

**Zenith Fixed Interest Release: "Savage Year Forces Re-Review of Risk"**

It's been a savage year for many fixed interest / income investors as the financial crisis deepened and losses accelerated in the latter part of 2008. While government bonds have showed their diversification appeal, some credit funds have behaved like "low beta" equity investments providing limited diversification benefits and negative absolute returns – in some cases making a mockery of their absolute return benchmarks.

Zenith conducted its **Fixed Interest Sector Review** in the "heart of the storm" of the volatility that was associated with fixed interest markets in the latter part of 2008. After reviewing an **investment universe of 88 products**, Zenith arrived at a **Recommended List of 13 funds** shown in the table below, including **5 new additions**. Zenith believes the list provides the ability to construct well diversified fixed interest / income portfolios for investors.

**Commenting on some of key issues arising from Zenith's Review, Zenith Associate Director, Ben Davis states:**

"Given the divergence of performance of funds in this sector, we have revisited the risk and return drivers of all the funds we have reviewed as part of this sector review. In addition to the risk/return factors we assessed last year, we have placed a stronger emphasis on liquidity, income and foreign exchange hedging risks."

**Sector Performance**

"While the broad divergence in performance of funds reviewed tells us that the risk of credit was understated and the benefits of government debt forgotten at this point 18 months ago, it is important that we do not rely on this data and adopt a "performance chasing" mentality. The key is to get strategic asset allocations correct to ensure the appropriate investments are chosen for the appropriate risk/return objectives and timeframes of investors.

**Status of Credit Markets**

"The events of 2008 have been described as the "perfect storm" for products with exposure credit markets. Falling prices have placed margin call pressure on leveraged investors and this situation was further compounded by higher borrowing costs (relative to risk free rates) and large scale redemptions - no doubt made worse by government guarantees on bank cash and deposit accounts. It is difficult to forecast when buyers will return to credit markets and when the deleveraging process will end, but credit market valuations now look attractive to longer term investors if they can forego short term liquidity and are prepared to weather short term volatility.

**Running Yields**

"On a running yield basis (yield of the portfolio divided by the total value of the portfolio), funds with exposure to credit markets are looking extremely attractive and this is being highlighted by many managers in this sector. While this statistic provides some guidance on the level of expected returns from a fund it should only be used in conjunction with a range of other statistics. That is, investors should have an understanding of the weighted average maturity profile (i.e. shorter maturity, lower probability of defaults), an expectation of defaults and recovery rates and ascertain whether there are any technical factors that will impact the fund's ability to achieve these running yields such as forced redemptions.

**Liquidity**

"The ability to achieve the attractive running yields highlighted by some funds could also be impacted by fund outflows which would result in forced selling at current low prices and / or potential fund closures. Forced selling could also result in managers selling their high quality, more liquid exposures and hold onto their less liquid lower quality issues. While we have confidence in the managers we reviewed it would be extremely difficult for them to take advantage of current opportunities if they are "net sellers".

**Foreign Exchange Hedging**

"The dramatic fall in the Australian dollar has exposed the currency hedging processes of some managers and impacted income distributions of "income funds". While the value of most overseas credit securities (mostly US) has risen in Australian dollar terms the collateral required to cover hedged positions has increased and this needs to be funded via either cash holdings in the fund or selling down securities if there is insufficient liquidity.

**Income Distributions**

"Income distributions have reduced significantly for some managers and in most cases this is directly related to the effects of net redemptions and foreign exchange hedging issues. While we expect funds in this sector to provide most of their returns via income, we are not overly concerned with reduced income levels in funds that target total returns and are best used as diversifiers in broader portfolios, such as most bond funds. We do have an issue with funds labelled as "income funds" who have not managed this issue effectively.

