

November 2009

## Fixed income – the case for active management

# INSIGHTS

While a passive approach results in investment returns consistent with those of the benchmark (in Australia, this is typically the UBS Composite Bond Index) no matter the environment, an active management approach has the potential to add value in rapidly changing market conditions.

Volatility in investment returns over the last eighteen months has led some investors to question the role of active management. In our opinion, a key reason for this has been a greater focus on active management fees during a period of negative absolute investment returns.

While passive management may fulfil this aspect of investor focus through lower fees, there are several advantages to an active management approach, particularly in fixed income markets. An active approach allows us to add value when managing sector allocation and stock selection within a fixed income portfolio. Rapidly changing market conditions such as during the last eighteen months mean greater dispersion between top and bottom performing companies and sectors. This may allow skilled active managers to maximise the benefit from taking portfolio positions. We believe an active management approach in 2010 is likely to add greater value for our investors, while actively focussing on risk, relative to a passively managed portfolio.

### Seeking a higher yield via sector allocation

Successful active management impacts the balance between government and corporate debt in a fixed income portfolio.

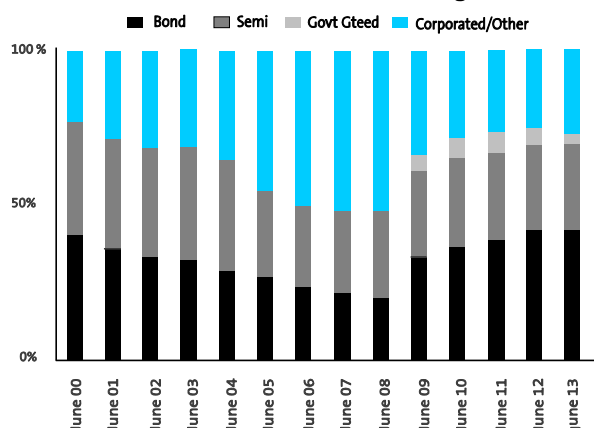
#### Passive versus active management

A passive investor in fixed income funds will normally invest consistent with the UBS Composite Bond Index (All Maturities). This is a market weighted benchmark where the elements of the benchmark are directly proportional to the value of bonds on issuance in the market. We believe there are disadvantages to this approach, particularly in the current environment.

With the global financial crisis easing, we believe banks have largely raised the extra capital they need to support their business in the future. Instead, governments have taken the brunt of this market fallout. After spending large sums to sustain

banks and individuals via fiscal stimulus throughout the global financial crisis, governments now need to raise money to support their own balance sheets. We are expecting to see an increase in government debt-raising relative to corporate bond issuance as a result. This increased value of government bonds in the market will be reflected in greater weights in the UBS Composite Bond Index, as demonstrated in the following chart.

Standard fixed income benchmark change in Australia



Source: UBS Composite Index

Therefore, the portfolio of a passive investor in 2010 will simply have more exposure to government debt as opposed to corporate debt, a reflection of market structure.

However, government bond yields are currently around two to three percent lower than investment grade corporate debt yields; the passive investor is locking into predominantly lower yielding bonds. We believe investment grade corporate debt remains priced above average yield levels where mean reversion will lead to additional capital gain. Companies are generally now more stable, making corporate debt an attractive opportunity in our opinion.

Taking an active investment approach allows the portfolio to be tilted towards corporate debt to seek a higher yield given current market conditions. Active management allows us to continually adjust to relative valuation changes in order to find attractive opportunities for our investors.

### Choosing the most attractive bonds

Active management techniques guide the decision of which company issues in the corporate bond universe should be selected, with the aim of maximising returns per level of risk.

As an example, earlier in the year when many companies' business models looked uncertain, the AMP Capital Fixed Income team focussed on investing in government guaranteed banking debt. These issues gave sovereign security and provided a reasonably high yield spread relative to historical levels. As an active manager, AMP Capital was able to

participate in this primary market deal, acting as a cornerstone investor. In contrast, a passive manager would have had to wait until month end to invest, when issues entered the index, and would not have been able to make a significant allocation.

