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Spectrum Insights

APRIL 20, 2016

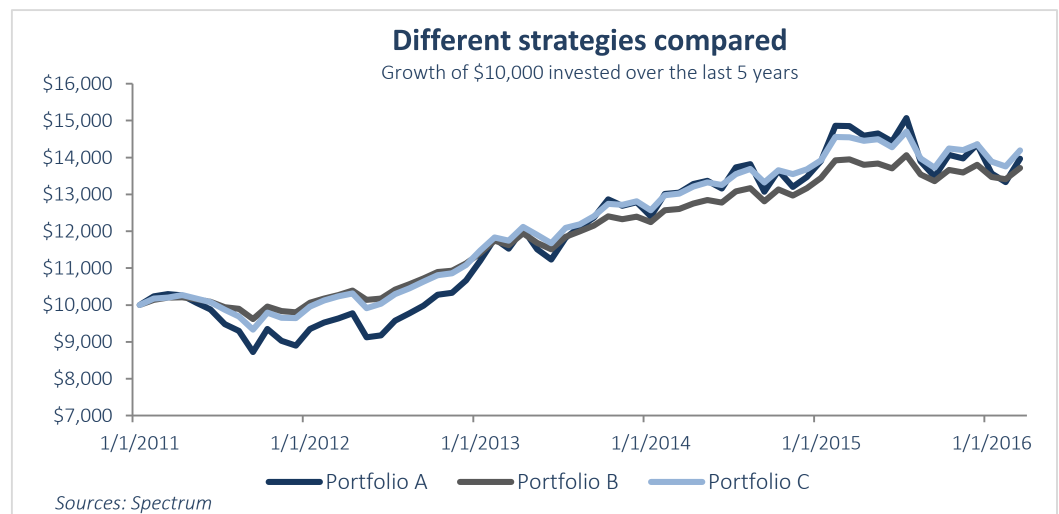
All in equities - is it worth the risk?

Many investors have financial goals. These presume certain returns over defined time frames. To achieve this, most Australian investors rely heavily on the local stock market. This may prove lucrative if you get your stock selection and timing right. As we have seen in recent years, however, equity returns can be highly volatile. At best, this can cause investor anxiety and at worst, it can mean financial goals are not met. If it is the latter, then important decisions, such as those relating to retirement, may need to be revisited. The good news is these risks can be reduced without necessarily giving up return expectations. An investment portfolio with asset classes, such as bonds and international equity, may deliver similar long term returns when compared to purely Australian equities - but with a sharp reduction in price risk.

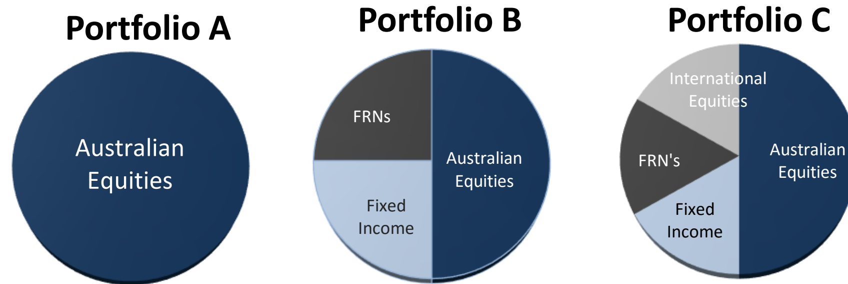
Different portfolios, different risk

The graph below illustrates the findings of our basic study of historical five year total returns and of volatility of various portfolios. These portfolios are one with Australian equities only – Portfolio "A"; then we add A$ bonds split between fixed and floating rate A$ bonds for the second portfolio "B"; and, finally, we add international equity in A$ for portfolio "C".

The graph shows that the total returns are almost identical over the last five years. They all generated around 6% per annum. So investors may ask themselves, "Why should we bother diversifying away from just Australian equity?"

