

# MyConsultant

Newsletter June 2011

## Why bonds when yields are so low?



**Brian Parker,**  
Senior Investment Strategist

Government bond yields in a number of countries remain close to historical lows, even after a reasonably savage sell-off towards the end of 2010.

The absolute level of yields does pose the question: why do we have global sovereign debt in a diversified portfolio? For example, is anyone going to build serious wealth by lending money to the Japanese Government for ten years and earning 1.3% pa? Lending money to the US Treasury for ten years at 3.3% pa looks more appealing, but it certainly doesn't sound like a compellingly attractive investment—especially given the well-documented debt and deficit issues facing the US Government.

My purpose here is to discuss why a diversified debt portfolio, including sovereign bonds, still makes more sense for investors even when the yields on offer look uninspiring to say the least, and despite many investors

being attracted to the certainty of term deposits which continue to offer attractive rates to investors willing to forego liquidity for a time.

### Gains from hedging

While the absolute level of yields in Japan, the US and elsewhere are low in local currency terms, sovereign debt portfolios are generally hedged back to the Australian Dollar (\$A). The reason for this is that the debt component of your portfolio is meant to have lower levels of volatility than the portfolio's growth assets. Hedging back to the \$A removes the potential for unwanted volatility in returns from fluctuations in currency markets. As Australian short-term interest rates are substantially higher than those offshore, hedging back to the \$A actually enhances the yield received by Australian investors.

### Exhibit 1 – Additional yield from currency hedging

	10 year yield	Gain from hedging back to \$A	Effective income yield (ie hedged into \$A)
US	3.30	4.50	7.80
Japan	1.21	4.58	5.79
Germany	3.21	3.51	6.72
UK	3.50	4.10	7.60
Australia	5.43	–	5.43

Source: Datastream, MLC Investment Management. Data as at 29 April 2011.

# Why bonds when yields are so low?

Exhibit 1 shows just what kind of additional yield is gained by currency hedging. The effective income yield on overseas government bond yields is higher than that available from Australian 10 year bond yields—even for Japanese bonds. At the risk of over-simplifying, these yields also compare favourably with the term deposit rates on offer from Australian banks, although term deposits do offer capital protection over the shorter term, whereas government bond prices can and will fluctuate.

## The future is essentially unknown – diversify

Even at very low yields, sovereign bonds can provide powerful diversification benefits in a time of heightened risk aversion, or if the global economy were to experience another recession, which would obviously have negative consequences for corporate earnings, and share market returns. The history of the Japanese Government Bond (JGB) market over the past two decades is instructive here. In 1999, 10 year JGB yields averaged about 1.8%, and most forecasts for JGB yields at that time probably had a '2' in front of them, or at least a '1.' A decision to hold long duration JGBs would have looked 'courageous' at the time to say the least. With hindsight, buying 10 year JGBs at yields of 1.8% subsequently produced solid capital gains as yields more than halved over the subsequent two years, and traded as low as 0.5%.

My point is not to say that JGB yields of 1.3% today look like a terrific buying opportunity, but rather to point out that under some scenarios, what looks to be ridiculously low yields can still provide more than useful returns, particularly in highly adverse environments. While the world economy is in better shape today than it was two years ago, it is still a highly

uncertain environment, and the probability of some kind of renewed crisis developing is not trivial. Should that occur, it may be that JGB yields at 1.3% or US Treasury yields at 3.5% will look relatively appealing.

At MLC, we have taken the view that under most plausible medium term scenarios, it is difficult to see value in longer dated government bonds, and accordingly, we have instructed our sovereign bond manager (Goldman Sachs Asset Management) to manage the portfolio against a benchmark of Australian Dollar cash, rather than a global sovereign bond index. The effect of this is to greatly reduce, but not entirely eliminate, our exposure to longer dated overseas government bonds. This should reduce interest rate risk, but at the end of the day, diversification remains our best defence against not knowing the future.

## Term deposits and inflation

While term deposits offer nominal return certainty, they don't provide the kind of protection investors need in the event of an inflationary shock. A diversified, actively managed strategy, especially one that includes inflation-linked bonds, and access to a wide range of both government and non-government securities, stands a much better chance of delivering the kind of real return protection investors' need. Skilled active managers are able to avoid those securities where risk is unrewarded, or adjust the maturity profile of the portfolio to capture the best returns on offer. In a rising interest rate environment, having access to securities such as floating rate notes, and being able to capture the opportunities when bond yields rise, can substantially enhance returns; a term deposit investor is locked in until maturity, and cannot be as flexible.

There will be times when term deposits will provide better returns than a diversified debt strategy, but these periods do not last. An actively managed, highly liquid, and well diversified portfolio of debt securities, including sovereign bonds, as well as term deposits, should continue to provide the cornerstone of a defensive investment strategy, or the defensive component of a more growth-oriented strategy.



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