Daintree
CAPITAL

Absolute Return Fixed Income Specialist

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Daintree Capital

As specialists in the management of absolute return income portfolios, our key focus is to offer higher returns than what is generally available through banking and other cash products. At Daintree Capital we focus on capital preservation as a cornerstone of our investment philosophy. Our boutique structure ensures that our interests are fully aligned with those of our investors.

Partnership with Perennial

Daintree has partnered with Perennial Investment Management Limited (Perennial) who together with associated companies manage $5.4 billion on behalf of retail and institutional investors. Perennial oversee the Responsible Entity and back office support functions of Daintree Capital.

Mark Mitchell
Director, Portfolio Manager – Credit

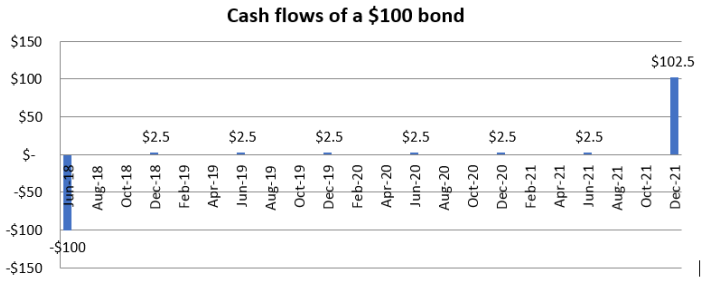
FIXED INCOME SECURITIES EXPLAINED: CORPORATE BONDS

Let's lift the lid on fixed income investment jargon as we uncover the different types of fixed income securities.

We begin with traditional corporate bonds which are effectively a contractual obligation to pay – very similar to a loan. The issuer of a corporate bond is borrowing money, while the purchaser (investor) is providing capital for the company to use. Company's issue bonds for a variety of reasons including business expansion, acquisitions, and to fund share repurchases and dividends. Countries and States also issue bonds to fund infrastructure projects and services to the people. These are known as government bonds such as the 30 Year US Treasury.

In exchange for providing a loan, investors expect to be paid interest over the life of the investment and to have their original capital returned at maturity. The terms of the arrangement are agreed in advance. There are many conditions that must be agreed but two of the key ones are the length of the loan and the amount of interest to be paid. This can explain why it is called fixed income. The longer the term, the more interest borrowers have to pay. The riskier the borrower is perceived to be, the more interest they will have to pay.

Below is an example of a typical cash flow for a bond. An investor provides the borrower $100 on day one. If we assume a 5% agreed rate of interest, the investor would expect to receive their interest throughout the year at regular intervals. In our example that is roughly 2.5% or $2.50 every six months. Then, at the end of the agreed period the investor receives their final $2.50 coupon, as well as the original $100 provided to the borrower.



Corporate bonds are widely held in fixed income portfolios both in Australia and overseas. They are generally much safer than equities (shares)as they provide a contractual obligation to pay income, unlike dividends which can be reduced or stopped at any time. A diversified portfolio of high quality bonds provides a regular, stable income stream, as well as materially better capital preservation (chance of getting your initial investment back) than seen in equity portfolios.

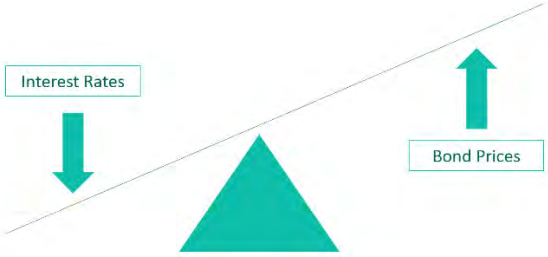
RELATIONSHIP BETWEEN BOND PRICES & YIELDS

Investors who are new to the bond market are often a little confused by the relationship between bond yields and bond prices.

The yield on a bond has gone from 4% to 3%. Is that a good or bad thing? The answer is it depends. If you already own the bond it's a great thing because you have realized some positive performance. However, if you were thinking about buying this bond the expected return of the bond is now lower given the rally in price already witnessed. Unlike stocks which theoretically have no limit as to how far they can rally, bonds are a contractual obligation to pay a fixed amount, so they will tend not to move too far away from the value of those agreed payments.

Bonds are generally issued at par or a price of $100. The value of a bond is estimated based on the present value of all expected future cash flows. If the price of a bond is par, then the expected return to maturity is roughly equivalent to its coupon. However, if the price of a bond is trading above par then the expected future return will be less than the coupon. If you buy a bond at $101, but only get $100 back at maturity, then the extra $1 paid at the time of purchase will detract from the overall return.

Let's say a company issues a bond with a 4% coupon and a 10-year maturity. A year later the prevailing fair value for a similar 9-year bond is 3%. Because the bond issued a year ago has a higher expected cash flow stream than newly issued bonds, the price of that bond will have traded up to reflect its higher relative value compared to similar bonds. The price of the bond will have increased roughly to the point where its expected 9-year annual return will have dropped to 3% in-line with fair market value. It's these changes in secondary market prices that allow bonds with different maturities and coupons to be compared and efficiently priced in the secondary market. This is why there is an inverse relationship for fixed rate bonds between interest rates and the price of previously issued bonds as demonstrated below.



The potential negative change in the value of a bonds caused by the change in prevailing interest rates is called mark to market risk. This is a risk that must be considered and managed when purchasing an individual bond or constructing a bond portfolio.

