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Dear Friends

**<u>If fixed interest funds are so secure, why are they showing negative returns?</u>**

Many may well ask this question, particularly those who have heard the argument around security as a reason for including defensive assets (such as low risk government backed bond funds) in a portfolio.

Government backed bonds from stable and mature economies are regarded as secure and transparent investments, without the inherent volatility of share markets. They are characterised by stable (albeit more conservative) returns over the longer term.

However, over the 6 months to 31 Jan 2022, the AusBond Composite index (the most widely followed representative benchmark for Australian fixed interest funds) has returned a yield of -3.85%. This yield is reflected in funds which track this and other bond market indices.

To make sense of this situation, it is first important to understand that there is an inverse relationship between interest rates and yields on bond funds. A rise in interest rates makes the coupon (interest) rate on existing bonds less attractive, leading to a fall in price – while a fall in interest rates makes the coupon rate more attractive, leading to a rise in price.

Similarly, when term deposit rates increase, the holder is locked into a lower rate of interest for the remainder of the fixed term – the difference being that bonds are traded on the open market, so that the opportunity cost is crystallised and becomes a capital loss.

Given that we have been in an unprecedented global environment of ultra-low interest rates, and with talk of inflation last year becoming a fact (where it is at an all-time high in 40 years) rising rates have meant bonds have taken a hit over the 6-month period.

Nevertheless, it is also important to understand that these losses, which are beginning to be reflected in current bond fund yields, are not long term. In the same way that term deposits are reinvested, the bond investor will eventually receive the benefit of the new, higher interest rate.

Returns on bonds will, therefore, experience changes in capital value as interest rates rise and fall depending on the stage in the interest rate cycle. Nevertheless, they play a risk reduction role by diversifying away from share markets, as generally, the factors which affect bond and share market returns have different drivers.

The construction of an investment portfolio, therefore, generally starts with a foundation of Australian and International government bonds, with (depending on the investment timeframe and risk appetite of the investor) the addition of Australian and International shares, property, and cash.

The objective is to diversify the investment risk, provide consistent long term returns and be sufficiently positioned to absorb the inevitable investment shocks.

Reducing investment risk does not, of course, end at just diversifying investments across the broader asset classes.

Diversification within equity stocks includes investing across different industries, regions and market capitalisation.

Similarly, managers of bond funds will look to diversify investment risk within their portfolios by holding bonds with varying terms to maturity – for example, ranging from six months to 10 years+ depending on the funding needs of the issuer – so that they can smooth out the immediate impact of interest rate movements over the longer term.

Points to bear in mind:

Yes, rising interest rates **do** cause short term capital losses in bond funds, but they are quickly recovered by the increases in interest rate yields.

Funds which invest in high quality government backed bonds continue to provide access to defensive assets; they can play an important role in a professionally constructed portfolio by providing a reliable income stream, as well as being an excellent source of liquidity – despite any short-term volatility they may experience.

The following links (available via Vanguard Investments Australia's Client Education Centre) provide some additional generic information regarding bond investments:

• Explainer: Bond portfolios and interest rates

• Explainer: Bonds and credit spreads

• Explainer: Bonds and diversification

**And one more thing:**

There is no doubt that the end of an ultra-low global interest rate environment has ramifications for share prices as well as the price of fixed interest securities.

Then there is high-profile Boston-based fund manager Jeremy Grantham's recent dramatic prediction that rising inflation, with shortages emerging for labour and commodities, is about to 'burst the bubble' of our prolonged period of global growth – with a warning that a significant stock market crash is nigh.

On the back of all of this speculation, there has been considerable commentary which puts forward the opposite case – the case for investing in Australian resource stocks, on the basis that Australia may be on the cusp of a further resources boom.

In addition, we are now witnessing the Russian invasion of Ukraine, a terrible situation which is already causing global economic shocks.

Perversely, for Australia, our plentiful natural resources in both energy and food may see us avoid an economic market downturn, and instead, see our economy continue to grow.

These and other contradictory points of view (as well as the ever changing and unpredictable geopolitical environment) all serve to reinforce the rationale that when investing for the long haul, we should ignore the investment noise and "stay in our seats" (in line with my comments in last month's February eGrow which you can reference here).

Yes, it is possible that a bond and share market downturn similar to that which occurred in 1994 could occur in 2022/23 – but history also tells us that the world did not end in 1994.

Despite the tragedy and suffering of the war in Ukraine, this is not the first war, and I am afraid it will not be the last, as history has shown us during the multiple and horrific wars of the 20th century – and the 2lst century thus far.

For our clients, this is why we always recommend quality investments, in portfolios which are well diversified (and which include, for those of you who are in the income drawdown phase the 'Marinis buffer' of a least 2 years income in cash) to ensure that you can ride out the investment shocks which will inevitably occur.

**Media:**

If you would like to read my recent media contributions, please click here.

As always, if I or any of my team can be of assistance to you, please don't hesitate to contact us on (08) 8130 5130 or email admin@marinisgroup.com.au.

Yours sincerely


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