5 Income Solutions for Life

UNDERSTANDING
FIXED INCOME

In the final paper of this series "*Income Solutions for Life*" we explore the role that Australian fixed income plays for the income investor. Through the course of this series we have spent time exploring strategies that don't necessarily sit in the traditional income space however, despite interest rates falling to multi-decade lows, Australian fixed income should not and cannot be ignored.

Recall in our first paper of the series we outlined Legg Mason's income building block suite reflecting the purposeful design of our investment strategies to meet the needs of our clients. To date we have covered the multiple issues faced by investors and highlighted the features offered by Diversified Income, Equity Income and Real Income to meet these challenges head-on. Lastly, but certainly not least, we now outline the important role fixed income plays in assisting the income investor in meeting their risk and return objectives.

For many investors, while fixed income may form a part of their overall investment strategy, it is probably the least understood of all asset classes. As a result, in this paper we decipher the key concepts of fixed income to assist the income investor in being able to make an informed decision as to what they should expect from an allocation to this important asset class.

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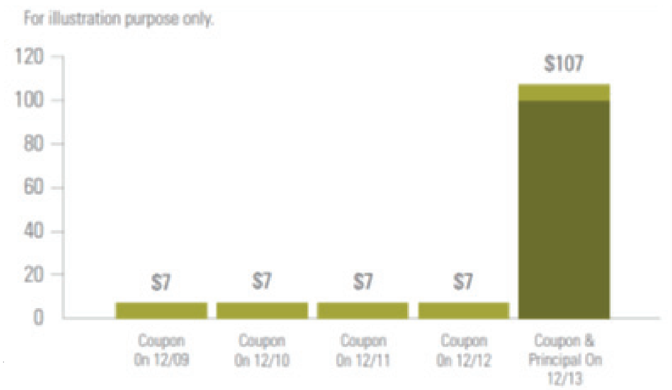
What you need to know

What is a bond?

Bonds, in their simplest form are no more than an IOU from a government or a company, but probably the least explored by individual investors. A bond is essentially a loan from an investor to a bond issuer – such as a government, government related agency or a corporation – for an agreed period of time. In return, the issuer generally promises to pay the investor a specified rate of interest (known as the coupon) typically monthly for the life of the bond. At the end of the loan period (known as maturity) the issuer then repays the initial loan amount (often referred to as the principal).

A bond is a series of future coupon payments and capital repayment



Cutting through the jargon

Unfortunately, reading a fixed income report can seem very similar to trying to understand the convoluted instructions for putting together your latest furniture purchase that arrives in a flat pack. Here we aim to provide a bit more colour around some of the commonly used terms within fixed income and guide you to what you need to know.

What impacts price and returns

Although the overwhelming majority of bonds pay out fixed interest to investors, the price of the underlying bond fluctuates as it is traded in the open market.

So we can think fixed interest as exactly that: you get fixed amounts of interest every month but the capital value of the bond you hold changes depending on the market conditions. However, if you buy a bond on issue and hold it to maturity then you will get back exactly what you paid – unless the issuer cannot now afford to pay you back.

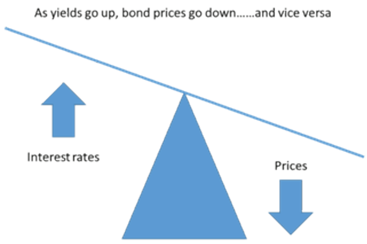
A number of fundamental factors cause changes in bond prices on a daily basis.

These include:

- The outlook for inflation
- Actual and expected changes in central bank policy and interest rates
- The outlook for economic growth
- Supply and demand of bonds
- Change in the bond issuer's creditworthiness (be they a government or a corporation)

Bond price vs bond yield

For investors the attractiveness of a bond can be measured by a bond's current income level. This can be referred to a yield, that is the amount of income you get divided by the price you pay. So if the income is $7 per annum and the price to buy the bond is $100 then the yield is 7%. What is important to note is that the relationship between the bond's price and its yield is inverse, in other words the yield moves in the opposite direction to the price of the bond. So in our example if the price of the bond then dropped to $90 then the yield would increase to 7.78%p.a.



- As yields go up, prices go down. If interest rates increase (or are expected to increase), the lower coupon on an existing bond seems relatively unattractive compared to new bonds. As demand for the existing bond falls, its price will generally decline, resulting in a rise in its yield.
- As prices go up, yields go down. If interest rates fall (or are expected to fall), the higher coupon on an existing bond seems more attractive compared to new bonds. As demand for the existing bond increases, its price will generally rise, resulting in a fall in its yield.

What is duration?

For bond investors, it is very important to understand the duration and how this will impact risk and return potential. Basically not all bonds are the same with different bonds being more sensitive to changes in (expected) interest rates than others. The degree to which a bond's price moves in response to this change is measured by 'duration'. The calculation of duration is based on a bond's price, coupon, maturity and yield and measures the percentage change in price due to a 1% change in interest rates or yield.

For example, if a bond has a duration of two years, its price would fall about 2% when interest rates rose one percentage point. On the other hand, the bond's price would rise by about 2% when interest rates fell by one percentage point. The longer the duration of a bond (or a bond portfolio) the more its price will move in response to a change in interest rates.

Dispelling the Myths

As an income investor it is important to be clear on the role you expect your fixed income exposure to play within your overall investment strategy.

