AUSTRALIAN INVESTOR PERSPECTIVES

With Australia’s recovery the most buoyant in the developed world, investors and asset allocators are deciding just how bullish to be as 2008 recedes in the rear-view mirror. And regulatory changes are also affecting demand across asset classes.

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CHANGES IN ASSET ALLOCATION

Cooper In terms of asset allocation, Cecily Williams, what have you seen emerge over the last 18 months and how is that expected to move forward from here?

WILLIAMS What we have seen is that clients have become interested in fixed income for the first time: they have realised this was an asset class that could have an impact on their lives, and it certainly did for quite a period of time.

In the first instance, what the crisis did was make our clients realise there is a difference between sovereign bonds and credit, whereas in the past many clients would have considered ‘fixed income’ as a kind of a conglomerate of various fixed income securities. Now there is a clear trend towards separating out the sovereign allocation from the credit allocation.

As far as sovereign allocations are concerned, there is a bit of interplay between hedging against deflation and whether we are facing a situation where governments inflate themselves out of their debt problems. Inflation is a big subject of discussion and that clearly has an impact on the outlook for sovereigns – and in that camp you would put triple-As, particularly in Australia. People are slightly nervous about those asset classes and might have a lower allocation going forward.

Cooper As far as asset allocation goes, how have investors seen changes come through in the funds you manage?

CARRUTHERS The triple-A sector has, for us, historically been a bit of a grey area. We have very deep and intensive research-based teams, which tend to spend a lot
of time on the low-investment grade space and rotation strategies. But the triple-A universe from time to time does offer opportunities, so allocation to triple-As is something we can’t ignore.

We were very large buyers of the government-guaranteed story. In December 2008 we became heavily involved and spent more than A$1 billion (US$915 million) on government-guaranteed bonds from banks in the first few deals, and then traded that down. More recently, with the withdrawal of the government guarantee it made sense to look at scarcity value for the bigger lines, to reallocate again and to think about how that sector will perform.

In a low spread environment triple-A gets overlooked by us because it is just not worth allocating a lot of research dollar. But certainly now, when the differentiation is very large, it makes a lot more sense. And the breadth of our mandates means it is a much more flexible environment than it used to be.

Cooper Do you think scarcity is outranking liquidity issues at this stage?

CARRUTHERS We spent a huge amount of time thinking through the initial pricing points in December 2008, of 120 basis points over swap for sovereign-guaranteed paper, and what that spread was to government risk and anomalies to other reference curves. Liquidity risk premiums more than compensated for the risk taken so it made a lot of sense – we still look back at that as one of the best risk-adjusted opportunities of all time in the domestic space. Scarcity will play a bigger role right now, and certainly a lot of guaranteed deals are bedded down.

We also spend more time looking at the offshore markets like the Federal Deposit Insurance Corporation (FDIC)-guaranteed market and the price behaviour going on there. Those lines are fairly liquid in US dollars as well due to the depth in agency-based players that Australia doesn’t tend to have. In terms of value, Australian dollar product offers a lot less than it did previously.

STRATEGY FOR TRIPLE-As

Cooper Have you taken much time so far to differentiate the triple-As across asset classes, and then within the asset classes on a comparable basis?

CARRUTHERS We have a macro markets team which focuses on rates and the yield curve: they look after the semi-governments and there is some crossover with the triple-A space that also involves the credit markets team.

Semis – as well as supranationals and agencies from time to time – typically get squeezed out of portfolio construction, because when you are overweight credit you are usually allocating from those triple-A sectors and the credit team typically incorporates their view of total return expectations of credit product and a constrained capital allocation. There are a number of ways in which we look at total portfolio allocation and asset allocation in a typical composite portfolio, and at risk-budgeting framework during the cycle.


DAVID CARRUTHERS AMP CAPITAL INVESTORS
There has certainly been plenty of interest in price points with the government-guaranteed deals, but we think those markets are now becoming much more efficient. We don't want to spend a lot of time on this sector for a couple of basis points here and there – we don't think it is a good use of our resource allocation time – so we look for much larger dislocations elsewhere.

**Anderson** With regard to triple-As, particularly given the sovereign risk emanating from Europe, analysis has become somewhat more sharply focused. This, combined with very attractive opportunities in semis and bank paper, has created a lot of competition for investment which encouraged switching away from sovereigns.

