

## interview with ipac's CIO on the recent fixed interest restructure



In October, ipac completed the restructure of the fixed interest segment of the active diversified portfolios to better meet the needs of clients. The changes included the introduction of two new sectors (government bonds and multi strategy fixed interest) as well as new strategies and managers. The changes are motivated by the objectives of the diversified portfolios as well as the changing structure of the market. The two new sectors replace Australian fixed interest, global fixed interest and alternative income. In this interview, ipac's Chief Investment Officer, Jeff Rogers, discusses the rationale behind the changes that have been made, and how these changes will improve the portfolios' ability to meet the needs of our clients.

### why has ipac chosen to make these changes now?

As a result of the GFC, the bond market is in a process of change. The deterioration of fiscal positions in developed economies including the US and the UK means that government debt issuance continues to rise to fund large deficits. Increased issuance has changed the dynamics of the traditional Australian and global fixed interest benchmarks by both increasing the supply of government bonds and increasing interest rate risk. At the same time, not all government debt can reliably mean 'risk free' anymore, especially given the levels of debt some countries have now taken on.

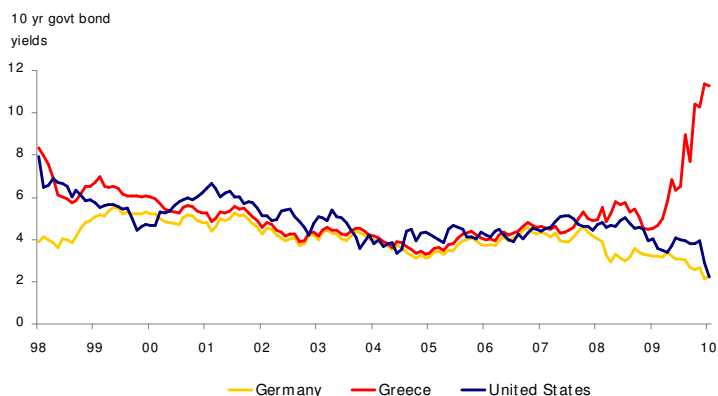
Chart 1 on the following page shows that for many years the 10 year bond yield of German, Greek and US debt was converging. As the GFC occurred, and the investment environment changed, we see that Greece's yield, for example, has risen substantially. This reflects the very negative view of the country's ability to service its debt. In light of these recent changes, we recognise that we can no longer view all government debt as the same, and that the risks between countries can vary quite considerably.

### have any changes taken place in the corporate bond market?

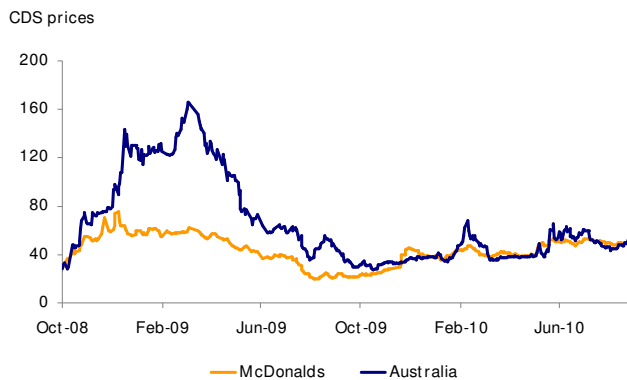
The corporate bond market had a long period of low volatility and low yields prior to the GFC. Over the past two years, however, this market has become more volatile. This volatility has uncovered some interesting trends. At times, selective credit selection has been more defensive than investing in government debt. Chart 2 overleaf displays an example of this and shows the market's estimate of default risk of McDonald's corporate bond versus the Australian 5 year government bond. As we can see, at one point during the GFC the market was actually rating Australia a greater risk than McDonald's!

This highlights that there are different levels of risk we need to consider when investing in corporate bond markets. This risk can relate to what country or sector the security belongs to, what the security's credit rating is and what types of assets are sitting on the balance sheet. We feel that there is a great deal of opportunity for active managers to take advantage of good buying opportunities in the corporate bond market at present.

