

# Fixed Income Investing

A guide for  
investors

# Markets today

## Fixed income and the global financial crisis

In recent years, we've seen the economic cycle reach a peak during 2007 and then deteriorate as the global financial crisis contributed to a widespread economic downturn. While fixed income securities such as government bonds were the top performers, especially over 2008, fuelled by a flight to quality and falling official interest rates, non-government or corporate bonds were impacted in varying degrees.

The tables are now turning as market interest rates stabilise and the current government stimulus is leading to a growing supply of government bonds on the market. This means that the potential for strong returns in this sector is unlikely over the next three to five years.

## Deleveraging – a positive direction

At the same time the global financial crisis has sparked a move to deleveraging, the process in which debt is paid off. The move offers a good environment for investing in non-government fixed income, particularly investment grade corporate bonds. As companies lower their debt, bond values tend to rise based on improving company ratings as more cash is available for interest repayments.

Bond issuers are also focusing on being more responsive to the needs of their lenders via better borrowing conditions. The result is that over the next few years, higher quality corporate bonds are more likely to be issued at good prices with stable income streams.

## Continued benefits of fixed income

Despite the ups and downs in markets, fixed income investments continue to be a popular choice for investors seeking regular income and investments that are less volatile than shares. More than ever, understanding these choices allows investors to make the most of the variety of fixed income investments on offer.

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# How fixed income works

One of the most common types of fixed income securities is a bond. A bond is a form of debt. Governments or companies (known as the issuers) choose to borrow from investors by issuing bonds. In its most simple form a bond pays the investor (or lender) interest rate payments and subsequently, at the bond's maturity, repays the principal. Key characteristics of a bond include:

- 1 A regular interest payment
- 2 A fixed maturity date
- 3 A market value over the life of the bond
- 4 A face or par value at maturity

Investor buys \$1,000 bond • Yield: 5% • Maturity: 5yrs • Coupon: 5% • 6 monthly	\$25 \$25 \$25 \$25 \$25 \$25 \$25 \$25 \$25 \$25 Year 1 Year 2 Year 3 Year 4 Year 5	At maturity investor receives \$1,000
	Interest payments	

## Trading bonds

Like shares, bonds are commonly bought and sold on a traded market rather than held to maturity. This is because the market value of a bond can change daily whether it is traded or not and investors normally want to maximise the value of their bonds at any given point in time. This means a fixed income portfolio can experience capital gains and losses and vary in terms of income and total return.

The market value of a bond is influenced by the current interest rate, demand and supply factors and the risk of default by the issuer. The yield is a figure that shows the current income received from a bond. When a bond is bought at face value, its interest payment is equal to its current yield. When the price of the bond changes, so does its yield. These two factors have an inverse relationship. When market yields rise, the price of existing bonds fall. This is because investors can lock in a higher interest payment by buying newly issued bonds at their face value. Consequently they will not pay the face value for the existing bond that is now offering lower yields or income. The reverse occurs when market yields fall.

## Example

An investor spends \$1,000 on a five year bond. It pays 5% interest per annum.



Market interest rates rise to 6% per annum soon after but the bond still only pays the investor 5% per annum as its interest payment is fixed.



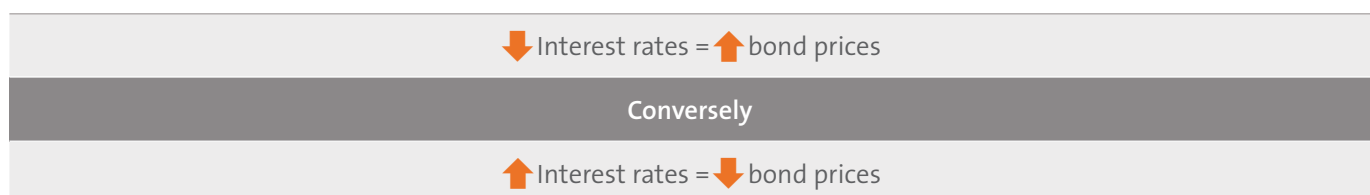
If the investor then wants to sell their five year bond, he or she will receive less than the original \$1,000 because the person buying it will want to pay less so that they can earn the market interest rate of 6%.