Brad Dunn
Senior Credit Analyst

RESPONSIBLE INVESTING IN FIXED INCOME – NOT QUITE AS EASY AS IT LOOKS

Responsible investing is about much more than just evoking the common catchcry of Environmental, Social and Governance (ESG). Fixed income investors need to employ a more nuanced approach to get the most out of responsible investing. We will share a few strategies that we believe are suited to fixed income investment. First, we will define the analysis framework in a more intuitive way, and introduce the concept of materiality. We will investigate the challenges of engagement for fixed income investors and how these interactions can be leveraged most effectively. Finally, we will assess some of the practical ways that responsible investing can be implemented at the individual bond level, essentially letting the investment dollar do the talking.

(Re)-defining the framework

Every business, large or small, has a unique set of characteristics and challenges. Therefore, assessing a business through the lens of a rigid grouping of factors across three major domains will almost certainly lead to sub-optimal outcomes. So how do we balance our analytical approach given limited time and competing priorities?

We believe one answer could be to adjust the analysis framework. In other words, approaching each issue based on how much influence the business can have on the outcome (internal factors) and those elements which a business has to comply with, respond to, or is generally out of its control (external factors).

A good example of this approach is with coal miner New Hope Coal. Putting aside any philosophical objections to fossil fuels, the two photographs in Figure 1 were taken six years apart, and demonstrate the remarkable efforts the business has taken to remediate a former mine site well above standard requirements, to the point that there are now grazing operations active on the site, with significant reforestation also underway in keeping with the local environment.

The requirement to remediate the site was an external requirement imposed by the state government as part of the mining lease conditions. However the additional effort to bring the land back to grazing quality and other measures were an internal decision taken with the community and the environment in mind.

Figure 1: Mine site remediation – going above and beyond

2012

2018

Source: New Hope Coal Limited

The current situation at AMP is another case in point. Incoming chairman David Murray raised eyebrows recently when he outlined his plans to give more control of the operational performance to the CEO, allowing the board more time to consider broader strategic issues. This has put AMP on a collision course with the ASX and many corporate governance advocates who have spent years making corporate governance principles more prescriptive, and applied at board level. Obviously, it is important that the board retains a strong oversight power, but we tend to agree with David Murray in that strong businesses ultimately require strong leaders that are given sufficient scope and leeway to execute their vision.

The importance of materiality

While changing the analysis framework can help to improve our understanding of the business, undertaking a full review would be very time consuming. Therefore, we need a way to focus the analyst's attention and ensure that the most important factors are pinpointed. One way to do this is to estimate the materiality of an ESG theme.

Materiality can be defined as the likelihood that a particular factor will influence the performance of a business, which could in turn have an impact on earnings, the environment, the community or its reputation. Materiality is ultimately subjective but researchers such as MSCI have made solid progress on estimating materiality at the sector level (see Figure 2).

Some of the risk assessments are self-evident, such as the materiality of climate change, pollution and the like for the mining, energy and utilities sectors compared to other sectors such as health care. However, despite the increasing shift to automation across many industries, MSCI identifies a Medium or High risk intensity to the management of human capital in all businesses.

Figure 2: MSCI ESG Risk Intensity

	Energy	Materials	Utilities	Consumer Staples	Health Care	Industrials	Information Technology	Consumer Discretionary	Financials	Telecom Services	Real Estate
Environmental											
Climate Change	High	High	High	Indirect	Low	Med	Low	Low	Low	Low	Med
Natural Capital	High	Med	High	High	Med	Low	Med	Med	Low	Low	Low
Pollution & Waste	Med	High	High	Indirect	Low	Med	Low	Low	Low	Low	Low
Social											
Human Capital	High	High	Med	Med	High	Med	High	High	High	Med	High
Product Liability	Low	Low	Low	Indirect	Indirect	Low	Low	Low	Low	Indirect	Low
Governance											
Corporate Governance	High	High	High	High	High	High	High	High	High	High	High
Corporate Behavior	High	Med	Med	Med	High	High	Med	Med	High	High	Med
ESG Risk Intensity	10	9	8	6	6	5	3	3	3	3	3
	Very High	High	High	Moderate	Moderate	Moderate	Moderate	Moderate	Moderate	Moderate	Moderate

Source: MSCI

With the focus channelled on those areas where the risk intensity is high, it is more likely that any significant red flags with the potential to impact performance will originate from these areas. Once we have the full view of the potential risk identified, the focus can turn to pricing these risks as part of the investment process. In the New Hope case, track record in previous rehabilitations helps to address the Natural Capital and Pollution categories in Figure 2. In the AMP example, the Chairman's proposed changes are related to the Governance factors and Human Capital, where risk intensity is estimated to be high.

The question of engagement

One way that investors can express their views when it comes to responsible capital allocation is through direct engagement with company boards and management. Fixed income investors find this much more difficult because they have a fundamentally different relationship with an issuer. Whereas equity investors have the board and management answerable to them as owners of equity in the business, fixed income investors have only a contractual relationship via their bond holdings. This does not mean that fixed income investors should push ESG analysis into the dark corner of their desk. The reality is there are often indirect opportunities to engage with company boards and management, such as:

- when a new bond is offered,
- during result announcements (for publicly listed companies), and
- via interaction at industry conferences and events.

