Bloomberg AusBond Bank Bill Index℠ may offer:

1. Access to a broader universe including shorter duration fixed interest securities
2. Greater flexibility to respond to a market environment of rising interest rates compared with traditional approaches
3. The potential to still generate income across volatile market environments.

Please note, this investment approach seeks to manage risk but is still exposed to a range of potential risks such as market risk, derivatives risk, currency risk, interest rate risk and fixed income security risk. The suitability of this approach and the extent for its use in a portfolio will depend on individual investor requirements.

Introducing the Advance Defensive Yield Multi-Blend Fund

Purpose built to help manage interest rate sensitivity

The Advance Defensive Yield Multi-Blend Fund combines the added flexibility of investing in short-duration fixed interest securities, an absolute return benchmark and a multi-manager approach to manage and help to protect fixed interest securities against the corrosive effects of rising interest rates. This Fund may be appropriate for an investor as part of their allocation to fixed interest in their portfolio.

Investment objective	Benchmark	Average duration
To provide returns of 2% pa after fees above the benchmark over the short to medium term.	Bloomberg AusBond Bank Bill Index℠.	Typically +/- 2 years around the benchmark.

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