Vivek Prabhu: How floating rate credit can help investors in a high-inflation environment

By Perpetual Asset Management
12 September 2023

Investors concerned about persistent inflation should consider lifting their exposure to floating rate credit, says Perpetual's Vivek Prabhu.

- Inflation likely to be higher for longer
- Floating rate credit can provide a hedge
- Find out about [Perpetual’s Diversified Income Fund]

NET-ZERO transition costs and a post-pandemic trend away from globalisation look like underpinning inflation for years to come – posing a challenge to the value of interest rate-sensitive fixed income investments.

But by shifting allocation from fixed to floating rate credit, investors could achieve reliable income while potentially protecting their portfolio from capital losses, argues Perpetual’s Vivek Prabhu.

“With inflation elevated, central banks respond with cash rate increases,” says Prabhu, Perpetual's head of fixed income.

“Floating rate funds can benefit from extra income generated, without the inverse relationship between capital and yields that you have with fixed rate bonds.

“That can provide a good hedge against inflation as well as generating income.”

The role of floating rate notes

Floating rate notes (FRNs) are bonds with variable interest rates that change with movements in broader interest rates, usually in line with an official rate like the 90-day Bank Bill Swap Rate.

This means that in a rising interest rate environment, the income generated by floating rate notes should increase along with the interest rate, delivering investors extra income.

Importantly, this also means FRNs should avoid the inverse relationship between price and yield suffered by fixed-rate bonds, which decline in value when interest rates rise because their fixed interest rate becomes less attractive.

Typical assets in Prabhu’s Perpetual Diversified Income Fund include corporate, bank and securitised debt (such as home mortgages, car loans, office equipment financing, and medical equipment financing).

Rate rises still on the cards

Continued rate rises are still likely as central banks fight inflation,” Prabhu believes.

“A lot of the things that were suppressing inflation over the last 15 years have done a 180-degree turn.

“Globalisation and China becoming the world's manufacturer has applied deflationary pressure historically.

“But moving forward, the developed world has recognised supply chain vulnerabilities and is onshoring manufacturing again — which is inflationary.

“Wage inflation is back in the tight employment market and people are demanding increases in wages.

“Decarbonisation is another — the flow-on impact to consumers from new taxes and investment to offset carbon emissions.

“These things are structurally embedding inflation at a higher level than we've seen over the last 10 or 15 years.”

Credit risk premiums

Prabhu says price movements in floating rate credit typically relate to credit risk premiums as measured by credit spreads.

Credit spreads represent perceptions of the risk associated with a particular investment.

“If credit risk premiums are rising, that makes the floating rate bond fall in value. Whereas if credit risk premiums are stable or falling, you’re either collecting the yield or making a capital gain on the contraction in credit risk premiums.”

Prabhu says the default history on Australian bonds – the times when borrowers failed to pay back their loans on time – is lower than the equivalent rating for US bonds.

That’s partly a result of the fact Australia is a small, protected economy with a high number of oligopolies, which makes for good credit risk.

Prabhu argues that floating rate credit provides the opportunity to earn a cash-plus return for taking very high quality, predominantly investment grade credit risk.

“We believe credit is the most repeatable and reliable source of alpha when investing in fixed income.”

About Perpetual’s Credit and Fixed Income team

Perpetual offers a range of cash, credit and fixed-income solutions and are specialists in investing in quality debt.

We take a highly active approach to buying and selling credit and fixed income securities and invest extensively across industries, maturities and the capital structure.

Find out more about [Perpetual’s Credit and Fixed Income capabilities]

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