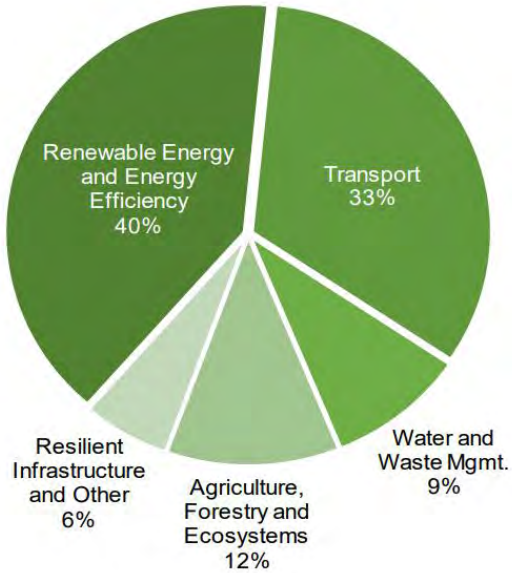
In each case, it allows specific ESG themes to be addressed in the public domain. While the company representative may be unable or unwilling to address the question in much detail at the time, simply asking the question will raise awareness in the broader market.

Practical incorporation of ESG in bond portfolios

While creating market awareness of ESG issues is important, it can be decidedly indirect. One way in which fixed income investors can take tangible steps to demonstrate a commitment to responsible investing is via specific purpose (otherwise known as "green") bonds. These securities are structured to raise money with specific intentions built into the terms. Investors can influence the allocation of capital to environmental (such as by financing renewable energy projects, recycling facilities, sustainable timber plantations, etc) or social ends (such as through social impact projects and even gender equality programs). We see great potential in these bonds to facilitate real change, and Daintree Capital actively assesses new issuance when it is offered to market.

At the global level, the Climate Bonds Initiative estimates that in just the first six months of 2018 there was almost US$75bn of green bond issuance, representing 156 issuers from 31 countries. At the institutional level, entities such as the World Bank have been issuing green bonds for Figure 3: Sector allocation, World Bank green bonds more than 10 years now, with more than US$23bn in committed, allocated or outstanding capital across

Figure 3: Sector allocation, World Bank green bonds



Source: World Bank

In Australia, financial institutions such as the National Australia Bank have taken a leading role in the development of a local green bond market. Many of the bonds are monitored by third parties to ensure compliance with bond terms, providing an extra layer of protection to investors. We see this independent oversight as an attractive feature to ensure that the bonds remain "true-to-label". Two examples are included in Table 1.

Table 1: Green Bond details

	NAB Climate Bond	NAB Gender Equality Bond
Maturity Date	16 December 2021	24 March 2022
Bond Coupon	Swap Rate + 100bps	Swap Rate + 95bps
Bond Purpose	Green bond with proceeds earmarked for financing, or refinancing, renewable energy and low carbon transport assets in Australia.	Social Bond with proceeds earmarked to finance, or refinance, organisations cited by the Workplace Gender Equality as Employers of Choice for Gender Equality.
Assurance	Climate Bond Standards certified green bond with assurance provided by DNV GL.	Second Opinion provided by Sustainalytics, with use of proceeds compliance monitored by EY.
Amount Raised	AUD$300m	AUD$500m

Source: NAB

Conclusion

Responsible investing is not a one-size-fits-all proposition. We have suggested an approach that distinguishes between internal and external factors, ranked by materiality. Investors in fixed income need to make the most of their opportunities to engage with companies, knowing that increasingly their investment decisions at the individual bond level can reap tangible results. As the sector develops over time, we expect the range of analytical frameworks to grow, allowing smoother integration into investment processes. Ultimately, this will be to the benefit of local communities, the environment, and corporate governance.

Simon Lee
Senior Quantitative Analyst

WHY YOU SHOULD ADD FIXED INCOME TO YOUR INVESTMENT PORTFOLIO

Equity markets feel familiar to most investors, whilst fixed income markets tend to be less well understood. Perhaps one reason is that compared to buying an equity, it is extremely difficult for an individual to buy a bond. It's not like you can head to a stock exchange and just buy a bond for yourself and pop it into your portfolio.

Equities are considered a growth asset, whereas fixed income products are generally more defensive, providing smaller, but much less volatile returns. However, fixed interest plays a very important role in an investor's portfolio – one of insurance. The cash and fixed interest component of your portfolio plays a role to smooth out negative returns and to limit the falls in your portfolio's value when equities markets go south.

(Take a look at the breakout box below for the amount of risk Australian retirees take when compared to their global counterparts.)

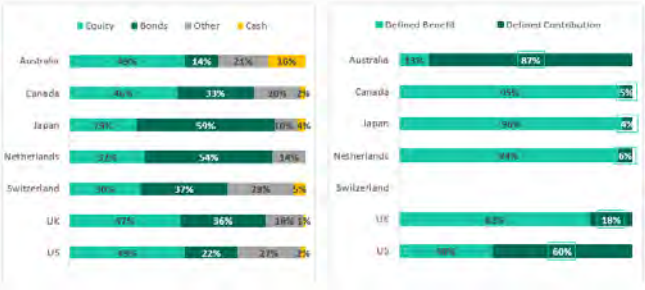
For simplicities sake: Let's compare equity versus fixed income returns of a $100 investment from 2005 to 2012 to illustrate the defensive role fixed income can play in volatile periods, such as the GFC:

Past performance is not a reliable indicator of future performance.

Overall, the fixed income index achieved the highest total return, and with the least volatility. Furthermore, the mixed equities/fixed income portfolio generated a higher return than the pure equities portfolio but with approximately only half the volatility. This is a good example of how fixed interest can improve portfolio outcomes.