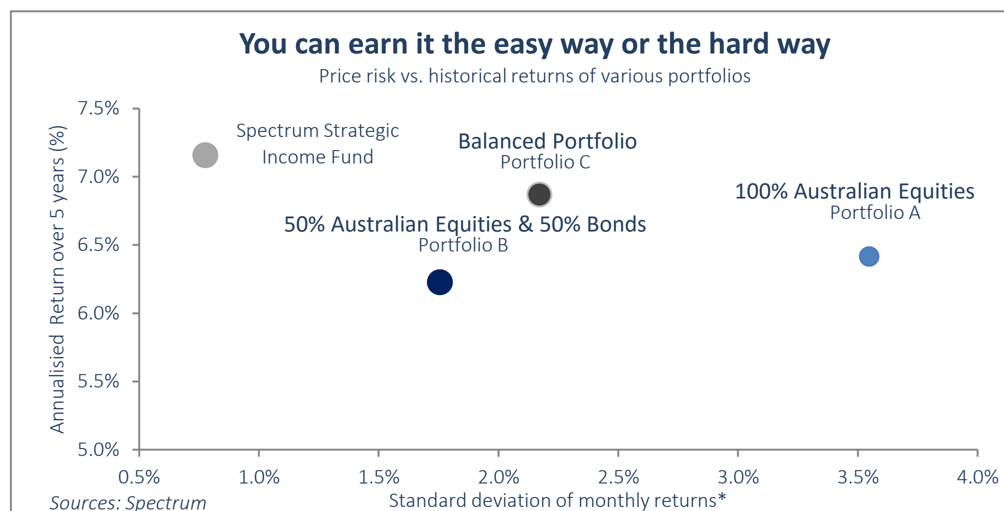


Study notes: We compare total return indices. That is those which include interest rate coupons and dividends. For Australian equities we look at the S&P ASX 200 Total Return Index. For bonds we take both the fixed rate coupon index (Bloomberg Composite Index) and the floating rate index (Bloomberg FRN Index) and for international equity the S&P100 Global 100 AUD Hedged Total Return Index. The impact of agency fees, bid-offer spreads and taxes are not included.



Similar returns, different risk

When looking at the risk or volatility of returns, the main benefit of diversification stands out. In short, the more diversified portfolios generate similar returns but in a far smoother pattern. Or, in other words, you got similar returns for a sharp reduction in risk by spreading your investments.



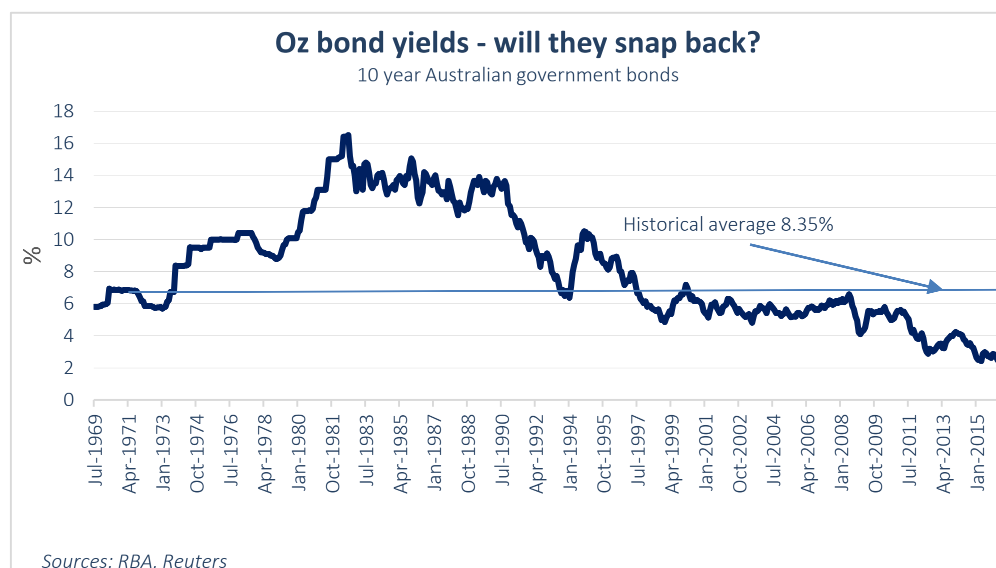
*The standard deviation, which is a measure of dispersion around the average point, allows us to grasp how risk can be reduced by diversifying.

Another way of looking at this is through the dispersions of returns. As the graph below demonstrates, there is a far narrower range of returns for the diversified portfolios. This benefits investors because they are less sensitive to timing when they need to draw down on their portfolio.

What type of bonds?

If investors want to get exposure to bonds in A$, there are two basic types: fixed and floating rates. Fixed rate bonds, as the name suggests, gives you a certain coupon throughout the life of the bond. Floating rate bonds or notes (FRNs) adjust to reflect the short term market rate. Corporate bonds provide extra yield over benchmark rates. For fixed rate bonds, the benchmark is the government bond yield curve. For floating rate notes, it is the Bank Bill Swap Rate (BBSW).