We saw fit to switch out of sovereigns early last year. At that time consultants were considering asset allocation settings to avoid the growing exposure to sovereign bonds within fixed income benchmarks as issuance grew. We actively switched away from sovereigns which essentially achieved the desired result.

In terms of triple-A credit work, we are certainly cognisant that we have an ‘Australian’ bond fund, so consideration of non-Australian country exposure is important. That is a sovereign risk issue rather than a credit one, so the starting point is more of a portfolio construction decision by considering sector exposures and ultimate guarantor. We look at the metrics of sovereigns – assessing the financial flexibility of the supranational-type institutions, the robustness of the legislation around them, the economic fundamentals, and the political environment which informs comparisons across different sovereign issuers.

By the end of last year, some uncertainty was introduced within the corporate bank sector with the advent of APS210. For a time, it created a buyers’ strike for bank paper until there was clarity. This of course then altered our relative view towards the sovereign/supra sector.

**IMPACT OF APS210**

**Cooper** Concerning the buyers’ strike you mention, obviously it was an initial reaction to the APS210 announcement. How do you see the impact now?

**Anderson** Certainly as people have become better informed, and there has been more open debate around it, we have become a little more comfortable with the risks. But it is not resolved – it’s still open.

All the messages we are getting point to the fact that a pragmatic solution will occur, but we will not be complacent about this matter. The reality is the funding environment has had a structural change for at least the next several years. Banks will be issuing a lot of paper, and all portfolios already have quite a meaningful exposure to bank issues.

You also have to anticipate when you are making investment decisions that it is not just a credit issue – you have to factor liquidity and regulatory risks in to your decision.

**Cooper** Joanne Dawson, how is the regulatory environment practically impacting bank treasuries?

**Dawson** There is a lot of uncertainty around the timing of the regulatory regime and the changes which will occur, particularly on the asset side – what is and is not included and also the transition time frame we will have to work over.

From our perspective we have been growing our liquid assets over the last few years in line with where the standard is for global banks, but we need to consider – and we do look at very closely – what assets we put in our book.

However, at the moment we still don’t have a definition of what will be in and what will be excluded. We need to think about the time frame: what we are holding in our portfolio for the short term and for the long term, and how we transition that.

Obviously you don’t want to be last to move, but you also don’t want to be first. If you are holding a pool of liquid assets that is greater than it needs to be there is a big carry cost that will impact the funding requirements of the bank over the long term. We try to manage that as best we can.
the regulatory regime will get to – that is the debate throughout the market but also in conversations with regulators and in the global environment.

We have a working model and that is what we operate to. Obviously that changes as we get more information, but the ongoing situation doesn’t mean that we just stop doing things. We still have a business to run and we still have liquid assets that are an important part of what we do as a bank in order that we can fund the operation of the organisation. It doesn’t stop what we do, but we certainly have to have a plan around how we think it will work out.

Davison How do you think the information flow has been, in terms of what the regulators are telling you about the development of their thinking?

■ DAWSON There was a lot of initial discussion with the regulators that came out in September and then there were a number of follow-up forums from there. It has gone a bit quiet in the last couple of months: the regulators are updating with the information they know, but they are also in a development phase where they have to talk to government and the Commonwealth Treasury. As they have more information, they will come to the market and allow us to all know what they are thinking, but it is still a work in progress.

DEMAND FOR RMBS, SENIOR BANK DEBT AND INFLATION-LINKED BONDS

Cooper Looking at residential mortgage-backed securities (RMBS) and senior bank debt, should they simply be excluded from banks’ liquidity books? How do you think that could impact the markets broadly, and your likelihood to invest in these asset classes?

■ SCOBIE If RMBS is excluded, clearly it will make it fairly difficult for that market to price significantly in from where it currently is. My understanding is that if spreads stay at around 130 basis points over swap it is not economic for banks to securitise, so it becomes quite a difficult market given that RMBS is a large part of banks’ balance sheets. It will be problematic for them.

If banks’ senior debt is excluded they will be forced offshore to fund, and if you look at the pricing differentials between offshore and onshore it is relatively large. We leave domestic deals alone and focus on offshore deals, and we’re certainly getting a better pick-up – we are taking on basis risk but we are prepared to accept that.

Michael Bath, Australian Office of Financial Management Cecily Williams, how much unmet demand do you estimate there is in the long-dated inflation-linked space? Is there much volume of defined benefit superannuation in Australia that is not sponsored by either a state or the federal government?