OR

Conversely if interest rates fall to 4% and the investor then wants to sell their five year bond, he or she will receive more than the original \$1,000 because the person buying it will pay more as the interest rate on the bond is higher than the market interest rate of 4%.

## Credit spreads

When trading bonds, credit spreads are an important factor in determining the relative value between the different bonds available. Credit spreads are the difference in income between a non-government (corporate) bond and an equivalent government bond in terms of maturity and geographic region. The extra income on the corporate bond is because an investor needs additional compensation for taking on more risk. Usually that extra risk relates to the risk of default for that corporation plus its ability to be traded and the volatility of its return relative to government bonds. As mentioned above, generally there is an inverse relationship between credit spreads and price so narrow credit spreads means higher prices and vice-versa.



# Different types of fixed income investments

In the last few years there has been a huge growth in the variety of fixed income investments available and the opportunities for investors to access them. New and innovative products have been developed to suit a range of risk and return profiles. Today's markets offer fixed income alternatives ranging from cash-enhanced products, government and corporate bonds, to hybrids, asset backed securities, credit default swaps and private debt.

## Major types of fixed income investments

Fixed income investments	Description	Risk profile
<b>Cash-enhanced or cash plus</b>	A type of managed investment that invests mostly in cash and cash-like securities such as 90 day bank bills.	Low
<b>Government bonds</b>	Bonds issued by governments which allow them to borrow money from the public for various public sector initiatives. They are normally considered low risk due to the low likelihood of a government defaulting on its capital or interest payments. Their value will change in response to the changes in market interest rates.	Low to medium
<b>Corporate bonds</b>	These are similar to government bonds except issued by a company and characterised by higher returns due to the perceived higher risk than a government bond. This higher risk is default risk.	Varied (depending on the underlying issuer)
<b>Hybrids</b>	A hybrid has the characteristics of both corporate bonds and shares. Listed hybrids generally pay a fixed income similar to a bond while containing the option of being converted into shares in the issuing company, or cash.	Medium to high
<b>High yield</b>	A high yield bond is a corporate bond that is rated below investment grade. These bonds have a higher risk of default than investment grade bonds but typically pay a higher yield to make them attractive to investors.	High
<b>Private debt</b>	Private debt is not traded in an active market such as a bond or share market. Investors lend money to a business on a private basis with an agreement that the business will repay the capital and interest at a specified rate.	High
<b>Emerging market debt</b>	Emerging market debt is bonds issued by countries that need to finance developing commercial and financial infrastructures. Such countries have greater potential for economic growth than more established economies, however with historically greater volatility.	High
<b>Securitised assets</b>	This category includes asset backed securities (ABS), mortgage-backed securities (MBS) and collateralised debt obligations (CDOs). These securities are linked to a portfolio of debt obligations such as car loans or credit card debt. Securitised assets can be made up of physical corporate bonds or their derivatives, or a combination of both. The collection of assets is divided into portions or tranches with different risk and return characteristics.	Varied (depending on the underlying tranche)
<b>Credit default swap (CDS)</b>	A CDS allows the credit risk of an asset such as a corporate bond to be transferred from one party to another. Credit default swaps give an investor protection against a credit default similar to an insurance policy. The seller of the CDS receives a premium from the buyer in return for taking on credit risk. The buyer collects a periodic fee and profits if there is no negative event such as a credit default. Credit default swaps can also be used to provide exposure to credit to add value to an investment.	Varied (depending on the underlying issuer)