Our concern with fixed rate bonds is that government yields are very low from an historical perspective. Yields and fixed rate bond prices move in opposite directions. Therefore, should government bond yields revert towards their historical average and rise then sizeable losses in A$ fixed rate bonds would follow.

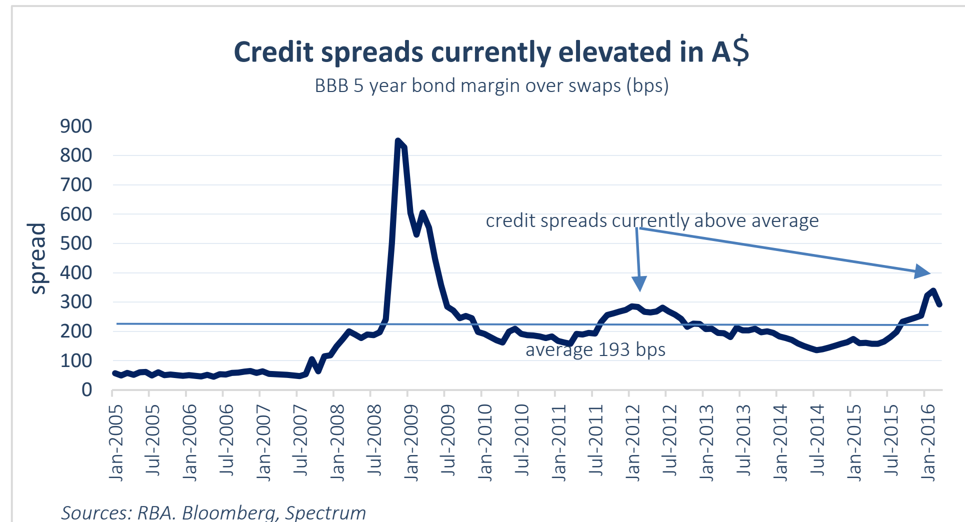


Sources: RBA, Reuters

In contrast, should government bond yields revert towards the historical average there would be minimal impact on the prices of floating rate bonds.

For corporate bonds, investors get extra yield over benchmark rates. These are known as credit spreads. The spread largely rewards investors for the perceived risk of default.

In contrast to government bond yields, A$ credit spreads are elevated at present. This is largely due to rising default rates in the US and emerging markets. Default rates in the A$ corporate bond market are low and are likely to remain so in our view. Hence, A$ corporate bonds appear to reflect sound overall value.



Sources: RBA. Bloomberg, Spectrum

Spectrum sees value in A$ corporate bonds at present but prefers floating rate notes over fixed rate notes due to the risks of rising government bond yields.

How much diversification?

The portfolio scenarios above are designed to show the benefits of spreading one's risk. They are not recommended asset class weightings. Generally speaking, though, the less volatility an investor wants, the more an investor should diversify. Investors may wish to get financial advice on how they should weight their portfolios in different asset classes to reflect their risk appetite and financial needs.

What type of diversification

The asset class examples used are those which are readily available to investors in Australia via managed funds. The study looks at historical returns. The discussion regarding current valuations centres on A$ bonds. This is what Spectrum focuses on. To assess whether other asset classes look attractive, investors, once again, should seek financial advice.

Smooth sailing or rough riding

An investment portfolio of just Australian equities may enable an investor to reach their realistic financial goals. Savvy timing of the entry and exit out of the market, though, may be pivotal in achieving this. As history shows, market timing can be challenging for even the most seasoned and skilled investors. To increase the chance of realizing investment targets in a timely manner, Spectrum recommends diversification into asset classes such as A$ corporate bonds.

Hamid Yahyaei, analyst at Spectrum Asset Management, assisted in the preparation of this report.

Spectrum Asset Management manages the Spectrum Strategic Income Fund. This fund invests in AUD corporate securities of which the majority are floating rate notes. The intention is to make this portfolio relatively immune from the bond yield volatility which can, in turn, hit equity and fixed income markets. The fund is also designed to deliver an income stream while generating capital gains from time to time. For more information and how to invest please go to our website http://spectruminvest.com.au or contact your mFund broker http://www.asx.com.au/mfund/foundation-members.htm#tabs-218. Spectrum and the author have investments in either securities mentioned in this report or comparable securities

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