■ WILLIAMS Not among our clients, but there is a lot of discussion about inflation-linked bonds, and there is a lot of analysis of the pros and cons of using that asset class. There are issues – for example about whether they will be a good inflation hedge and, if they are a good inflation hedge, whether the price is right, and then whether it is a market you want to be in anyway. The illiquidity of the inflation-linked market and the number of issues in play in Australia lead us to conclude that it is probably not big enough and liquid enough to be a permanent part of a portfolio.

We always give our managers scope to invest in inflation-linked bonds, and at the moment we are seeing the duration risk of an inflation-linked bond perhaps offsetting the real return component if we do have rising yields and inflation going forward. We are not enthusiastically jumping into any inflation-linked bonds across our client base, which is not to say that some of our clients won’t warrant an allocation and trade that sector. But as a market it has a lot of shortcomings preventing permanent allocation across our client base.

THE IMPORTANCE OF LIQUIDITY

Cooper We have been seeing larger lines issued by supranational, sovereign and agency (SSA) issuers recently. Have investors seen liquidity increase as a result of the increased deal sizes and volumes coming through?

■ CARRUTHERS We do distinguish between triple-A markets, so if we are taking a macro sector view in size we are thinking about our potential ability to turn that ship around relatively quickly. We don’t want to be stuck in something we can’t sell or rotate.
It is definitely encouraging to see the larger benchmark SSA lines, because they suggest the composition of books has improved. There has been an increase in reverse enquiry from Asia, private banking, Asian central banks and European investors. This has led to a real increase in the depth and amount of tickets being printed in these deals, which is quite encouraging. It’s almost circular to some extent – once you see more depth, liquidity should become a little more favourable.

Cooper We have talked about liquidity for banks and liquidity for issuers. Anne Anderson, how much liquidity is there in funds at the moment? Is there a lot of cash and more to do on the investing side?

ANDERSON There is strong cash flow, cash rates are still quite low, and credit has been very well priced. International investors are attracted to the strong Australian dollar and the relatively high yield levels on offer in Australia.

So there is plenty of cash and a lot of money is waiting for corporate issuers to come. In our market, there is limited paper available – and that is why people are buying offshore bonds and swapping them.

SCOBIE In terms of cash, we have been fully invested for some time and we remain so. We have been a fair way down the credit spectrum in terms of fixed income investment, so this year we are likely to become more conservative as the ebb goes on: we are likely to build up cash, all things being equal.

Our focus has been largely global – we have looked at global bonds and swapped them back. Credit default swaps (CDS) are an integral part of our strategy – we run overlays across all our books and the CDS markets on which we are particularly focused are Europe and the US.

The reason for that is they have deep, liquid markets with easily-available information, as well as names we have been researching for years and which we understand.

In the main, there has not been a problem with pricing – pricing is tight and that is a differentiating point from the Australian market. There are only a handful of names in Australia which trade and you can’t always get a price, and sometimes when you get the price it is a long way away from where it should be.

Cooper How do you view the likely liquidity that will remain in government-guaranteed lines after the scheme expires?

SCOBIE Going forward, liquidity will fall away but there will be scarcity value. It is difficult to give a definitive answer, but you can look at what has happened elsewhere: typically, when markets have realised there is no new supply they move on unless there is a relative value opportunity. Once supply dries up, securities quickly become relatively illiquid and relatively infrequently priced. I suspect this is what will happen with the guaranteed market here.

In that respect, we look at it in terms of relative value. And from our perspective we were typically prepared to buy unguaranteed paper from the outset in the belief that it should give better risk-adjusted returns. That is not to say we don’t hold some guaranteed paper, but there has not been an overweight allocation. I suspect it will become less relevant for investors in the next year or two.

Cooper One of the issues being reported right now is potentially increasing the requirement of fixed income holdings within superannuation funds. Cecily Williams, what is the impact of that and should it happen?

WILLIAMS This is not something we are necessarily anticipating. We do expect that more illiquid assets may be permitted in a default option, and those illiquid assets include credit to some extent – as well as private debt and direct property.

We anticipate that the kinds of liquidity requirements the funds have to offer their investors will change – there will be a longer period before investors can take money out, and that will give access to different types of assets including different types of credit assets.

We view fixed income increasingly as a global world and we don’t necessarily see a problem with issuance volumes of global sovereign debt. The supply of sovereign is not necessarily an issue if investors have to hold more fixed income. We anticipate there being lots of changes in the default option: we are expecting that and we do see opportunities in the fixed income space post the global financial crisis.
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