# The investment benefits

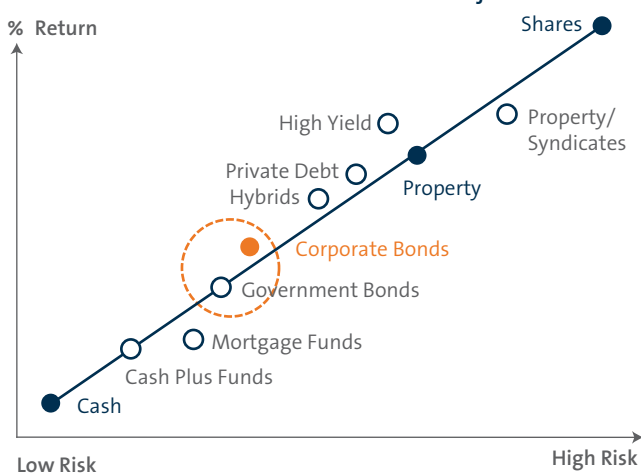
## Regular income

Bonds can provide investors with regular income. This income is generated via the interest payments governments or companies pay on their borrowings from investors. Companies that issue bonds are legally bound to pay this income. If a company does suffer financial difficulties, interest rate payments to fixed income investors are a higher priority and more guaranteed than payments, such as dividends, to shareholders. As a result, bond investors usually have a higher security of income than ordinary shareholders.

## Higher returns than cash with less volatility than shares

Over a full investment cycle, fixed income can offer higher returns than cash or cash plus investments. The chart below shows where bonds and other types of fixed income investments are positioned on the risk and return chart in relation to more growth-oriented investments such as property and shares. By lending to companies and taking on more credit risk, investors can receive a better return relative to cash, providing good risk-adjusted returns. In addition, traditional fixed income (such as government bonds or investment grade corporate bonds) acts as a defensive asset class within a balanced portfolio offering relative capital stability, liquidity and low or sometimes negative correlations to growth assets such as shares and property.

### Indicative risk and return chart across the major asset classes



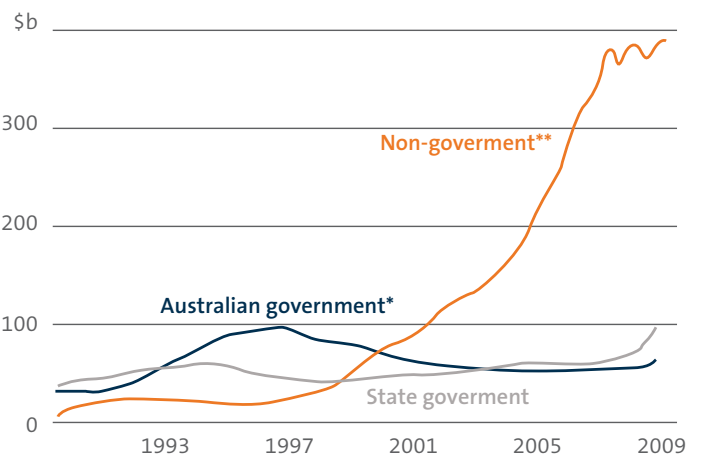
Source: This chart is an illustrative view sourced from AMP Capital Investors.

## Opportunities for diversification

The fixed income spectrum offers a range of securities from the more traditional government bonds to more innovative higher yielding assets. These provide new opportunities for higher rates of return as well as new sources of portfolio diversification.

With thousands of securities both locally and globally, fixed income investments can form a core part of a balanced portfolio. For example, as shown in the chart below, investors can be part of a growing corporate bond market. Industries within the corporate bond market can range from non-cyclical consumer staples such as utilities, telecommunications and healthcare, to cyclical industries including building and manufacturing to the more highly cyclical industries such as luxury goods.

### Bonds on issue in Australia



\* Excludes bonds purchased by the Australian government

\*\* Excludes ADI's self-securitisations

Sources: ABS; RBA

## Returns maximised through active management

Active management of fixed income securities not only has the potential to add value through sector and stock selection, it can also minimise the risk of default, particularly in the case of lower rated bonds. By applying credit analysis and focusing on areas such as business risk, financial health and management ability, an active approach can help determine the likelihood that a company will outperform or underperform its industry peers.

In addition, as market conditions shift, active management facilitates tactical allocation between sectors, with the potential for value add between cyclical versus non-cyclical industries or investment-grade versus non-investment grade bonds.

