

MARKET COMMENTARY

Unhedged corporate bonds deliver capital losses

13 August 2009

A number of prominent corporate bond funds have delivered negative returns for the first half of the year. This has come as a surprise to some investors – particularly those who have seen domestic and global shares deliver positive returns as talk of ‘green shoots’ of economic recovery spreads.

The culprit this time is not bond defaults but a sharp rise in long-term interest rates. Ten-year interest rates have risen 1.56% in the past six months. When interest rates increase, corporate bonds – which offer a fixed return to maturity – tend to drop in value to a level that ensures the purchaser of the bond will get the new, higher rate of interest. The daily pricing of some corporate bond funds has led to negative returns over the past six months as long-term interest rates have been rising over this period.

**New Zealand long-term interest rate:
1 January 2009 to 30 July 2009**



“Following the difficulties associated with finance companies and mortgage funds last year, investors have rightly focused on investing in corporate bonds issued by high-quality household names,” says Michael Lang, Chief Investment Officer at New Zealand Funds Management Limited (NZ Funds), who oversees approximately \$310m of bond investments. “Investors are worried about the possibility of default and are therefore focused on the quality of the issuer. Although this is logical, what many fail to appreciate is that when interest rates go up the resale value of corporate bonds tend to go down – even if they have not defaulted.”

Investors who hold corporate bonds to maturity can still expect to receive their investment back, assuming the issuer

does not default. However, investors who sell prior to maturity may not be so lucky. Lang points out that most of the recently issued retail bonds in New Zealand have five or more years before maturity. “It’s fine if investors end up holding the bond for the entire period but if interest rates continue to rise and investors are really just parking cash in corporate bonds, they could be in for a rude shock when they come to sell.”

A recent example of the impact interest rate changes can have on corporate bond values is the \$900 million Rabobank Capital Securities bond that was issued in October 2007 and which is now trading at only \$0.745 cents in the dollar as at 30 July 2009, despite no change in the credit quality of the underlying issuer.

**Rabobank Capital Securities bond valuation:
9 October 2007 to 30 July 2009**



Lang says that NZ Funds utilises a portfolio management approach to managing income assets and that this is different from traditional corporate bond funds. Lang points out that while NZ Funds uses a PIE tax structure like other corporate bond funds, its portfolio approach means that clients have access to a wider range of income-producing assets than just New Zealand corporate bonds. For example, its portfolios also hold government-guaranteed bonds, mortgage-backed securities and international corporate bonds. Most importantly, NZ Funds has the flexibility to hedge against interest rate movements using derivatives such as options and swap contracts – which convert fixed-rate bonds into floating-rate bonds so that their returns rise when interest rates increase.

NZ Funds successfully hedged clients' global share exposure in late 2007, saving clients from an estimated \$150 million loss. Lang is using similar investment tools to hedge clients' exposure to rising interest rates as he thinks this could be the next big surprise for investors. "Broadly speaking, since peaking in 1981, US interest rates have been falling ever since – that's 28 years of falling interest rates. New Zealand rates have followed US rates. The risk is that interest rates will start rising as the global economy recovers and this will affect the return on income-producing portfolios if they are not correctly hedged. We're applying the same concepts that we successfully developed to protect clients from large losses in the share market to our income portfolios," says Lang. This has protected NZ Funds' income portfolios from losses during the year to date.

**US long-term interest rate:
31 December 1969 to 30 July 2009**



Lang warns that a long-term increase in interest rates may already have begun. "New Zealand 10-year interest rates increased 1.56% to 5.75% during the first half of the year from a multi-year low of 4.19% and this is possibly just the beginning."

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