Smart Money

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Bye-bye bonds?

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NO class of investment has performed worse in the past few years than bonds.

Even cash in the bank – which is more conservative and less volatile than bonds – has delivered higher returns in some years, especially for people who have embraced the new high-interest online bank accounts.

However, financial planners say that bonds will one day become fashionable again. Given the current turmoil in the share market, that may be sooner rather than later.

Bonds – more often known as fixed interest – is a conservative investment class that was historically a loan from an investor to a government, with a fixed rate of interest paid.

Today, investing in the sector can be much more complex, with government bonds, corporate debt, hybrids, international fixed interest and emerging markets debt among the destinations where fixed interest funds invest.

A conservative investment portfolio in a superannuation fund might hold up to 50 per cent of the money in bond-type assets, while a balanced portfolio could be about 30 per cent – large amounts to be sitting in an asset performing worse than cash.

In three of the past five years, cash has produced higher returns than bond funds.

Marinis Financial group financial strategist Theo Marinis said a key reason for this had been because long-term interest rates – on which bond yields are based – had been lower than short-term interest rates, to which cash deposits are linked. This worried analysts because it meant interest rates – and therefore inflation and economic growth – were expected to be lower a decade from now, he said.

Fixed interest funds have also suffered from the low interest rate environment, and the fact that they usually have a management fee of up to 1 per cent – a bigger chunk of your investment return when rates are low.

Mr Marinis said bonds added stability to a portfolio when the share market was falling.

"It has been pretty poor returns, but maybe in the next couple of years a 4-5 per cent guaranteed income is better than minus-five or minus-10 per cent," he said.

Monitor Money financial planner Rex Whitford said bonds were "the least sexy type of investment but still important."

"As with all assets, they all have their day in respect of being fashionable and people's appetite for risk," he said.

"In the great cycle of economics, there will come a time where interest rates will go up and up, and those who have very long-term bonds when the cycle's at its peak will be very glad they do." For example, people who invested in long-term bonds through an annuity 20 years ago, when interest rates were 15-20 per cent, were enjoying that rate of return for the rest of their lives.

"Try and tell them that bonds are not fashionable," Mr Whitford said.

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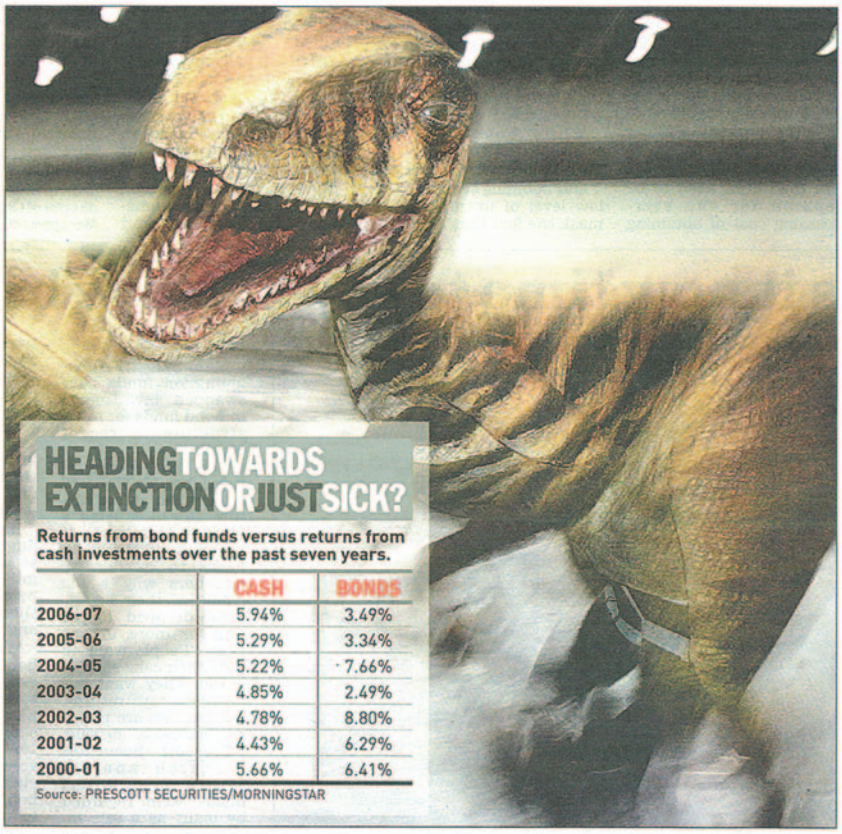

HEADING TOWARDS EXTINCTION OR JUST SICK?

Returns from bond funds versus returns from cash investments over the past seven years.