Aside from the risk of default, we believe index or passive investing can present additional risks in the way of high concentration hazard, especially within the UBS Composite Bond Index (All Maturities). This is because the highest proportion of the index is exposed to the largest borrower or type of fixed income security (such as government or semi-government bonds) which may not always be an appropriate investment choice.

# Tools used to manage fixed income portfolios

## The concept of 'duration'

Duration is the weighted average period to maturity of a bond's cashflows. It also measures a bond's price sensitivity to changes in interest rates. Duration is considered a measure of risk – the higher the duration, the higher the risk. Portfolio managers can increase or decrease the duration of a bond portfolio relative to a benchmark depending on whether they believe interest rates will rise or fall.

### An example

For a 1% change in interest rates, the capital value of the bond will change by approximately its duration (expressed as a percentage)

#### Example 1

If you own a bond with a 5 year duration, and interest rates fall (rise) by 1%, its capital value will rise (fall) by approximately 5%

#### Example 2

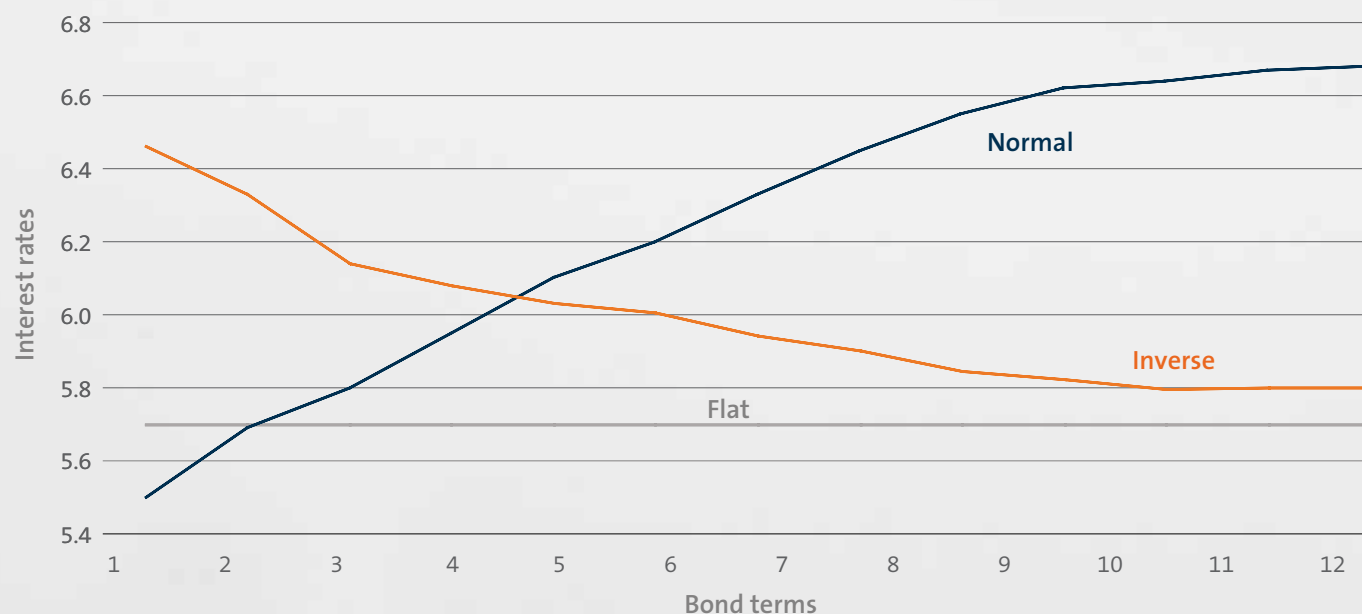
If you own a bond with a 4 year duration, and interest rates fall (rise) by 2%, its capital value will rise (fall) by approximately 8%

## The yield curve

The yield curve maps the relationship between the yield and term to maturity of different bonds of the same type and is an important tool in assessing future bond valuations. Views on the yield curve also assist a portfolio manager's views on duration as expressed above. In Australia, anchored by the current cash rate set by the Reserve Bank, the shape of the yield curve represents where investors think interest rates are heading. There are three main types of yield curves:

- **Normal:** When a yield curve is normally shaped, investors predict that short term rates will be higher in the future.
- **Inverse:** When a yield curve is inversely-shaped, investors predict that short term rates will be lower in the future.
- **Flat:** When a yield curve is relatively flat, investors are predicting that short term rates will remain steady into the future.