At Daintree Capital, we are very aware of the role that fixed interest plays in your investment portfolios and, given our absolute return style of investing, we aim to achieve a positive return across all market cycles. Our Core Income Fund is intended to be just that, the core part of your fixed income portfolio. You can find out more about the portfolio here.

Global Retirement Fund Comparison



Not only does Australia have the joint highest equity and lowest bond allocation but Australia also has by far the largest defined contribution style split. (There are a number of reasons for this including our generous franking credit regime, although we are not addressing the reasons why here.) However we are pointing this out as it highlights that Australians are taking comparatively more risk than investors in other countries with their retirement savings.

Simon Wang
Senior Credit Analyst

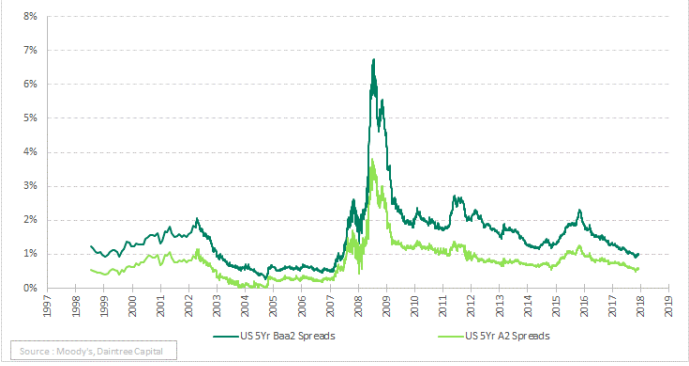
WHAT YOU SHOULD KNOW ABOUT CREDIT SPREADS

A credit spread represents the additional risk (or risk premium) added on to a base interest rate (usually the rate of a government bond) when pricing corporate bonds. Credit spreads are closely related to a company's estimated likelihood of default.

A riskier company's bond would have a higher credit spread to compensate for the additional risk. As credit spreads tighten (contract), a corporate bond is seen to be more expensive due to it offering a lower yield. The global low interest rate environment has led to a hunt for yield across asset classes, where in the bond space we have seen credit spreads contract across all rating bands.

As you can see in the chart below, after the GFC, spreads have been contracting almost without hiccup since 2012. In the investment grade (IG) rating spectrum, Aaa is seen as the safest bonds, followed by the A band, while the Baa band sits at the bottom of the investment grade ratings. From the chart below, you can see that investors are receiving approximately 1% less return per annum on a 5-year Baa US corporate bond (bottom IG band) now, than in 2016. In fact, investors in Baa-rated paper are now receiving the same return that investors in A rated paper (middle IG band) were receiving in 2016. (More information can be found on credit ratings in the breakout box below).

Whilst there has been a long period of spread contraction, you can see in the chart below that spreads right now are still not as tight as levels seen pre-GFC, where 5 year Baa spreads reached a low of 26 basis points vs ~101 basis points now. Daintree Capital, being an absolute return manager, provides you the flexibility, via our Core Income Fund, to take advantage of spreads whether they continue to tighten or, indeed, widen. This allows us to provide you, as an investor, a stable return regardless of the direction of credit spreads.



Brad Dunn
Senior Credit Analyst

TERM DEPOSITS. DO THEY MAKE GOOD INVESTMENTS

Term deposits. Banks talk about them all the time. They mention interest rates and maturity rates but we want to look at them more broadly from an investment perspective. Do they make good investments?

What is a term deposit?

A term deposit, as the name implies, involves depositing money with an authorised deposit-taking institution (ADI) for a set period of time. Typical investment periods can be anywhere between one month all the way up to five years. Interest accrues over the life of the deposit, and is either paid periodically or, more commonly, at the end of the term.

For example, a $100,000 term deposit with Bank A for a term of one year at a rate of 2.5% per annum would return $102,500 back into your bank account at maturity. Alternatively, Bank B might offer you a rate of 2.7% per annum if you invest for two years, with interest paid annually.

What else should I consider?

The interest rates offered are based on a range of factors, including the type of depositor (e.g. an individual, SMSF, corporation), the proposed term, and what the ADI's internal requirements for deposits are. Essentially, banks use deposits to make loans to other customers, charging borrowers a higher rate than what they pay for deposits.

Term deposits are very difficult to break once they are established. Generally speaking, if you wish to break a term deposit before its maturity date, you would need to provide at least 31 days' notice, and you may also be charged an early withdrawal fee which would reduce your overall return. If having access to your cash quickly is important, you could purchase a one month deposit, but at the current rate of about 1.9% per annum, you would be sacrificing 0.3% per annum compared to a six month term deposit (Figure 1).

Figure 1: TD Interest Rates

Source: RBA. Rates are for a $10,000 investment.

When investing money at set rates, reinvestment risk is worth considering. When it comes to term deposit, reinvestment risk relates to your bank or ADI not having attractive interest rates when you have cash available to invest. Shopping around for the best rate would be time consuming and create an administrative burden.

Are term deposit worth it?

Term deposit rates are currently very low. After accounting for inflation the real return is close to zero, meaning your cash, while safe, is not really working very hard. Because term deposit rates are connected to bank profitability, there is no guarantee that if the RBA increases the cash rate that term deposits will follow.

Generating a sufficient, reliable income in today's market requires consideration of a wider range of options. Cash provides stability, but the price of that stability is high in the form of foregone returns. Daintree's low risk approach seeks to achieve a better balance between income and flexibility by investing in high quality and readily tradeable credit securities.

