

# Australian Fixed Income Investors - It's a premier time to invest

By Nick Tribe, Senior Manager Fixed Income



For many years now, fixed income has been a forgotten asset class. It has been viewed as dull, boring and perhaps not relevant. Some investors have even preferred an allocation to cash ahead of a diversified fixed income fund. Now, however, is the time for fixed income to take centre stage.

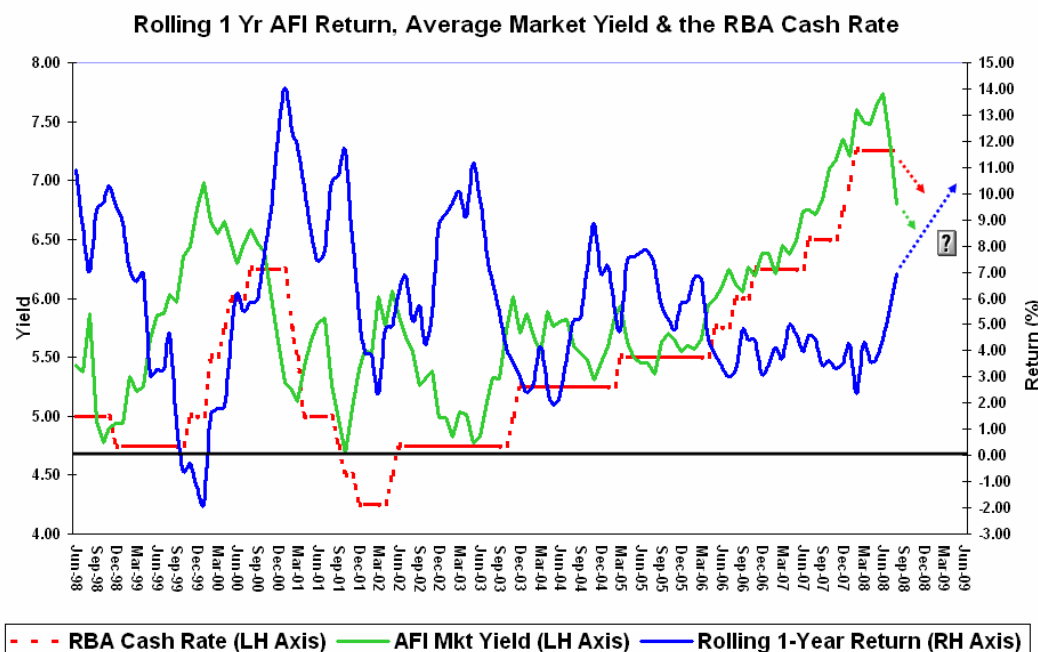
History tells us that the best time to invest in fixed income is at the end of a tightening cycle or when the official cash rate is at its cycle peak. The peak in the interest rate cycle occurred in March of this year when the Reserve Bank of Australia (RBA) lifted the cash rate to 7.25%.

Quite simply, when the RBA moves to an easing bias, the fixed income<sup>1</sup> market delivers higher returns than cash. The fixed income market leads the cash rate cycle, which can be demonstrated by having a look at the numbers.

The table below compares the return of the Australian fixed income market (measured by the UBS Composite Bond Index) in the 1 and 2 years after the peak of the interest rate cycle to the return of cash (measured by the UBS Bank Bill Index). A clear observation is that in the first 12 months from the peak of the last two interest rate cycles, fixed income outperformed cash substantially. We expect this to be the case again in the coming year. In fact the outperformance of the Australian fixed income market versus cash has already begun. Since 1 April 2008 the Australian fixed income market has returned 4.4% which is 1.1% above the cash return as measured by the Bank Bill Index.

Interest rate cycle peak	Year 1	Excess v cash	Year 2	Excess v cash
<b>12/1994</b>	17.8%	<b>+9.8%</b>	12.6%	<b>+5.1%</b>
<b>05/2000</b>	9.4%	<b>+3.5%</b>	5.1%	<b>+0.5%</b>

As I said earlier, the fixed income market leads the cash rate cycle. The chart below highlights this. The green line is the average yield of the market measured on the lefthand axis; the red line is the level of the RBA cash rate also on the lefthand axis; while the blue line is the rolling 1 year return of the AFI market as measured on the righthand axis.



<sup>1</sup> When we talk about fixed income, we are referring to fixed term government, semi-government bonds and non-government bonds. We are not referring to high yield securities or portfolios invested in credit only.

Look what the blue line (your returns) did in the last easing episode around 2000/2002! It was a period of double digit returns. Since then, you can see how the long tightening cycle that began in May 2002 and ended in March 2008 has weighed on AFI returns (blue line). These headwinds have now abated and we are about to have a zephyr at our backs, the first for many years. As a result we expect to see the red and green lines trending down, delivering an uptrend to AFI returns. Another period, like 2000/2002, of double digit returns is now favoured.

And here is an important point, we are talking about fixed interest here not cash. Cash will not deliver these expected returns as there are no capital gains with cash – there is with fixed interest.

Fixed income continues to play an important role in a fully diversified portfolio of investments. As well as providing a regular income stream, fixed income is negatively correlated with equity markets, helping to smooth returns over the long-term, and the premium for this insurance is as cheap as it's been for many years.

In the coming year, double digit returns from a diversified fixed income investment are likely, so being in cash is not the answer. Therefore it remains clear to us that the Australian fixed income market offers significant value to investors. It's a premier time to invest.