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IAM INCOME ASSET MANAGEMENT CAPITAL MARKETS

Thought Piece

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The 5% Club

Recently the number of fixed-rate investment-grade bonds achieving the magical 5% mark has expanded. Uncertainty and volatility have persisted over the last few months, which has seen a selloff in fixed-rate investment-grade bonds to yields last seen back in 2013/2014.

Part of this has been led by the disruption caused by Russian's invasion of Ukraine, which has added fuel to the inflationary fire. Furthermore, while interest rates are expected to rise in both the US and Australia, markets are becoming increasingly fearful of the US curve flattening activity, which is generally noted as a recession indicator. A flatter US curve, accompanied by increasing inflation expectations, would lead to stagflation. Whether this plays out or not is unclear yet, but pressure is escalating in markets.

However, it is also useful to put these corporate/credit securities into context on a duration-adjusted basis. Focusing on BBB- to BBB+ rated investment-grade bonds, we have prepared a list of those bonds offering greater than 5% yield to next call but also calculated the yield per unit of mod duration. This is a measure of the return an investor can expect adjusted for the interest rate sensitivity inherent within the security.

Investors need to be aware of how much interest rate risk is in their portfolio. A general rule is that the longer the maturity and the lower the coupon, the more the bond price can fluctuate, both up and down. This is effectively what the mod duration of a bond calculates. A bond's mod duration is how much in percent the bond price will adjust to an unexpected 1% shift in interest rates. For instance, if you own a bond with a mod duration of 7 and then interest rates increase by 1%, the price of your bond will go down by 7%.

Security Name	Issuer Name	ISIN	Yld to Nxt Call (Mid)	Mod Dur (Mid)	Yld per Unit of Mod Dur	Fixed	Cpn	Maturity	Currency
Agif 2.9381 06/24/31	Agi Finance Pty Ltd	AU3CB0281152	5.00	7.76	0.64	Y	2.938	24/06/2031	AUD
Llcau 5.425 12/07/28	Lendlease Finance Ltd	AU3CB0259224	5.09	5.40	0.94	Y	5.425	7/12/2028	AUD
Bacau 4 1/2 12/30/30	Brisbane Airport Corp	AU3CB0272854	5.10	7.01	0.73	Y	4.500	30/12/2030	AUD
Wennex 3.15 03/31/31	Westconnex Finance Co Pt	AU3CB0279057	5.18	7.58	0.68	Y	3.150	31/03/2031	AUD
Tqlau 3 1/4 08/05/31	Transurban Qld Finance	AU3CB0279958	5.25	7.75	0.68	Y	3.250	5/08/2031	AUD
Qphfin 2.85 01/29/31	Qph Finance Co Pty Ltd	AU3CB0273373	5.26	7.50	0.70	Y	2.850	29/01/2031	AUD
Llcau 3.7 03/31/31	Lendlease finance ltd	AU3CB0278711	5.30	7.43	0.71	Y	3.700	31/03/2031	AUD
Azoau 3 03/09/28	Aurizon Finance Pty Ltd	AU3CB0278380	5.36	5.28	1.02	Y	3.000	9/03/2028	AUD
Azjau 2.9 09/02/30	Aurizon Network Pty Ltd	AU3CB0274173	5.47	7.19	0.76	Y	2.900	2/09/2030	AUD
Pnhau 3.7 09/24/29	Pacific National Finance	AU3CB0266906	5.48	6.34	0.86	Y	3.700	24/09/2029	AUD
Pnhau 3.8 09/08/31	Pacific National Finance	AU3CB0282812	5.50	7.65	0.72	Y	3.800	8/09/2031	AUD