Brad Dunn
Senior Credit Analyst

ESG IN FIXED INCOME – CAN IT BE DONE

Incorporating Environmental, Social and Governance (ESG) analysis into fixed income has progressed by leaps and bounds in recent years. While a thorough analysis of each of the key ESG themes takes place as part of a company review, at Daintree we are taking this a step further by seeking to determine the materiality of those factors.

Materiality can be defined as the likelihood that a particular factor will influence the performance of a business, which could in turn have an impact on its earnings, the environment, the community or its reputation.

Materiality is ultimately subjective, but research groups such as MSCI have made solid progress on estimating materiality at the sector level (see Figure 1). Some of the risk assessments are self-evident, such as the materiality of climate change, pollution and the like for the mining, energy and utilities sectors compared to other sectors such as health care.

Figure 1 : MSCI ESG Risk Intensity

	Energy	Materials	Utilities	Consumer Staples	Health Care	Industrials	Information Technology	Consumer Discretionary	Financials	Telecom Services	Real Estate
Environmental											
Climate Change	High	High	High	Indirect	Low	Med	Low	Low	Low	Low	Med
Natural Capital	High	Med	High	High	Med	Low	Med	Med	Low	Low	Low
Pollution & Waste	Med	High	High	Indirect	Low	Med	Low	Low	Low	Low	Low
Social											
Human Capital	High	High	Med	Med	High	Med	High	High	High	Med	High
Product Liability	Low	Low	Low	Indirect	Indirect	Low	Low	Low	Low	Indirect	Low
Governance											
Corporate Governance	High	High	High	High	High	High	High	High	High	High	High
Corporate Behavior	High	Med	Med	Med	High	High	Med	Med	High	High	Med
ESG Risk Intensity	10	9	8	6	6	5	3	3	3	3	3
	Very High	High	High	Moderate	Moderate	Moderate	Moderate	Moderate	Moderate	Moderate	Moderate

Source: MSCI

With the focus channelled on those areas where materiality is high, it is more likely that any significant red flags emanating from these themes will impact performance over time. Therefore, using a materiality approach we hope to identify potential risks sooner and avoid companies that do not demonstrate a commitment to improving ESG outcomes where we assess the risk intensity to be material.

The ESG thematic in fixed income continues to evolve at a rapid pace. We believe that using a materiality approach has improved the quality and efficiency of Daintree's ESG process and allowed us to stay at the forefront of developments.

Justin Tyler
Director, Portfolio Manager

PROBLEMS WITH FIXED INCOME INDICES

Is my fund manager doing a good job?

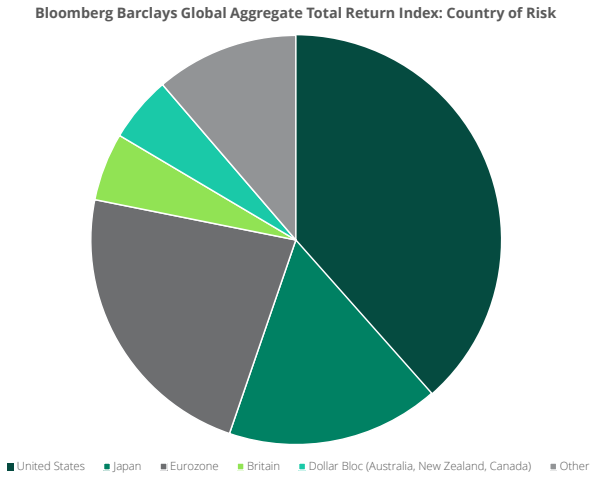
Fund managers play an important role in the provision of secure retirements for millions of Australians. So it is important to be able to assess whether a fund manager is doing a good job on behalf of investors. It remains very common for market benchmarks to be used in this assessment process; for example, Australian equity managers may be assessed with reference to the S&P/ASX 200 Accumulation Index – the more they outperform, the better they are perceived to be.

When it comes to the fixed income asset class, however, this approach is problematic. In this piece we will first outline the reasons why this is the case. We will then comment on alternative approaches and suggest a practical way to address the question of whether your fixed income fund manager has done a good job, or not.

In indexing an appropriate framework?

Funds management is a very quantitative endeavour. The performance of managers is measured on a daily basis. The phrase "lies, damned lies, and statistics" comes to mind though, because our industry has many ways of defining success. The main one is outperforming a given market benchmark. In fixed income, the Bloomberg Barclays Global Aggregate Index is one such benchmark. It contains a wide variety of bonds including those issued by governments, sovereign agencies and municipalities, and corporates. Each bond is weighted by its size; which means that the largest bond issuers are those with the largest index representation.

The Figure 1 below shows the country of risk grouping in the Bloomberg Barclays Global Aggregate Index. Notice the predominance of the United



Source: Bloomberg, Daintree (as at 24/09/18)

Issue: Outsized investments in the largest issuers of debt

This is an important flaw of benchmarks in the fixed income universe. Remember, an entity issuing a bond is, all else being equal, increasing its debt. The more bonds that a company or other bond issuer has outstanding, the greater the representation that issuer will have in the index. Thus the United States and Japan are the largest countries represented in the Bloomberg Barclays Global Aggregate Index. We could show other indices as well and the same issue would be apparent.