	CASH	BONDS
2006-07	5.94%	3.49%
2005-06	5.29%	3.34%
2004-05	5.22%	-7.66%
2003-04	4.85%	2.49%
2002-03	4.78%	8.80%
2001-02	4.43%	6.29%
2000-01	5.66%	6.41%

Source: PRESCOTT SECURITIES/MORNINGSTAR

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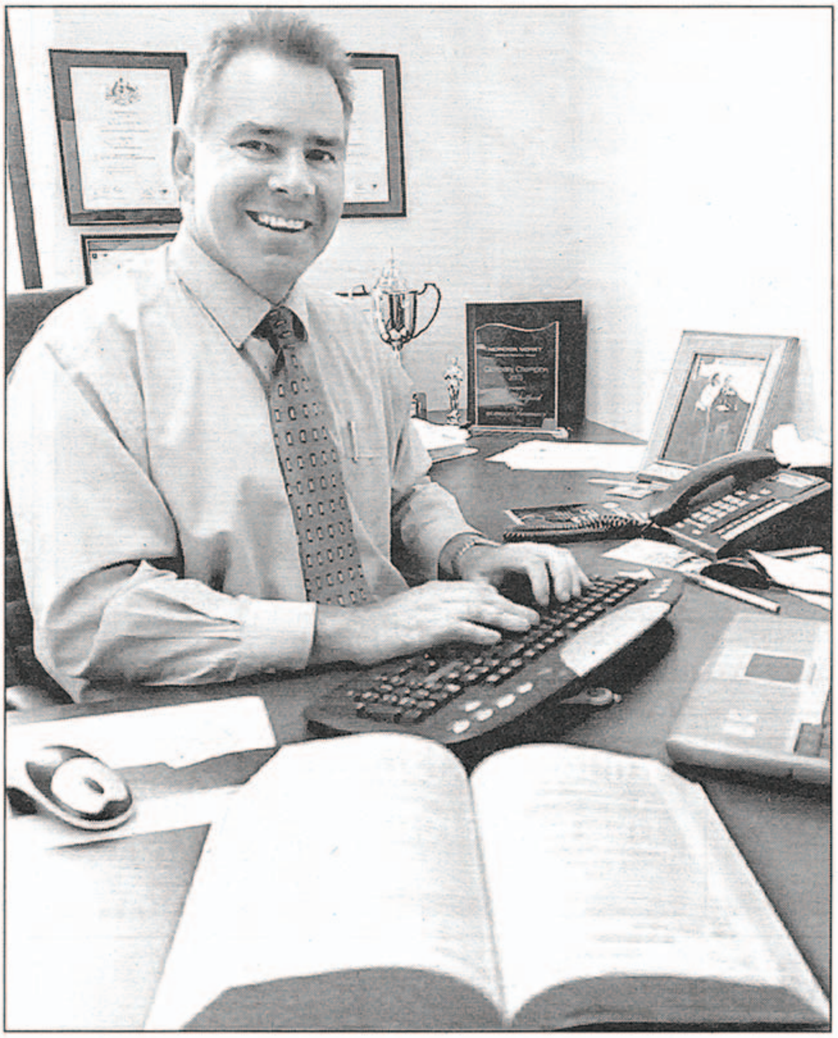
Is it now time to say bye-bye bonds?



HIGH EXPECTATIONS: Investors want low risk with high returns – two incompatible aims, says Rex Whitford. Picture: CHRIS MANGAN

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Many industry superannuation funds have swapped investments in bond funds for infrastructure in recent years.

This has boosted returns, but Mr Whitford said, when infrastructure stocks suffered a future downturn, it would be difficult for funds to explain to members why a big chunk of their investment dropped 15 per cent or more in one year. "People want to have their cake and eat it too. They want low risk but high returns, but the two are mutually exclusive," he said.

Prescott Securities research analyst Jeremy McPhail said bonds were regarded by many as a safe investment, but people could still lose money.

"Basically, if you invest in a bond with a certain term and hold it until maturity, you will receive the yield you purchased the bond at plus your money back at the end of the day," he said.

"One of the main issues with the longer-term bonds, though, is that the access point for most retail investors is through a managed fund. With an actively managed fund, in some cases the fund managers attempt to provide higher returns by trading the bonds which can lead to capital gains – and losses – in these funds, rather than holding the bond until maturity for the income stream."

Investments in the funds are priced daily so when yields rise as interest rates rise, the price of the bonds themselves can fall, and vice versa.

Mr McPhail said bond funds performed exceptionally well between 1989 and 1993, peaking with a 25 per cent annual return in 1991. "This was all reversed in 1994 when yields increased and bond prices fell, leading to an average return from bond funds of minus 5 per cent," he said.

But fixed interest can still have a place in investment portfolios. "For many investors, it may be prudent to maintain some sort of longer-term fixed interest investment within your portfolio for diversification purposes and to reduce risk – whether it be a term deposit, a conservative mortgage fund or bond fund," Mr McPhail said.