

understanding risks in fixed interest investments

A LOW RISK ASSET CLASS?

Fixed interest is traditionally thought of as being a low risk asset class. On most risk-return diagrams it is shown as being a little more risky than cash but less risky than property. While fixed interest is less volatile than equities and listed property securities (REITs), this is often taken as evidence that fixed interest is 'low risk'. However, volatility alone is not a good measure of risk in this asset class. Fixed interest can experience low or even negative returns from time to time. As in all investments, the devil is in the detail and it is worth understanding the various components of risk within a fixed interest fund.

INFLATION RISK

Periods of strong economic growth can lead to rising inflation which erodes the value of the future interest payments on a bond. For this reason, long term bonds in particular tend to be sensitive to changing inflation expectations.

INTEREST RATE RISK

Higher inflation typically leads to higher interest rates because investors

require a better rate of return to compensate for the loss of purchasing power. 'Duration' refers to the sensitivity of bond prices to changes in interest rates. Given that fixed interest securities are typically longer-dated, investors are exposed

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to duration risk should interest rates rise. The longer the duration, (usually measured in years) the more sensitive bond prices are relative to interest rate changes. For example, if interest rates were to rise, a three year fixed coupon

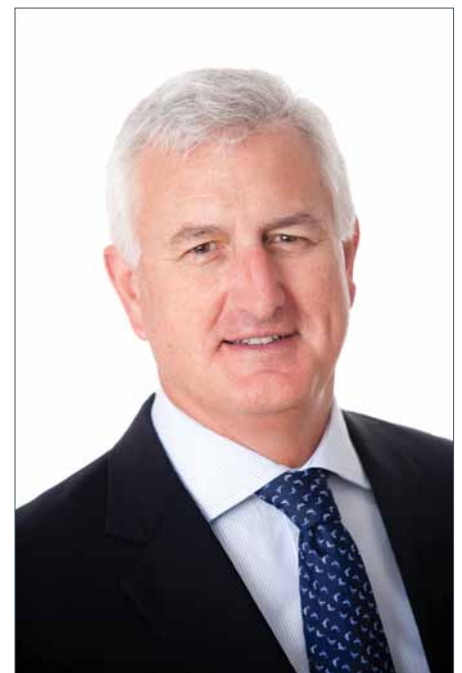
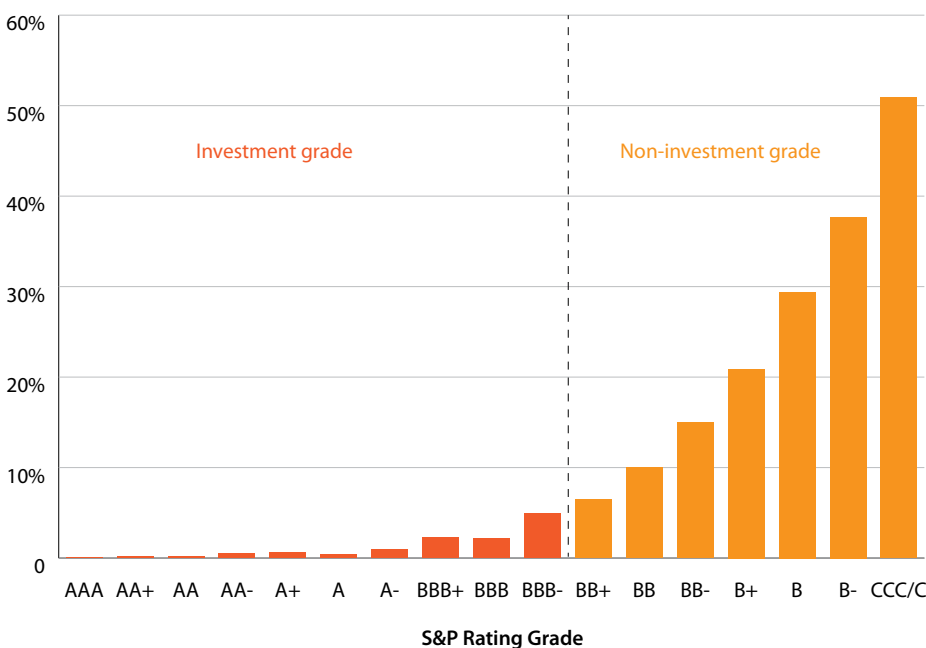
bond would fall in price but would fall less than a five year duration fixed coupon bond (all other things being equal).

CREDIT RISK

This is the risk that the bond issuer defaults on the repayments of either the interest and/or the principal. The risk of default increases exponentially as a bond's credit rating deteriorates. In particular, the default risk can be extremely high for very low rated securities. The danger of extending too far down the credit risk spectrum is clearly evident in Graph 1. A bond rated BBB has about a 2.5% probability of defaulting within five years of its issue, whereas a CCC rated security has over a 50% probability of defaulting within five years of its issue.

