Defensive portfolios in a world of 2% bond rates

What is the role of defensive asset classes within the overall investment portfolio? Allocations to these asset classes are intended to provide stability when equities – the largest driver of the growth assets portion of the portfolio – underperform. Traditionally the defensive portfolio of Australian superannuation funds has been around 30% of total assets (ie most funds run a 70:30 growth/defensive split) and has been dominated by cash and fixed income.

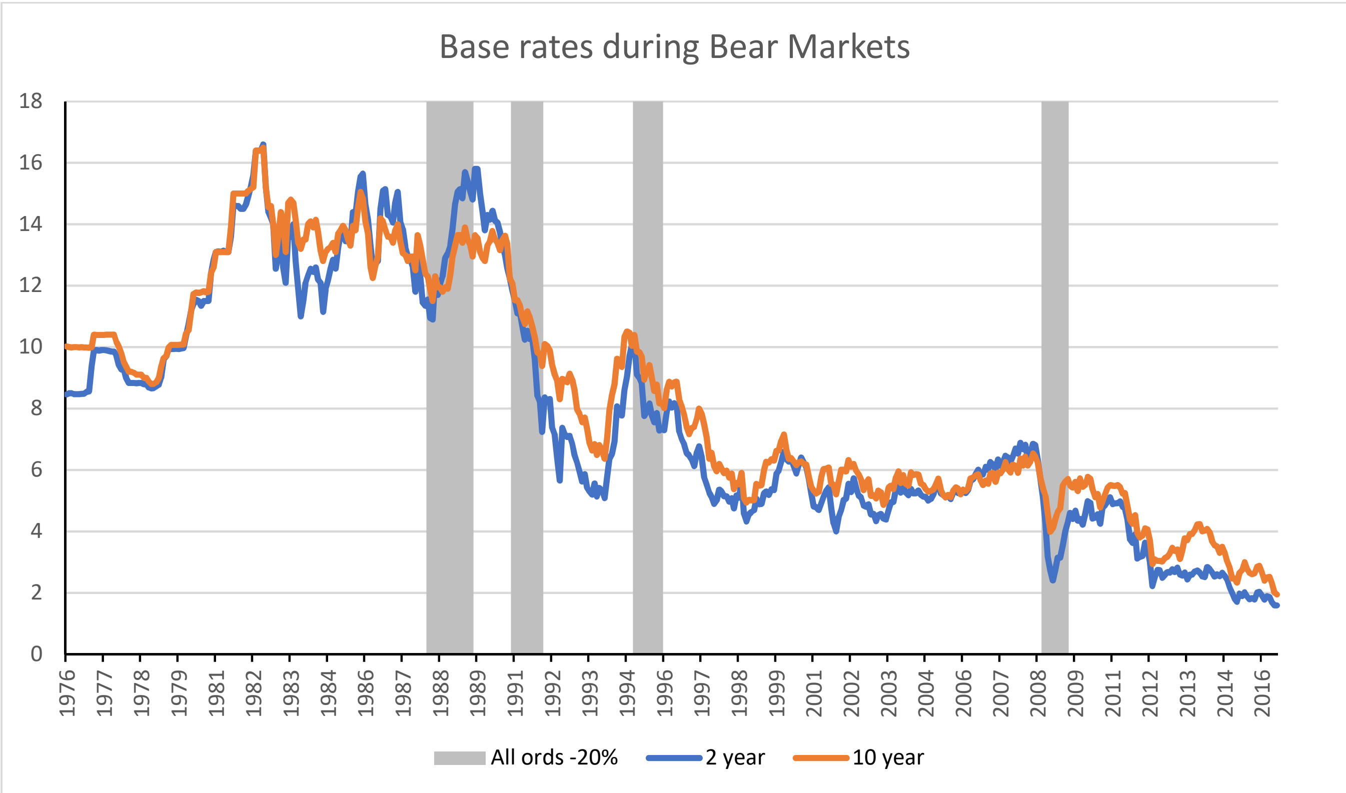
A key attribute of fixed income (compared with cash) is the potential capital gain from falling bond rates. A fall in bond rates results in a rise in bond prices (a capital gain). Typically, in a financial crisis or recession, when equities are performing poorly, bond rates fall, providing a capital gain on fixed income. This mitigates the overall impact of weak equity returns on the portfolio.

Importantly, this discussion is focused on high quality or sovereign bonds. Higher risk bonds don't have the same capital gain potential as credit spreads tend to widen during crises.

It is this potential to hedge equity risk which has been a key driver of most superannuation funds having significant allocations to fixed income in their defensive portfolios.

In fact, fixed income has traditionally been preferred over cash – even though fixed income has more volatile returns. For example, over the last 10 years, the standard deviation of cash returns (measured by the S&P Bank Bill index) has been 0.5% and the volatility of Australian fixed income returns has been more than five times higher at 2.8% (measured by the S&P Australian Fixed Income Index).

The chart below shows the history of 10 and 2 year bond rates over the past 40 years. The shaded areas represent occasions when the All Ordinaries Index has fallen by more than 20% over 12 months.



Over the past 40 years each time the All Ordinaries has fallen by 20%, bond rates have fallen an average of 1% and average cash rates (proxied with 2 year bond rates) have fallen by 2%.

<u>From today's starting point, that implies a negative cash rate and a potentially sub-1% ten year bond rate!</u>

While QE and unconventional monetary policy has shown that negative interest rates are in fact possible, there are limits to these policies. If rates are sufficiently negative, savers will stockpile physical cash (and there is already talk of a spike is safe sales in Japan). Likewise, negative interest rates can significantly harm bank profitability (as banks will find it hard to charge negative interest rates on many classes of depositors). For this reason, it is reasonable to expect there is a fairly tight limit on how far below zero interest rates can go.

This is particularly the case for a small country with a long history of dependence on imported capital such as Australia. We should not kid ourselves that the monetary manoeuvres that have been undertaken in the US (the reserve currency of the world) or Germany/Japan (countries with large levels of domestic net saving) could be repeated here!

This means fixed income has a reduced capacity to deliver a capital gain in a crisis. It reduces the appeal of traditional sovereign fixed income as a defensive asset.

While fixed income's capacity to provide a capital gain in a crisis is reduced – its capital loss potential has increased. At current yields it will only take a 40bp rise in interest rates to drive bond returns negative.

What should funds do? Funds could switch to higher cash allocations. Cash is defensive. Its liquidity provides an option to move quickly to take advantage of distressed pricing during a crisis. However, returns are not particularly appealing. Cash rates in Australia are currently 1.75% and are expected to be cut further. While inflation is likely to be relatively low, real returns will be low (probably negative) and certainly well below member expectations.

Is there a third way?

Yes – funds could consider increased allocations to floating rate credit. This doesn't have long term interest rate sensitivity of bonds. Floating rate assets have a high degree of capital stability. Floating rate credit can provide a meaningful return pickup.

However, in pursuing this option it is important to preserve the defensive qualities – that is, you want to pursue a return pickup vs cash but need to be mindful not to sacrifice the defensive qualities that are the reason for the allocation in the first place.