Investors who follow fixed income benchmarks are often compelled to invest ever greater amounts of money in the bonds of issuers with large amounts of debt already outstanding, eschewing more attractive risk-adjusted expected returns elsewhere. This clearly fails the common-sense test. In fact, the optimal approach to fixed income investing leads to the exact opposite situation, whereby investors allocate more cautiously to entities with more debt outstanding. Why? There are two main reasons that are best illustrated by comparing bonds to equities:

1. An equity manager may be rewarded for a concentrated position in few stocks. A bond manager will not. In fixed income, upside returns beyond the income expected at the initiation of the investment are limited.
2. Both equity and bond investors face the total loss of capital in the event that something goes wrong.

The table at the end of this paper contrasts the characteristics of bonds with those of equities more fully. For now, the main takeaway is that given the asymmetric risk profile of bonds it makes no sense to make large, concentrated bond investments. There is simply no likelihood of the sort substantial upside performance that might justify an investor taking this sort of risk, and this is particularly the case where credit risk is heightened because an issuer already has a lot of debt outstanding.

Issue: Opportunity costs

Fixed income markets are extremely large and diverse, and are multiples of the size of equity capital markets globally. There is a huge diversity of issuers in the bond market for investors who are sufficiently resourced and incentivised to look for good risk-adjusted returns. This illustrates another problem with indices in bond markets: indices have become less representative of the rich opportunity set available, because increasingly they have become dominated by the issuance of large bond issuers, like governments. There is no single index that does even a reasonable job of representing the very large investable universe. That is the case locally, and even more so the case offshore. Thus, investors who use benchmark-focused approaches are suffering a meaningful opportunity cost. The index dictates investment decisions that should, in fact, be dictated by careful research of whether risks are being adequately compensated.

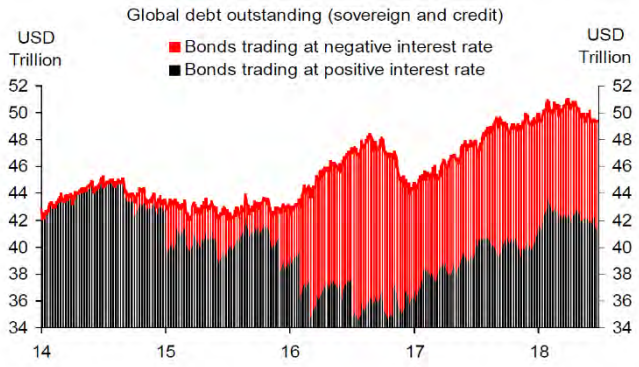
Issue: Timing of investment

In fact, investors who follow indices often incur actual costs too. Consider the decision a borrower faces when fulfilling their funding needs. Sometimes there is an imminent need that determines timing, but often the decision is based on price. That is, bonds will typically be issued when an issuer considers the cost of doing so to be low. Lower cost issuance means lower expected returns for investors and when investors bid up the price of some new issues because of likely inclusion in an index, expected returns are reduced still further.

Once a bond enters a benchmark index, this cycle of perverse behaviour can continue. Consider what an investor should do if a bond increases in price by more than similar bonds. Given our comments earlier about the significant breadth of opportunity in global fixed income markets and also the limits to upside potential in fixed income investing, common sense might dictate reducing exposure. An appropriately directed research effort is likely to uncover another bond with a similar risk profile that offers investors a better income stream. Is this the course of action a benchmark-hugging investor is likely to take? Perhaps not. In fact, such an investor may feel compelled to do the opposite, because weightings in benchmarks increase with price. An egregious example is the

massive issuance of bonds by government issuers engaged in quantitative easing. This has pushed the yields of an increasing basket of bonds into negative territory, as shown in Figure 2 below. Outside of official demand, much of the demand for these bonds is likely to come from investment managers who are beholden to market benchmarks. This is a point that bears highlighting: investors who follow market benchmarks are in some cases not even being paid an interest income by some bonds in their portfolio. Instead they are paying bond issuers for the 'privilege' of holding their stock so that they can replicate their chosen benchmark as closely as possible.

Figure 2: Stock of bonds with negative yields



Source: Deutsche Bank (as at 24/09/2018)

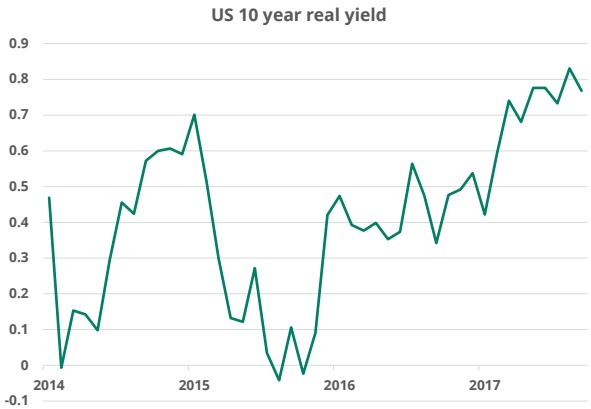
Issue: Flawed manager incentives

The issue of flawed manager incentives among those who follow a traditional approach to the management of fixed income portfolios extends still further. At a more basic level, this misalignment of incentives is at the heart of the rise of absolute return investment approaches. What services should a fixed income fund manager be providing for their clients? A benchmark-focused manager aims to outperform the benchmark; is this sufficient? If an index is down 2% and a fund manager is only down 1% the fund manager will be pleased with their efforts, but will the end investor also be pleased? Investors have many different risk/return preferences, time horizons and so on; but many view losing money as a poor outcome, full stop. They will not be satisfied if a fund manager outperforms a benchmark and yet still loses money. At Daintree, we believe that the strong growth of absolute return fixed income funds over time shows that this mismatch between fund manager incentives and investor expectations remains an issue among the end users of fixed income.