However, as an element of risk preference came back to the market in 2009, other investors entered this market. This caused yield spreads to shrink and the opportunity became less attractive in our opinion. In response, our stock selection focus recently changed to strongly income generating companies issuing corporate debt. We believe these companies are showing signs of successfully deleveraging their balance sheet, while yields still remain at historically high levels.

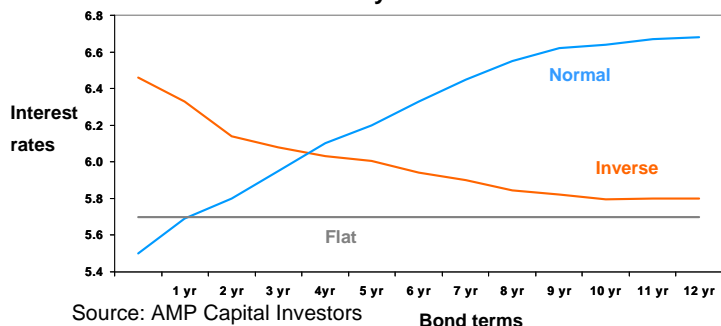
## Maximising value as interest rates change

In our opinion, active management of duration (interest rate strategy) allows us to add value for investors, even in a changing interest rate environment.

We believe the economy is now entering a recovery phase and the Reserve Bank of Australia (RBA) has begun to raise interest rates in response, partly to avoid the risk of inflation. These are the first increases since early 2008, with markets anticipating a rising interest rate environment. When it comes to active management of fixed income portfolios, it is not the direction of interest rate changes that must be considered, but importantly, how interest rates rise relative to prior market expectations. If an interest rate rise is fully expected by the market, there will be a less significant effect on fixed income returns.

In Australia, anchored by the current cash rate set by the RBA, the shape of the market yield curve depicts consensus interest rate expectations. It maps the relationship between the yield and term to maturity of different bonds of similar type, and is an important tool in assessing future bond valuations. Typical yield curve shapes are illustrated in the chart below.

The yield curve



Currently, the yield curve shape is normal (upward sloping), indicating that investors expect long term interest rates to be much higher than short term rates.

When taking an active management approach, it is important to analyse what markets are expecting or 'pricing in', as well as current influences in order to add value. Markets usually expect interest rates to rise well before they actually start rising. For example, when looking at the interest rate on a residential house mortgage, it is often too late to fix a low rate once interest rates have actually started increasing. This fixed rate will have already been priced from a market yield curve that expects rates to rise (upward sloping), including this as a consideration when setting the rate. Once variable rates start to rise, often the fixed rate offers show no significant changes.

Similarly, an active investment decision can be made based on how management views match market expectations. At present, the AMP Capital Fixed Income team believes that the market consensus of how quickly interest rates will rise may be too optimistic. As at November 2009, the market is expecting the cash rate to be around five and a half percent by the end of 2010, but we believe this may be unlikely given history of how Australian markets have typically reacted to a slowdown. Often it takes the Australian market between three or four years to return to the long-term average rate. Further, we believe the Australian economy would struggle to support such a steep increase in interest rates due to the continued highly levered state of many Australian consumers. While evidence suggests that consumers in the United States have begun to deleverage, saving to pay off existing debt, as yet, Australians have not embraced the same change in behaviour.

## Actively managing market changes

We believe that active management of a fixed income portfolio is likely to provide the best long-term results for investors through the full business cycle. While passive investing may have delivered better short-term returns recently, active investing allows us to navigate volatile markets with the aim of managing portfolio risk and adding value for our investors.

The AMP Capital Corporate Bond Fund (the 'Fund') offers investors access to an actively managed portfolio of credit securities, with a focus on investment grade corporate bonds. The active management of the Fund helps to add value through many bond management techniques, including stock selection and management of the interest rate environment.

## Contact us

If you would like to know more about how AMP Capital can help you, please visit [ampcapital.com.au](http://ampcapital.com.au), or contact one of the following:

### Financial Advisers

Your Business Development Manager or call 1300 139 267

### Private Clients

Your Financial Adviser or call us on 1800 188 013

### Wholesale Investors

AMP Capital's Client Service Team on 1800 658 404

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