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Realm Market Review: The argument for more credit

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In a risk vacuum investing can be as simple as picking the highest yield or historical return. This was evident everywhere before the US housing crisis. Here in Australia it saw listed Hybrids trade at spreads below where senior unsecured debt trades today, in sovereign bond land we saw the Euro periphery borrow at German rates and in equity land higher beta was better.

Most investors could not have conceptualized the chain of events that followed. However, as the fog of war cleared, the obvious question was what's next? For context, the "what's next" question is now being asked by a better informed and less trusting clientele.

If there has been one winner out of all of this, it has been product providers and advisers that can provide a message focused on outcomes and greater return certainty. One need looks no further than the demand for term deposits, lifetime annuities, hybrid securities or defensive dividend paying stocks to see this. This is symptomatic of a marketplace that is putting less faith in blue sky to solve for return short-falls.

In our opinion it is a healthy change and in many ways a lot more "normal" than the pre-crisis status quo. This beckons the question that if this is normal, is your asset allocation and portfolio positioning acting to reflect this?

One noteworthy trend here in Australia has been a move away from the disproportionate responsibility on the equity portfolio in meeting return targets. Investors and their advisers have now started to focus on the space between the cash/share barbell, both for diversification and return certainty.

The chart below illustrates the pre and post crisis returns of the UBS 0-5 year credit index on top (BBB- and higher securities) with the second panel providing you a chart and returns for the All Ords, All Accumulation index, the coloured lines provide total and annual returns pre and post US housing crisis.

The 5 years through to the end of 2007, saw the All Ord's all accumulation index deliver over 23% per annum. Meanwhile, the record low credit spreads that drove the boom saw credit deliver 4.90% per annum over the same period. In many ways the picture tells us what we already know, that cheap money drove GDP and thus equity outperformance.

However, as the climate changed post crisis, credit investors demanded more. The reduction in debt market liquidity and credit availability cut the ability to use leverage to drive positive earnings momentum.

In the post crisis period, weaker economic growth, new capital rules and a pickier credit market has seen spreads rise. While they have rallied of late they remain well above the pre-crisis levels.

These are structural factors, after all BASEL III is all about increasing systemic capital to limit market risk. The focus of regulators is on getting real money investors to take some of the load off the banking sector with a view to protecting against the banks holding governments to ransom because of their size.

In that context issuers will continue to need to compensate real money investors to help out. That goes some way to explaining why credit has done relatively well in the post bubble world, as the last 5 years show in the graph.

In every country this manifests itself differently and is a function of how local regulators interpret global capital rules as well as the market structure.

Here in Australia, the heavily banked nature of the market sees the opportunity to participate for the mainstream limited to higher TD rates and Equity Capital.

However, credit is a broader and richer opportunity set than many people realize, especially when you expand the view to encompass Asset Backed Debt and other forms of enterprise funding. For those with the ability to understand and value risk in this space, the asset class continues to present good value.

Our belief is that credit has the ability to deliver value in terms of yield and diversity to the end client over the cycle. Given the changing environment, it may yet have a bigger role to play in most people's asset allocation moving forward.

Realm Investment House, Level 17, 500 Collins St, Melbourne, VIC, 3000, AUS
T: +613 9008 7290 W: www.realminvestments.com.au E: ClientServices@realminvestments.com.au

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