Buyer beware

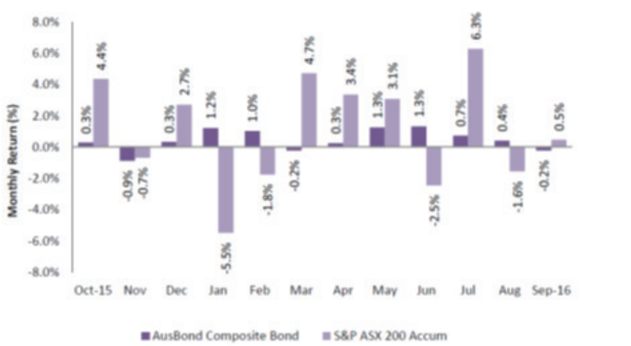
The universe of bonds available to invest in comprises a far wider risk spectrum than many investors may realise. The higher risk sectors of the fixed income universe, such as corporate bonds or emerging market bonds, offer superior income returns compared to the lower risk sectors, such as government bonds. The reason is simply that the bond issuer has to compensate investors for the higher risk of them failing to make the payments due in future be it the regular interest payment and/or repayment of the principal at maturity.

These riskier bonds therefore tend to exhibit greater volatility and can be more correlated with equity market returns.

As a result, it is important to ensure that you understand the type of fixed income fund you are investing in, as not all strategies may provide the defensive characteristics that an investor might traditionally expect to receive.

As readers will recall from the second paper in the series we focused on the role that diversification can play for income investors. The fixed income allocation is designed to provide the defensive exposure within the Diversified Income strategy, with its role best captured in the chart below. Put simply, to provide downside protection and capital protection when growth markets (eg. Equities) are under stress.

S&P/ASX200 Accumulation Index vs Bloomberg AusBond Composite Index: monthly return performance 2015/2016

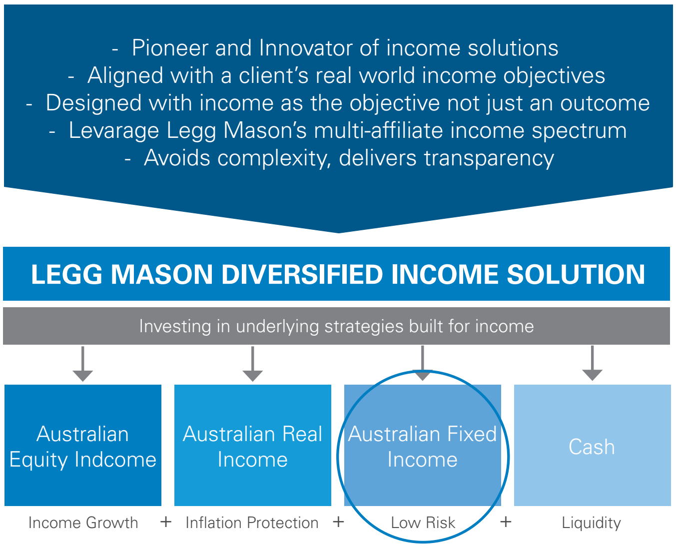


Source: Bloomberg Report September 2016

How Legg Mason can help

At Legg Mason we have been focused on designing and building a range of income solutions focused on meeting the requirements of Australian investors seeking income since 2010. This suite of income solutions provides investors with a high level of flexibility; the Legg Mason Western Asset Australian Bond Fund is a good illustration of this – investors can access this Fund directly to complement their broader portfolio or alternatively gain access via our Diversified Income Fund as depicted below.

Legg Mason Income Building Blocks



'True to label' - Actively defensive fixed income

The Legg Mason Western Asset Australian Bond Trust is managed by Western Asset, one of the largest fixed income managers in the world. With eight offices around the world, Western Asset has specialist teams dedicated across the full spectrum of fixed income investing.

The strategy is designed to maximise the investment opportunities from Australian fixed income as well as promote the defensive attributes that fixed income offers. As a 'traditional' fixed income strategy, the fund primarily invests in government and semi-government bonds, corporate bonds and asset-backed securities.

What are the key benefits?

- An actively managed fixed income option for the defensive part of a portfolio
- Low risk, low fee investment that is suitable for retirees or those nearing retirement
- Strong risk management focus – limit interest rate risk and a focus on credit quality

- Diversification benefits, with low correlation to other asset classes
- Winner of Australian Fixed Income Manager of the Year 2016 – Zenith/Professional Planner awards

Western provides investors with the best of both worlds with a dedicated local team focused on meeting the needs of Australian investors, supported by the vast global resources and expertise of one of the largest dedicated fixed income managers in the world. The Fund is a great example of how Legg Mason, through working with its affiliates, provides clients with a range of tailored solutions to meet their income objectives.

This defensive quality makes it the perfect complement to other income 'building blocks' – whether an investor chooses to design their own income solution or utilise the dedicated resources and asset allocation skills of Legg Mason via the Diversified Income solution, the Australian Fixed Income Fund has an important role to play.

Through this series "*Income Solutions for Life*" we have explored in detail the key aspects of income investing, keeping in mind that the clear objective is delivering a sustainable, growing and real income stream. Along the way we have challenged conventional wisdom as it relates to income investing and provided investors with what we believe is a more effective income solution. As we outlined at the outset, Legg Mason has been a pioneer of income investing since 2010 and we remain committed to what we see as a key part of an investor's portfolio.

Contact

Brandywine Global
Clarion Partners
ClearBridge Investments
EnTrustPermal
Martin Currie
QS Investors
Rare Infrastructure
Royce & Associates
Western Asset Management

leggmason.com.au 1800 679 541

Beau Titchkosky
Head of Sales
btitchkosky@leggmason.com
0410 407 046

Colin Taylor
Director of Sales
ctaylor@leggmason.com
0427 023 692

Tony Pattison
Director of Sales
tpattison@leggmason.com
0448 277 060

Rosa Huddy
Director of Sales
rhuddy@leggmason.com
0429 205 069