With interest rates on the way up, how is MLC managing this risk to its bond portfolios?

February 2019

Bonds are an important source of diversification in a balanced investment portfolio. However, one of the key risks of investing in bonds is that interest rates will rise. When this happens, bond prices fall and so does the value of your portfolio.

After a decade of unusually low interest rates in response to the GFC, central banks are returning to more normal monetary policies, which means interest rates globally have started to rise and bond prices to fall. So how is MLC managing the bond strategies in its multi-asset portfolios?

An active approach to bond investing

At MLC, we've always believed that the best way to manage interest rate risk is by carefully selecting the bonds we invest in, rather than investing passively in line with a bond index. Active management also helps us to manage other risks of bond investing and find more ways to make returns. As a result, we actively manage bonds in all our multi-asset portfolios: MLC Horizon, MLC Inflation Plus and even our lower cost MLC Index Plus portfolios.

We can help manage interest rate risk by actively managing duration

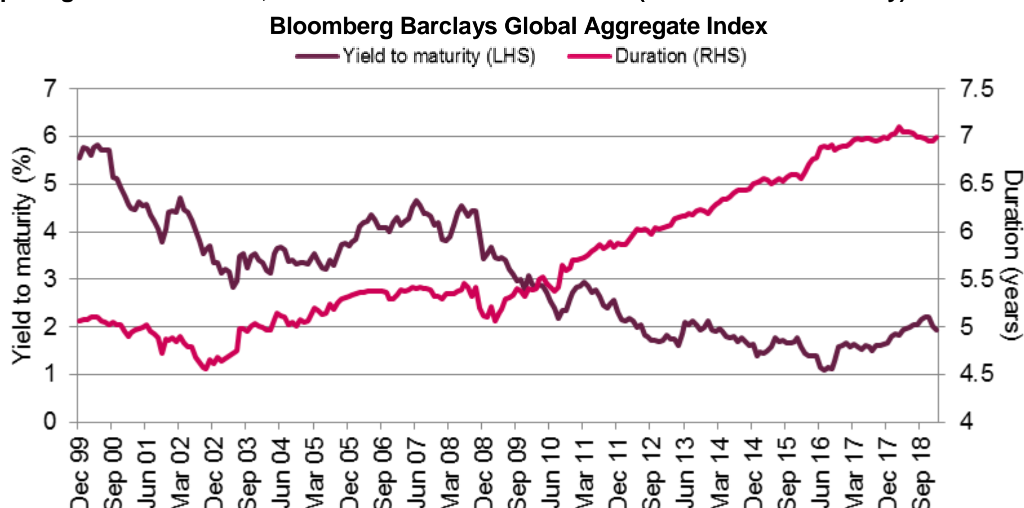
Buying a bond is similar to making a loan to the issuer, which could be a government or a company. Like a loan, you receive interest along the way and your money back at the end unless the issuer defaults. However, like other investments, the value of the bond can rise and fall.

Duration measures how sensitive a bond is to movements in interest rates – the longer the duration, the more sensitive, and therefore the more risky, it is. The time to repayment and the interest payments determine duration.

By actively managing the duration of our bond portfolios, we can better manage interest rate risk. For example, Chart 1 shows that since the GFC, the duration of a typical global bond index has increased from five to seven years, while the return (or 'yield to maturity') fell from 4.5% to almost 1.5%. This was because bonds were issued with low interest payments and long terms to maturity. The combination of higher risk and reduced return potential led us to reduce our allocation to government bonds.

In contrast to the index, in MLC's most popular multi-asset portfolios we've reduced the duration of the actively managed bond strategies to between four and five years to reduce our exposure to rising interest rates. This gives our bond investors much more protection against rate rises than index investors, while giving up only a marginal amount of return. This careful weighing of the potential risks and returns of an investment opportunity is the core of active investing.

Chart 1: In a typical global bond index, returns have fallen and duration (interest rate sensitivity) has risen



Source: NAB Asset Management Services Limited.

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We can limit exposure to riskier issuers

Passive, or index, investing means you're exposed to all the bonds in the index − the good and the bad. Unlike a share index, which is usually weighted according to the size of the companies in it, a bond index is weighted according to the volume of issuers' debt. Some of the world's most highly indebted countries and companies are also the riskiest and are a large part of the index. Rather than exposing investors to this level of risk, we select bonds that we think have the right balance of risk and return.

We can find return opportunities in a wider range of bonds

Through active investing, we can also choose bonds we expect will provide better returns than those in an index. For example, bonds issued by governments may seem very safe investments, but in fact up to a quarter of these (mostly from Europe and Japan) currently have negative yields. This means that even if interest rates don't change, they will deliver negative returns. If interest rates rise, they could perform very badly indeed. MLC has been able to avoid these.

Many types of bonds and other fixed income securities aren't available to passive investors as they aren't included in typical bond indices. At MLC, we can invest in other parts of the fixed income market that may provide good return opportunities for an acceptable level of risk, including global high yield bonds and global bank loans. These are complex investments and to manage them we use specialist firms that are experts in these parts of the bond market.

We can exploit structural aspects of the index

When bonds reach maturity, they may be reissued if the issuer rolls them over to keep loan funds flowing. However, new bonds are only added to an index at the end of the month in which they're issued. Issuers typically try to make sure all their new bonds are purchased by offering a discount to investors who buy on the issue date, so active managers like MLC can benefit from the new issue discounts. If a large amount of debt is being rolled over and the issuer particularly needs the funds, there may be opportunities for further discounts.

In addition, when bonds have less than one year to maturity, they are automatically removed from indices, which means managers of passive portfolios are forced to sell them. This can provide buying opportunities for active managers like MLC.

Conclusion

Actively managing bonds in MLC's multi-asset portfolios is not just an effective way to manage interest rate risk. It makes a real difference to our portfolios by providing ways to manage other risks, and find opportunities for returns, that aren't available to index investors.

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