

## A guide to fixed income for pension funds – Part 1

Bonds are often seen as less glamorous compared to their equity brethren because of their lower returns. However, the benefits of fixed income should not be underestimated. As with any investment strategy, diversification is the key. A properly constructed portfolio will not only provide pension funds with protection from volatile stockmarkets but also help enhance its overall performance.

In addition, bonds, particularly the long dated variety, can help pension funds better match their liabilities which have become increasingly important as liability driven investing strategies have gained momentum.

Over the past few years, fixed income instruments have developed and matured as an asset class. At its most basic level, a bond is technically a loan. By purchasing a bond, money is being lent to a government, corporation or other entity known as the issuer. In exchange, the issuer promises to pay a specified rate of interest during the life of the bond and to repay the face value of the bond (the principal) when it “matures”, or comes due. Once issued, bonds are traded continually and so their yield, the income they pay relative to their market price at any time, also changes.

During the recent bull market, some bonds struggled to perform against the backdrop of strong economic growth and rising interest rates. However, post credit crunch central banks have been cutting interest rates and GDP growth has slowed giving a boost to government bonds and high-quality investment grade corporate bonds, which tend to perform well in this type of environment.

### Diversification is key

Trustees are advised to review their holdings to see whether they have the right mix to meet their requirements. It is important to compose a well-diversified fixed income portfolio to help reduce risk whilst increasing returns. There is a range of fixed income instruments available in the marketplace but in turbulent times investors often turn to the safe haven of *government bonds* because the risk of default is perceived to be zero for most developed markets.

*Corporate bonds*, on the other hand, normally carry a higher yield than government bonds because there is a risk that the company could go bankrupt and default on the bond. Therefore it is important for investors to not only analyse the financial health of the company but also the sector that it operates in, as well as the ‘spread’ (the difference in yield) over the perceived ‘risk-free’ government bond.

For example, take a bond issued by a telecoms company. Pension funds should take a closer look at the spread between the yield of the bond and the yield of the government bond to determine whether the risk is justified. Also, important is the credit risk rating which, in this case, encompasses the telecom sector, the company’s competitive position and management as well as its financial position - profitability, capital structure and cash flow protection.

As well as government and corporate bonds there are also high yield, asset backed securities and emerging market debt instruments that can provide diversification benefits in a fixed income portfolio.

*High yield bonds* are corporate bonds that do not qualify for “investment-grade” ratings by one of the leading credit rating agencies, and so provide higher yield but for higher risk.

*Asset Backed Securities (ABS)* are bonds or notes that are backed by financial assets, such as mortgage loans, credit card or car loans. They differ from most other kinds of bonds in that their creditworthiness (which is at the



triple-A level for more than 90% of outstanding issues) derives from sources other than the paying ability of the originator of the underlying assets.

While this article has provided a general overview of the different physical bonds on offer, next week, we will examine how derivatives can also be used effectively in a fixed income portfolio.

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