Elegant alternatives to corporate bonds

By Perpetual Asset Management

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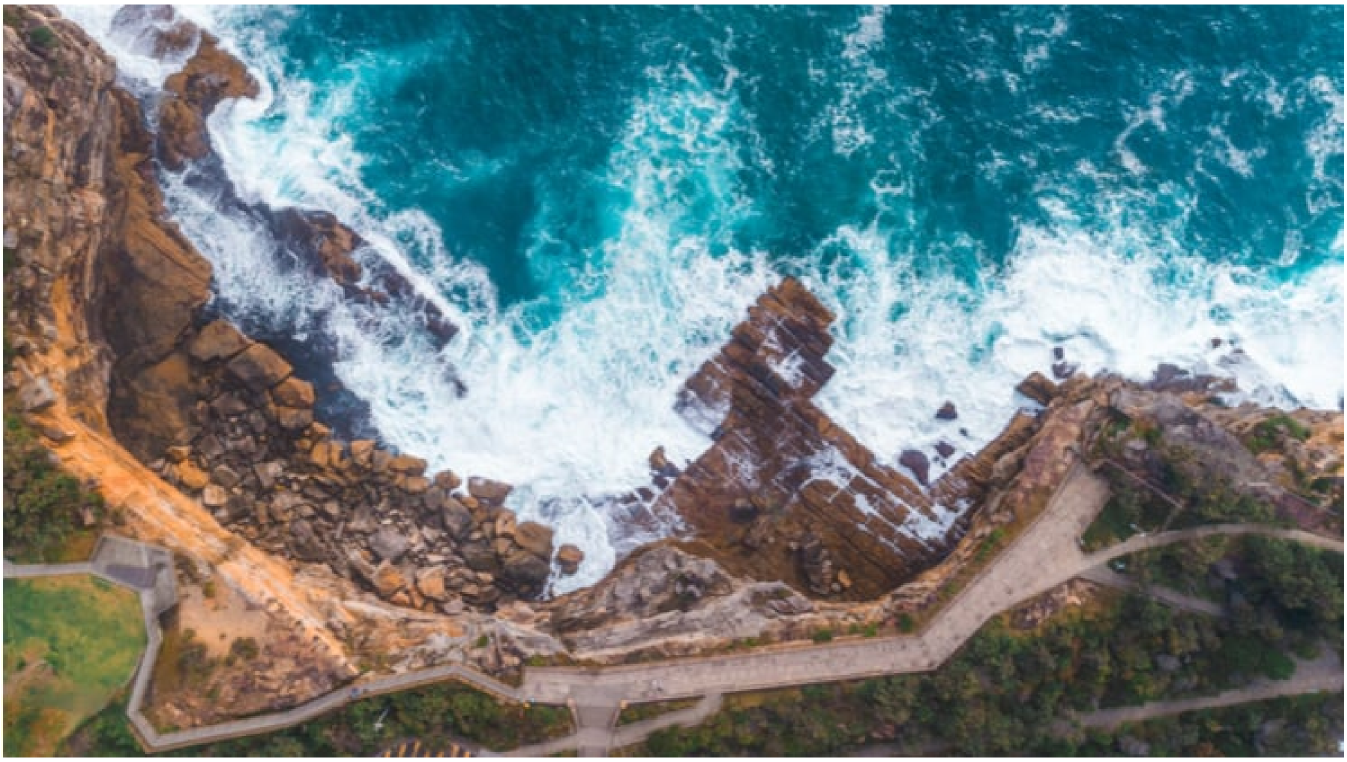

The anaemic returns delivered by government bonds and term deposits in recent times has left some retail investors concerned about their defensive assets. But while the corporate bond market is often inaccessible to these investors, there are alternatives to consider for the low-risk component of income-generating portfolios.

Income focused investors have seen the yield on government bonds and term deposits diminish to the point that many have turned to higher risk equities to maintain an adequate level of income. Corporate bonds offer a more competitive yield at a lower level of risk but are inaccessible to many investors. We believe that actively managed corporate credit focused Listed Investment Companies (LICs) and Listed Investment Trusts (LITs) as well as Funds offer an opportunity for investors to access more substantial income and play an important role in any income-focused portfolio or Self Managed Super Fund (SMSF). Investors building a low-risk income generating portfolio are facing a challenging market with low interest rates on government bonds and term deposits. Notwithstanding recent volatility, government yields are at record lows globally and real yields (adjusted for inflation) are negative. At the same time, with increasing inflation and RBA tightening ahead, interest rate risks are elevated and asymmetric (meaning the downside is high while the upside is limited). In these conditions, the viability of government bonds and term deposits as low risk sources of substantial income is in question.

We believe corporate debt offers an essential middle ground between the anaemic yields offered by government bonds and term deposits and the elevated risks associated with equities. Debt issued by businesses offer a sometimes-significant yield premium to government debt to account for the increased risk of default. Corporate bonds are, however, less risky than equities as valuations are less volatile and in the event of financial distress, bondholders have higher priority of repayment than shareholders. Perpetual believes that the outlook for corporate credit is robust, supported by strong economic and corporate earnings growth.

The issue many investors find in attempting to allocate to corporate bonds is that direct investment in corporate bonds is inaccessible to retail investors. While hybrid debt is freely available, it comes with equity characteristics and significantly increased capital structure risk. As noted by the ASX's head of Strategic Delivery, Ken Chapman, when speaking to the Sydney Morning Herald in November: *"We've got this sort of gap where we don't really have much in the way of corporate bonds traded on the exchange. It's a glaring anomaly of the investment landscape."* [1] There are potential legislative solutions to facilitate a more accessible bond market but, in the meantime, retail investors including retirees reliant on income generating assets have to look for alternatives.

While the Australian Dollar credit market is largely inaccessible to retail investment, there is an elegant alternative to direct investment in corporate bonds available in the form of credit-focused listed investment companies and funds. These investments allow access to the competitive yields offered by corporate debt in an already diversified, actively managed vehicle. Investors in these products can get access to the experience and expertise of institutional management teams as well as exposure to private debt market, which offer substantial yield premia. Due to the breadth and complexity of credit markets, experienced, active management based on rigorous research and due diligence is essential to manage risk. In the case of Perpetual's suite of credit-focused funds and its credit LIT (ASX: PCI), the interest rate risk typically associated with bonds is also reduced as a result of their floating rate structure.

As the endless hunt for yield draws income seeking investors towards riskier and riskier assets, actively managed credit focused funds as well as LITs and LICs provide an alternative, offering competitive yields at a lower level of risk than equities.

Find out more about Perpetual's Credit Income Trust