The three main types of yield curves



Source: AMP Capital Investors

# Knowing the risks

While fixed income offers a variety of opportunities for investors, with these opportunities come additional risks. However, when managed effectively, risk can also mean the potential for high returns.

**Interest rate risk:** The risk of fixed income values fluctuating as interest rates fluctuate. Normally when interest rates rise, the capital value of fixed income falls and vice-versa.

**Credit risk:** The risk of financial loss when the issuer (or borrower) fails to pay or defaults on their financial obligations under that transaction. Many fixed income products are rated by independent ratings companies such as Standard & Poor's. The rating is a measure of a company's assessed ability to repay the principal on its debt as well as interest.

The highest credit rating for a security is AAA indicating a very low probability that the company issuing the debt will default on its interest payments to the investor. Correspondingly its income levels are lower than higher risk securities. As you invest further down the credit scale towards BBB or BB rated securities, credit risk increases but investors are normally rewarded by higher returns.

**Liquidity risk:** This is the risk that an investment may not be easily converted into cash, which may cause delays or loss of capital.

**Equity risk:** The risk that the valuation of a bond will fall due to the issuer or company's exposure to the sharemarket.

**Sovereign risk:** The risk that a government, for example due to political reasons, may not meet its future debt obligations.

**Event risk:** The risk that an issuer will be unable to make interest and principal payments because of an unanticipated rare and very large change in the market environment such as a natural disaster or some major regulatory change.

**Currency risk:** Currency risk is the risk that the value of an investor's foreign assets in Australian dollar terms may be affected by changes in the value of the Australian dollar, relative to the value of the foreign currency. Fixed income portfolios can be fully hedged or unhedged. As currency changes can increase portfolio volatility, it is common to fully hedge fixed income portfolios in order to remove exchange rate risk. In the case of a fully hedged approach, while capital is protected, income payments can still be impacted by currency movements.

## Credit ratings and definitions by Standard & Poor's

Investment grade ratings		High yield ratings	
AAA	Has extremely strong capacity to meet its financial commitments	BB	Is less vulnerable in near-term than other lower-rated obligors
AA	Has very strong capacity to meet its financial commitments	B	Is more vulnerable than obligors rated BB
A	Has strong capacity to meet its financial commitments	CCC	Is currently vulnerable and is dependent upon favourable business, financial and economic conditions
BBB	An issuer has adequate capacity to meet its financial commitments, but more subject to adverse economic conditions or changing circumstances	CC	Is currently highly vulnerable
		D	Has generally defaulted on its obligations
		NR	Not rated

Ratings from AA to CCC may be modified by the addition of + or – sign to show relative standing within the major rating category.

Source: Standard & Poor's (for more information go to [www.standardandpoors.com.au](http://www.standardandpoors.com.au))

# AMP Capital fixed income credentials

AMP Capital has a major presence in the Australian fixed income market, with over 30 years of fixed income experience, including being one of the early investors in the Australian corporate bond market.

Our fixed income expertise is demonstrated in our track record of being a cornerstone investor in newly issued investment grade bonds, and in our Fixed Income team's reputation and experience across a broad range of financial markets. This includes experience in banking, funds management, ratings agencies and research. The team's management of Australian and global credit investments incorporates a specialist approach across industries and sectors, and the active management of credit risk.

The team is also supported by the broader resources of AMP Capital's extensive economic strategy and equity capabilities.

## Contact us

To find out more about AMP Capital's Fixed Income capabilities visit our website [www.ampcapital.com.au](http://www.ampcapital.com.au) or [www.digitalinsights.com.au](http://www.digitalinsights.com.au)

\*As at 30 June 2009

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**Investing.  
It's what we do.**

“AMP Capital manages almost \$30 billion in fixed income alone. This includes around \$3.5 billion in credit and over \$9 billion in cash.”\*