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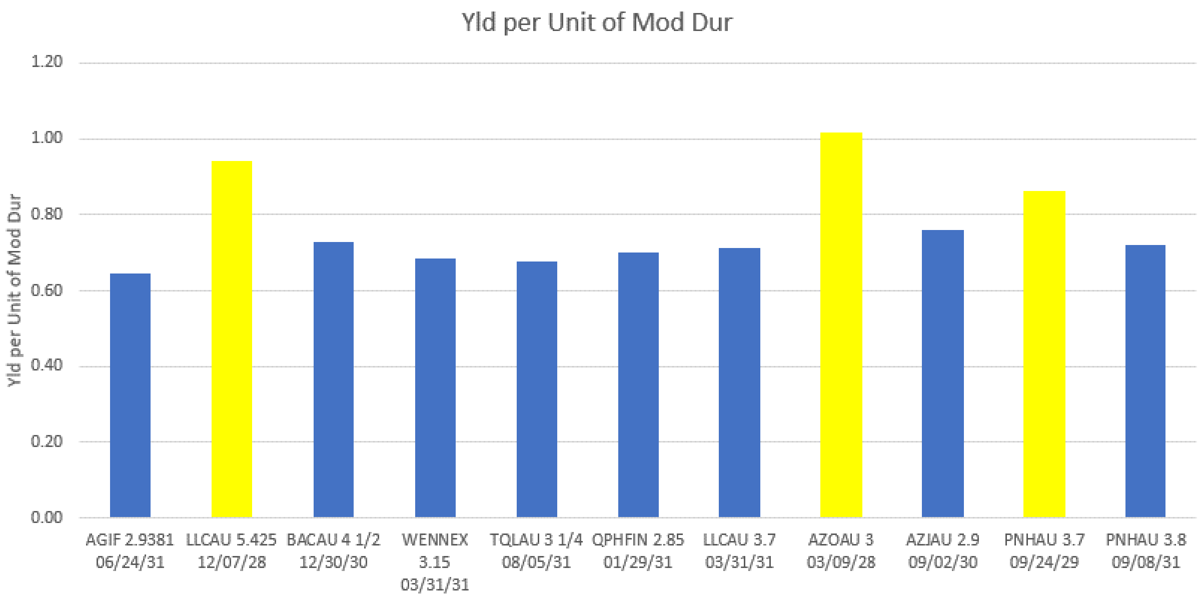
On deeper analysis of the 5% Club, there appears to be some corporate/credit securities which offer better value on a duration-adjusted basis (see *yellow* highlighted bonds). If an investor wants to manage both return and interest rate risk, they'd be better served looking at the LLCAU 5.425 12/07/28, AZOAU 3 03/09/28, and PNHAU 3.7 09/24/29 securities.

Chart 1. Yield Per Unit of Mod Dur



Source: IAM Capital Markets

Below, one can see the AusBond Credit 7-10 year index (BACR7X Index – *white line*) which is a measure of the market of Australian corporate/credit securities The index has an average credit rating of A- and mod duration of around 7 years. Interestingly, the yield did go above 5% but this was back in 2010-2013 when most global economies were still recovering from the global financial crisis (GFC).

Chart 2. Ausbond Credit 7-10 Year Index

Source: Bloomberg

The chart below shows the AusBond Credit BBB- to BBB+ Index (BACRBBB Index – Green Line) which is the best proxy for BBB credit. The data for this index stops in 2014, but that's around the last time yields on BBB rated bonds were in the mid 4%.

Chart 3. AusBond Credit BBB- to BBB+ Index

Source: Bloomberg

About Matthew Macreadie

Matthew's current responsibilities include providing credit commentary/views on the bond market and specific issuers, with the aim of aiding investors to make better risk-return decisions.

Prior to joining Income Asset Management, Matthew spent eight years working as a Credit Portfolio Manager at Aberdeen Standard, where he was responsible for the credit portfolio construction and security selection across a wide range of financial and non-financial sectors.

Matthew began his career at KPMG working in Auditing and Assurance within the consumer and industrials group. Matthew holds a Masters of Applied Finance from Macquarie University and a Bachelor of Commerce from UNSW.

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