**Impact of Aberdeen / Credit Suisse Transaction on Zenith Recommendations**

"Last week, it was announced that Aberdeen would seek to purchase a range of Credit Suisse Asset Management's equity, fixed income, and balanced products, in exchange for a 25% stake in Aberdeen Asset Management. Importantly, Credit Suisse's Leveraged Investments Group (LIG) that manages the Credit Suisse Global Income Fund and Credit Suisse Syndicated Loan Fund will be staying with Credit Suisse and will not be involved in the transaction. As the Syndicated Loan Fund provides exposure to a capability that is internally managed by LIG we remain comfortable with a Recommended rating as we believe there will be minimal disruption to this Fund. Zenith will also retain a Recommended rating on the Global Income Fund. However, we note that the Fund has some exposure to investment capabilities and investment teams that are part of the proposed transaction. While we believe this can be effectively managed (based on discussions with both Credit Suisse and Aberdeen), there are a range of issues that we need to monitor over the short term. One of the key issues is closely monitoring net fund flows as we want to ensure that any potential, reactive outflows based on this announcement do not result in forced selling at current depressed prices.

**Zenith Market Outlook**

**Australian Cash** - "There are further forecasts of interest rate cuts in 2009 and with the RBA not expecting inflation to subside in the short term, there is an increased probability of earning negative "real" returns from cash in the short term (i.e. cash returns lower than inflation). This is further supported by current 90 Day Bank Bill Swap Rate Futures pricing and forecasted Australian inflation rates.

**Australian Bonds** - "Australian bonds will continue to provide diversification benefits to broader portfolios especially if conditions continue to deteriorate, although we want to stress to investors that the short term upside in total returns is now limited. That is, running yields from domestic bonds are now hovering below 5.00%. This should be noted by investors considering switching into domestic bonds purely based on recent performance.

**Global Credit** - "Credit market valuations look positive relative to historical levels. The pricing of credit securities now offer protection for 2-3 times (higher for high yield sectors) the worst level of default levels ever recorded. This provides downside protection as from this point forward investors should only suffer negative returns if defaults and recovery rates are worse than what is implied in current pricing. Zenith ultimately believes credit markets look attractive from a valuation perspective but only for long term investors that can forego short term liquidity and ride out volatility. Furthermore, we want to stress to investors that the credit markets were the first to recognise the severity of the current economic downturn and ultimately current pricing may be proved to be a correct estimate of the poor state of the global credit and economic environment.

**Media:** For a copy of the Sector Report please contact Ben Davis – [ben.davis@zenithpartners.com.au](mailto:ben.davis@zenithpartners.com.au) or Tel: 03 9642 3320.

**Clients:** Zenith clients can access the report at [www.zenithpartners.com.au](http://www.zenithpartners.com.au).

Australian Fixed Interest – Bonds	Rating
Aust Unity Vianova Strategic Fixed Interest Trust W/S	Recommended (New Addition)
Australian Fixed Interest – Corporate Debt	Rating
Macquarie Income Opportunities Fund	Highly Recommended
Perpetual's Wholesale Diversified Income Fund	Recommended
Australian Fixed Interest – Specialist	Rating
Goldman Sachs JBWere Core Plus Australian Fixed Interest Fund	Recommended (New Addition)
International Fixed Interest - Bonds	Rating
EQT PIMCO Wholesale Global Bond Fund	Recommended (New Addition)
International Fixed Interest - Corporate Debt	Rating
CFS Wholesale Global Credit Income Fund	Recommended
Credit Suisse Global Income Fund	Recommended
Credit Suisse Syndicated Loan Fund	Recommended
International Fixed Interest – Diversified	Rating
Colonial First State Wholesale Diversified Fixed Interest	Recommended
Macquarie Diversified Fixed Interest Fund	Highly Recommended
EQT PIMCO Wholesale Diversified Fixed Interest Fund	Recommended (New Addition)
International Fixed Interest - Specialist	Rating
DDH Global Fixed Interest Alpha Fund	Recommended
Putnam Worldwide Income Fund	Recommended