

# understanding the role of fixed interest in your portfolio

## THE ROLE OF TRADITIONAL INCOME FUNDS

Fixed interest plays a number of roles within a balanced portfolio. These include dampening equity market risk, providing a source of relatively stable income, and as a return enhancement within the defensive part of the portfolio, relative to cash.

## DAMPEN PORTFOLIO VOLATILITY

An allocation to fixed interest will tend to reduce the impact of equity market risk, which usually comprises the largest component of risk in a balanced portfolio. Fixed interest is much less volatile than equities and property securities (A-REITs), as shown in Graph 1 below. This means that there is less variability in the month-to-month returns in a fixed interest fund, relative to growth assets such as equities and listed property trusts which can be highly volatile.

Graph 2 (over) shows the historical relationship between Australian equities and Australian fixed interest since 1990. Over the period between January 1990

and September 2010, Australian and global bonds have been negatively correlated with equities and have shown very low positive correlations with listed property and infrastructure. With the exception of 1994, when equity and bond markets both performed poorly, fixed interest tends to do well when equities underperform.

The combination of lower volatility and negative correlation with equities means the fixed interest component will tend to smooth the overall portfolio returns. The benefit of this diversification becomes most apparent during times of uncertainty, when 'risky' assets such as equities may dramatically underperform the 'safer' assets such as bonds.

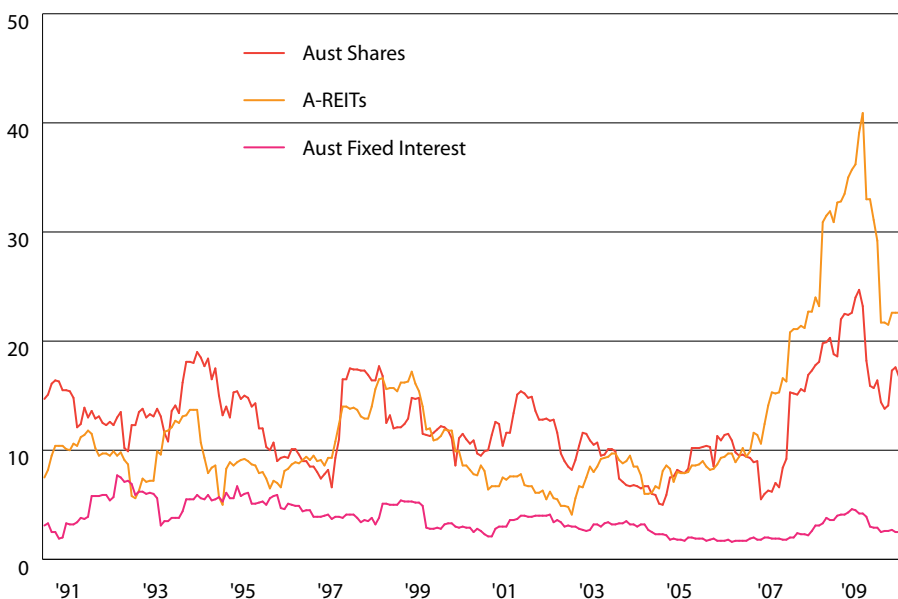
## A SOURCE OF INCOME

Fixed interest funds are a good source of income, as bonds pay regular fixed payments to bond holders, assuming that the issuer does not default. Additionally, if a fixed interest manager buys and sells securities, then the capital gain or loss from those securities is also distributed as income.

Unfortunately, income received from a fixed interest fund is not necessarily 'fixed'. This can be explained by a number of factors:

- The pooling of a large number of bonds with different terms and the trading of securities within a unit trust structure will mean that the income paid out each quarter will vary from period to period.
- While default and credit risk is negligible for governments of developed nations, it can be highly cyclical for corporate bonds, particularly during periods of market stress. This can reduce the ultimate return to the investor.
- In the case of global fixed interest funds which are managed on a fully hedged basis, as most are, gains and losses from currency hedging must be offset against the income received. In benign currency environments this is unlikely to have much impact on

Graph 1: Asset class volatility (std dev %pa)



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

distributions. However, when there are extreme currency movements, hedging may have a detrimental impact on the income paid out. The dramatic devaluation of the \$A in 2008 meant that fully hedged funds experienced significant hedging losses which had to be off-set from the income received by the fund, which in turn led to a reduction in distribution payments.

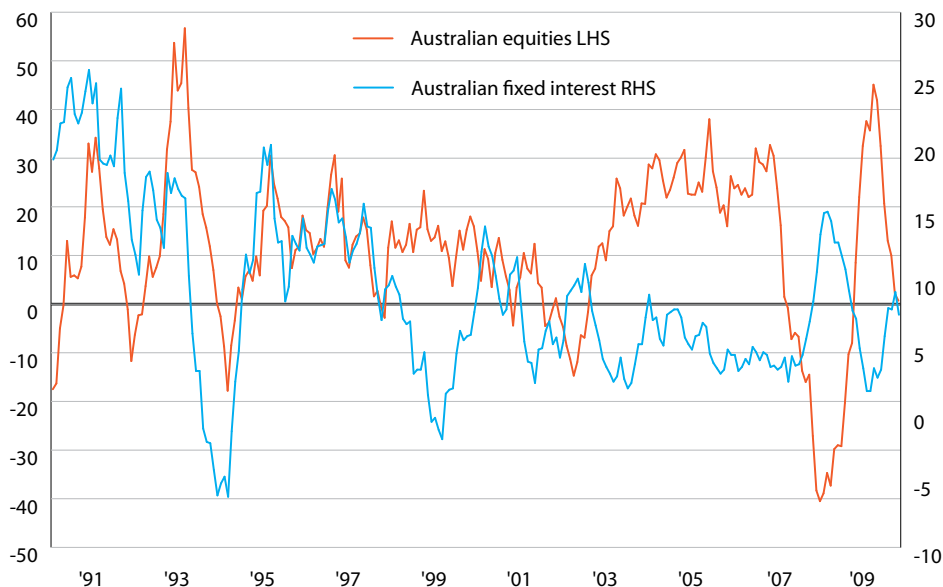
- Different distribution policies. Some funds distribute each quarter and wait until the end of the financial year to assess the final tax position in relation to gains and losses. Other funds may attempt to smooth distributions over the year, potentially resulting in some distribution of capital.

### ENHANCED RETURNS RELATIVE TO CASH

Typically an investor in a longer term security such as fixed interest should expect a higher return to compensate for the forgone liquidity of that investment. As the table to the right shows, traditional fixed interest historically has delivered better returns than those achieved by cash.

While cash is considered to be a 'riskless' asset class, there are longer term opportunity costs for investors holding cash in preference to other more risky assets. These opportunity costs are in the form of lower returns or the erosion of returns by inflation.

Graph 2: Relationship between equities & bonds (% rolling annual returns)



Market returns to Sept 2010	1 year %	3 year %pa	5 year %pa	10 year %pa	15 year %pa	20 year %pa
Cash	4.3	5.4	5.7	5.5	5.7	6.2
Australian fixed interest	7.4	7.6	6.2	6.4	7.2	8.6
Global fixed interest	11.0	10.0	7.8	8.4	8.3	9.3



## Shadforth Financial Group

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