Issue: Interest rate risk

The final issue that we highlight concerns interest rate risk. Many fixed income indices are biased towards (and often exclusively focused on) fixed rate bonds. For example, the Bloomberg/Barclays Global Aggregate Index mentioned earlier has seen its duration drift from 5.3 pre-crisis, to more than 6 today. This is partly due to issuance patterns through time, but it is also reflective of the market environment because all else being equal, as interest rates fall the duration of fixed rate bonds increases further. Unconventional monetary policies in various jurisdictions have been the main culprit for lower yields globally. Right now, markets are grappling with the fallout as these policies start to reverse. Financial conditions around the world have start to tighten after years of easy money and strong financial asset returns (Figure 3). Bond investors taking duration risk are at the forefront of this shift, and just as the interest rate sensitivity of their portfolios has hit its maximum point, they now face the inevitable headwinds of capital losses that will reduce the expected returns of their fixed income holdings for the foreseeable future.

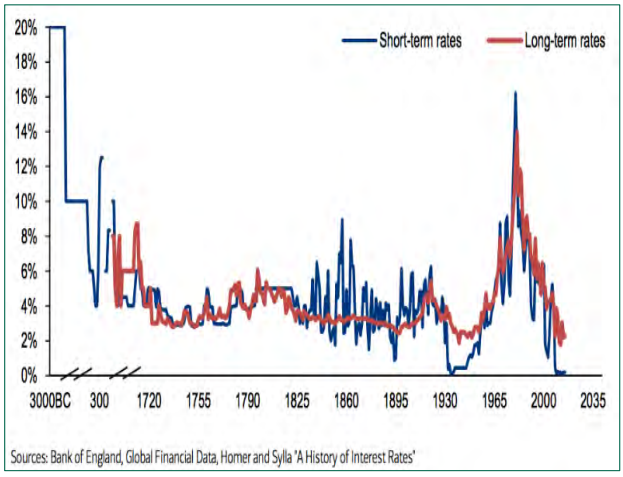
Figure 3: US 10yr real yield



Source: Bloomberg, Daintree

Capital losses are one issue such investors are facing; another related issue is defensiveness. Index-aware investment approaches are used by many investors in large part because they expect this part of their portfolio to offset losses in their equity portfolios. Historically, duration has been the most important driver of this defensive behaviour, causing fixed rate bonds to rise in value as interest rates and equity prices fall. But with bond yields at lows not seen for literally thousands of years (see Figure 4 below), bond prices do not have the same ability to rise as they once had. Of course, central banks in some jurisdictions have resorted to negative interest rates to increase the scope for bond prices to rise. Even then, however, there are greater limits to bond price appreciation now than have been the case for some time. As Figure x below shows, this has reduced the ability of a 'traditional', duration-heavy bond allocation to play the role of shock absorber in a multi-sector portfolio.

Figure 4: Interest rates are at extraordinarily low levels



Asset class	Nature of returns	Nature of risk	Implication for investors
Fixed Income	➢ Regular interest payments ➢ Return of principal at defined maturity date ➢ Income payments explain the vast majority of returns over time	➢ Bonds are exposed to a range of market risks. For example if interest rates rise, the price of bonds that regularly pay a fixed rate of interest will decline ➢ As long as there is a high likelihood that the bond issuer will make interest and principal payments as agreed, such risks are short-term in nature. Ultimately, income payments and principal repayment will explain the entire return of the bond if it is held until it matures ➢ If markets decide that there is a chance that principal or interest repayments will either be delayed or will not happen at all (i.e., a default), the price of a bond will decline sharply and there is a real risk of capital loss	➢ Bonds offer regular income, but no lasting participation in the upside of a company ➢ Bond investors face the risk of capital loss if interest or principal payments are not made in a timely fashion. ➢ The returns of bonds through time are therefore negatively skewed. Returns are positive most of the time, but occasionally investors will be exposed to a large loss ➢ Therefore there is little incentive to invest a large amount of money in a single bond, because there is little potential for upside. Conversely there is a strong incentive to hold a very diversified exposure to bonds, because then if losses happen the exposure is small
Equities	➢ Regular dividend payments, however companies are not under a contractual obligation to pay dividends ➢ Principal is not returned unless an investor sells ➢ Company performance and prospects are the main driver of returns through time	➢ Equities are exposed to broad equity market risk, as well as a range of idiosyncratic risks specific to company, sector or jurisdiction ➢ Equity prices can rise or fall sharply, dependent upon how all of the relevant risks are perceived by the market ➢ If bond prices fall, investors should remember that such falls will be temporary if income and principal payments are made as agreed. Equity holders may face losses that may persist for a much longer period of time ➢ Conversely, if a company outperforms expectations an equity investor can make an outsized gain	➢ Some equities offer regular income, but such income can be reduced or stopped dependent upon the needs of the company ➢ Equity holders face steep losses at times, but also have the opportunity to enjoy large gains. The return profile is thus more symmetric than for bonds. Investors will experience a range of positive and negative returns through time, and at times these returns (positive or negative) will be large ➢ Whilst there is little incentive to invest a large amount of money in a single bond (because there is little potential for upside), an equity investor may profit handsomely from a judicious, concentrated position in a single stock

Solutions

We have outlined a number of reasons why a benchmark-relative approach to fixed income is sub-optimal. Broadly, there are two courses of action investors might take as a result. The first is to change the nature of the benchmark.