If an issuer defaults, the investor may not only fail to receive the interest payments, but possibly also their principal as well. (In some instances, the entire principal may be lost, or else it may take many years to recover a nominal amount – usually after protracted legal

Graph 1: Cumulative Average Default Rates Within 5 Years (probability of default)



This article by Patrick Bennett (above), Head of Research.

recourse). One of the key risks in fixed interest investing is to have the credit rating of a bond down-rated after you have bought it, because its value will fall.

CAPITAL LOSS RISK

Although traditional fixed interest is a relatively low risk asset class, investors still can experience capital losses. Over the past 20 years, there have been two occasions where the fixed interest sector experienced negative annual returns (see Graph 2).

While negative annual returns from fixed interest funds occur infrequently, there also may be extended periods when fixed interest delivers low (sub 5%) returns and, as shown in the chart above, may also give a return less than cash.

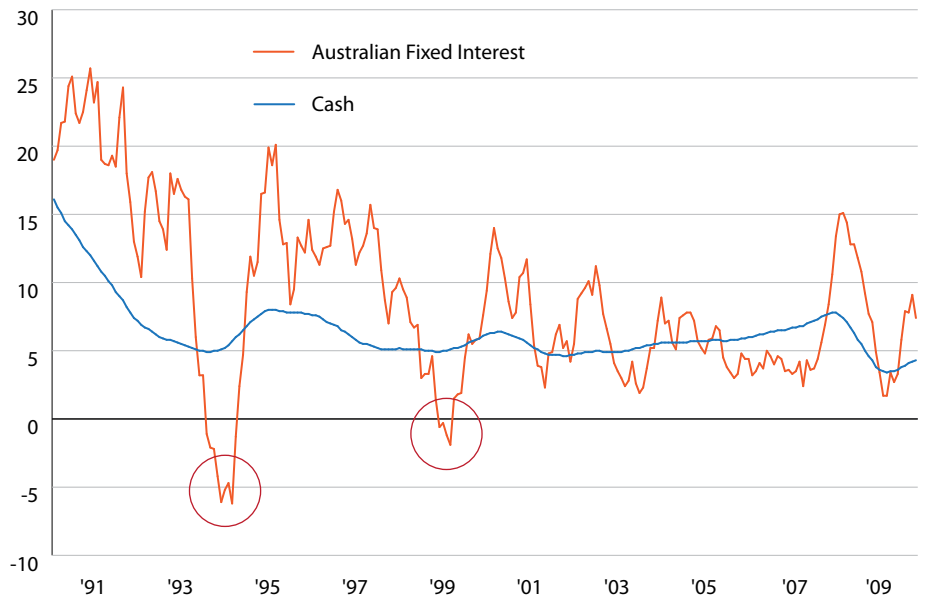
LIQUIDITY RISK

This is the risk that an investment may not easily be converted into cash. Most high quality fixed interest securities are liquid in that there is a deep secondary market and they can be readily traded. However, bonds issued by smaller or lower rated companies, or complex high yield securities that are difficult to price, can be illiquid if there is little demand for them, particularly during periods of market stress. These include securitised investments such as asset backed securities (ABSs) and collateralized debt obligations (CDOs) which became illiquid during the GFC.

MATURITY RISK

How long you lend money for is critical in determining risk. There is more certainty about a borrower's ability to repay in the short term and increasing uncertainty as the loan term increases. Longer maturity generally demands a return premium.

Graph 2: Cash vs Australian Bonds (rolling annual % return)



SOVEREIGN RISK

Bonds issued by governments have traditionally been regarded as the 'safest' form of fixed interest. However, sovereign defaults, the risk that a government may not be able to meet its future interest obligations or repay the capital in full at the bond's maturity date, are not uncommon. Troubled governments may find it is politically easier to default on foreign bond holders than on their citizen voters. This risk has reappeared in certain European countries, (Greece, Spain, Portugal, Ireland) which are struggling with debt in the aftermath of the GFC.

PRICING RISK

Bonds are not traded on an open centralised exchange like stocks. Instead they are traded on dealer-based over-the-counter markets. Consequently there

is less transparency on the value of the bond, its liquidity and the volume being traded. Bond markets are not regulated the same as equity markets. For this reason, bond trading should be left to experts.

DISTRIBUTION RISK

Fixed interest funds are usually a good source of income. However, the income received from a fixed interest fund is not necessarily 'fixed'. This due to a number of factors such as the pooling of fixed interest securities with different terms within a unit trust structure, default and credit events which can reduce returns, hedging losses which have to be off-set from the income received by the fund, and different distribution timing policies.



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