**chart 1: from convergence to divergence**



**chart 2: testing our assumptions about credit**



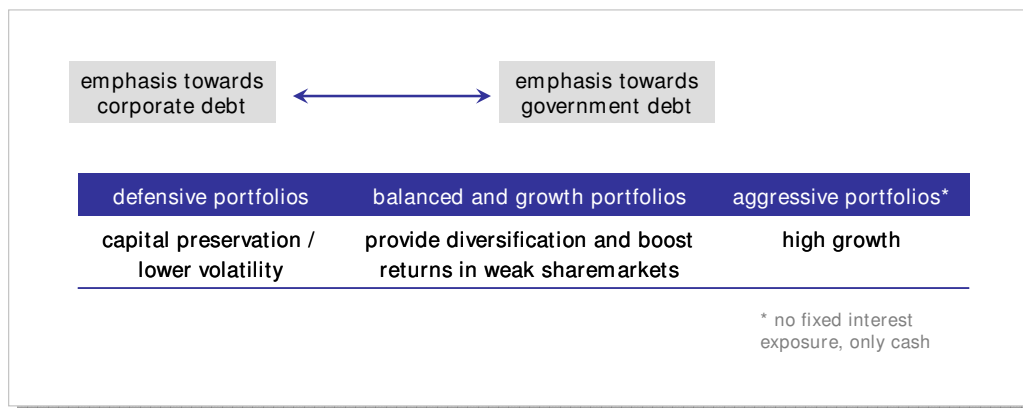
Source: Bloomberg. Data as of August 2010.

**how will each of the diversified portfolios look under the new structure?**

Each of the diversified portfolios has a different investment objective. For example, the defensive portfolios aim to provide some level of capital preservation with smaller fluctuations in value than the other portfolios. At the other end of the spectrum, the growth portfolios aim to provide higher growth with larger short term fluctuations a necessary companion. We have considered the individual portfolios' investment objectives when determining how much credit or interest rate risk we want them to be exposed to at a point in time.

For defensive portfolios ipac looks to limit interest rate risk which is the largest source of volatility in the bond market. These portfolios prefer a steady incremental return through receipt of coupons.

The balanced and growth portfolios are heavily exposed to equity, and can benefit from substantial interest rate exposure due to its diversifying qualities. In these portfolios, we look to invest in assets that investors flock to in times of fear. Over the long term, government bonds have displayed these characteristics.



## which strategies do the sectors invest into?

The previous structure aggregated a number of exposures (real rate, inflation, term, credit, currency and liquidity) on a conventional regional basis. ipac has sought to allocate to these risk factors discretely as the relevance of these factors to each diversified portfolio is different.

The new strategies and managers are shown in the table below. In short, the government bonds sector provides exposure to Australian and global government bonds and Australian inflation linked bonds. These strategies provide investors with exposure to interest rate risk. The multi strategy fixed interest sector employs a range of strategies to add value and diversify away from interest rate risk. Strategies are employed across the full spectrum of investment grade bond markets, including the debt of industrial and financial companies, and are used to exploit mispricing opportunities.

old sectors		
Australian fixed interest		Macquarie
Global fixed interest		PIMCO & BlackRock
Alternative income		PIMCO
new sectors	strategies	managers
Government bonds	Australian inflation linked bonds	Antares
	Australian government bonds	Macquarie
	Global government bonds	Old Mutual & PIMCO
Multi strategy fixed interest	Absolute return strategies	Kapstream & PIMCO
	Global corporate bonds	Morgan Stanley & PIMCO

Note: Further

information on these strategies and managers can be found in the relevant sector profile.

## will the benchmarks be the same?

ipac has redefined the benchmarks to better capture the risks we want. Some benchmark constituents will issue a large number of bonds we do not want. We will also set duration benchmarks at the lower end of the range as there is likely to be larger issuance of longer duration bonds.

## in summary, what are the benefits to the investor of the recent fixed interest changes?

The new structure allows ipac to move to an approach where interest rate risk is separated from credit risk. The structure also enables ipac to target and mandate managers towards the risks we want them to manage and/or optimise. This means that we are capturing risk in a way that is commensurate with the client's investment need.

## what is ipac's current fixed interest positioning?

At today's prices, ipac prefers corporate debt to government bonds. Government bond yields are currently at historically low levels. These levels reflect fear of deflation in some developed economies which we believe to be exaggerated. On the other hand, investment grade corporate bonds still offer considerable reward for risk. That is to say, the premium you receive for taking on corporate debt at current prices gives you an above average margin of safety against the risk of the security defaulting. We also continue to see opportunities in the bank capital space which is an area that our portfolios have already benefited from in recent months.

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