Potential solution: Smart beta

A number of index providers have proposed changes to benchmark indices designed to address some of the issues listed above. Such approaches are commonly called 'smart beta' and involve altering the weighting methodology used to construct indices. In fixed income, one such change might be to weight bonds in an index according to metrics that impact issuers' ability to repay debt. Sales, cash flow, or book value of assets are all metrics that come to mind; for example, a corporate bond benchmark may be constructed with larger weights to companies with better cash flow generation. Such a benchmark would go some way to alleviating the issue mentioned above, whereby traditional benchmarks shepherd investors toward companies that have a large amount of bonds on issue.

As such, a smart beta approach represents a more logical choice than a traditional benchmark for a fixed income investor. But such an approach does nothing to address any of the other issues we highlighted. This is why Daintree believes that the best way to manage a fixed income portfolio is to remove benchmarks from the discussion entirely.

Optimal solution: Absolute return: Benchmark agnostic

An investment in fixed income can be constructed in a very risk aware way without the somewhat arbitrary restrictions that a benchmark introduces. For example, a benchmark may lead an investor to certain biases (intended or unintended) in terms of interest rate exposure, sectoral exposure and the like. If an investor does intend to bias a portfolio in a particular way, the manager can be directed to invest with the appropriate bias in mind – a benchmark index does not need to be in place to facilitate this. For example, duration exposure could be tightly controlled without the need for a traditional benchmark to play that role in portfolio construction.

The whole pitch to investors is therefore changed. Instead of outperforming a benchmark with minimal tracking error, success is defined as delivering the targeted return in the context of specifically targeted risk exposures that are tailored to bond investors, not to an index provider's rules that may instead advantage bond issuers. The trade-off is that the manager has full access to global fixed income markets in order to construct portfolios that fulfil these goals.

This is what absolute return fixed income managers like Daintree Capital seek to achieve. Truly active management should mean that managers are not beholden to arbitrary benchmarks. End investors are able access a portfolio where expected returns and risk tolerances are carefully defined, and the following issues are ameliorated:

- Investments are made solely on the basis of attractive risk-adjusted expected returns. Careful research is undertaken across the global investment universe to find assets that are likely to achieve the best risk-adjusted returns, regardless of whether such assets are part of a given benchmark.
- Opportunity costs that result from restricting the investment opportunity set are avoided.
- Investments are made when risk-adjusted returns make sense to the investor, not when issuance suits the needs of the issuer.
- The focus is on achievement of a risk/return target that can be entirely customised to the needs of the end investor. The end investor does not instead have to adapt their requirements to a market benchmark.
- Interest rate risk can be reduced to appropriate levels given current market conditions. There is no incentive to 'hug' a market benchmark that may incorporate excessive exposure to interest rates.
- Returns are positive in absolute terms, not relative terms

Conclusion

At Daintree Capital, we ignore market benchmarks. Such benchmarks are flawed constructs that do not allow for adequate risk management, do not account for the market environment or for client needs and objectives, and indeed encourage perverse manager behaviour. Instead, we assess our performance by aiming to consistently deliver our target return, while taking as little risk as possible. We never sit still: that means always looking for the most effective way to achieve our target return with minimal risk.

Simon Wang
Senior Credit Analyst

TIPS & TRICKS TO CREATE RELATIVE VALUE IN YOUR FIXED INCOME PORTFOLIO

Whenever a new bond issuance comes to the market, one of the ways to determine an indicative range of spread is through looking at the existing curve for an issuer. If there is an existing curve, you can approximately solve for what the indicative spread for that maturity issuance should be.

In this post we will look at a prior transaction in the AUD domestic market where there was a relative value opportunity through the bonds available in the offshore market.

The issuer is Verizon who are the leading US wireless provider and the 2nd largest in the wireline segment in the US. It is the highest rated US telecommunications at Baa1 by Moody's, BBB+ by S&P and A- by Fitch (for credit rating definitions and more information see our previous post here).

Verizon was a first time issuer in the Australian market in August 2017, where they issued 5.5 year, 7.5 year and 10 year maturity bonds. We will be looking at the 5.5 year issue where the spread was at 122bps over swap.

In the chart below, you can see that at the time of issuance, the AUD Verizon bond was priced at 122bps over swap. At the same time, the USD Verizon bond of similar maturity (7 months longer), was pricing at 20bps higher at 142bps over swap (converted back to AUD). We need to look out for differences in the bond documentation and terms. In this instance, apart from an upcoming tender for the USD bonds, the terms were quite similar. So by looking offshore, astute investors can pick up the same exposure to Verizon with a similar maturity for 20bps more.

Source: Daintree Capital

The chart shows that eventually the market corrected itself with the AUD and USD Verizon bonds now trading at a similar spread.

Being an absolute return manager, Daintree Capital is able to look offshore in various currencies to find relative value and capitalise on these opportunities. In this instance, we found that the Verizon USD bond of a similar tenor was giving a 20bps pickup compared to the first time issuer in AUD which would normally command a new issuer premium. This opportunity to take advantage of the relative value trade on the same issuer just by comparing the USD v AUD issuance, has created Daintree Capital investors 0.20% in added return. We are pleased with this result.

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