Bond Market Concentration

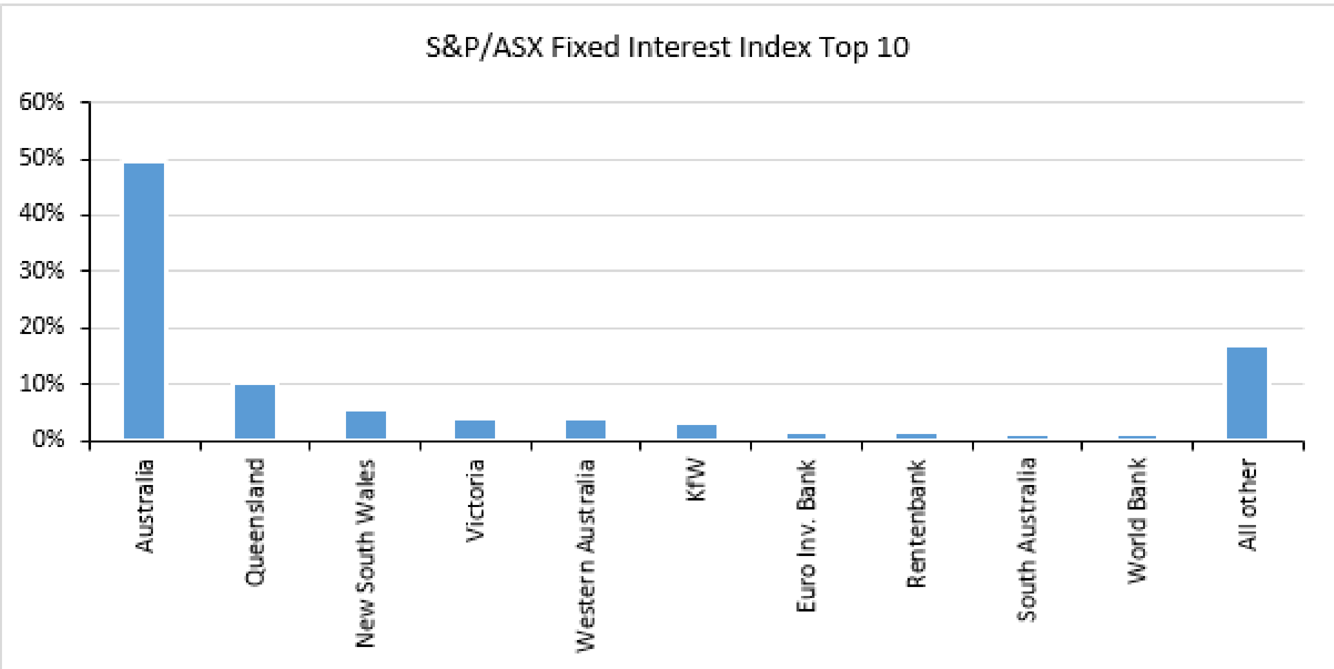
For Article 2 of our Winter Rethink series we look at the composition of traditional Australian fixed income benchmarks. Benchmarks don't often get a lot of attention – but it is useful to look at fixed income benchmarks to remind ourselves what Australian fixed income portfolios are principally invested in.

Bond Market Concentration

Superannuation funds generally benchmark their domestic fixed income asset allocation against a market capitalisation weighted investment grade bond index such as the S&P/ASX Australian Fixed Interest Index or the Bloomberg Composite Ausbond Index. Bonds are included in these indices if they meet certain criteria (A$ denominated, fixed rate, minimum issue size, investment grade rating) and are weighted in proportion to their market value.

Diving into the S&P fixed interest index, the top 10 issues are all Australian Sovereign issuers (Commonwealth or State Governments) or European development banks. The largest non-government issuer is KfW (Kreditanstalt für Wiederaufbau) a German development bank.

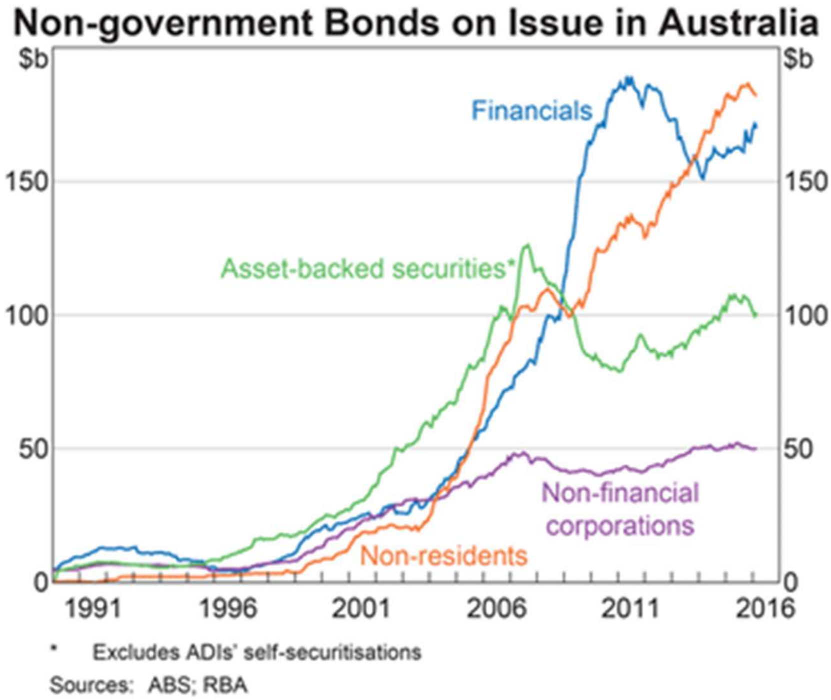
The top 10 issuers comprise 83% of the index. The total index has a modified duration of 5.2 years and a yield to maturity of 2.14%. Investors might be surprised that no Australian company (for example, any of the big 4 banks) makes the top 10..



To provide a comparison - the top 10 issuers in the ASX 200 equity index account for only 48% of the total market value.

Are bonds representative of the fixed income universe?

There are approximately $650 billion in government bonds and $500 billion of non-government bonds on issue in Australia (see chart from the RBA below). The largest category of non-government bonds is Australian dollar denominated bonds issued by non-residents – that is around a third of the Australian non-government bond universe is actually bonds issued by overseas companies.



The next biggest category – also around a third of the non-government sector – is financials – which is dominated by the bonds of the big 4 banks.

Only around $50 billion are domestic non-financial corporates. That is, only around 10% of non-government bonds are what you would typically consider Australian corporate credit.

This is tiny when compared to the loan market. According to APRA data, Australian banks have loans to Australian non-financial corporates of more than $650 billion.

This raises the question of whether traditional composite bond indices – which are meant to be providing investors with a balanced exposure across sovereign and corporate fixed income – are representative of the underlying investment universe?