



## IMAP Independent Thought Podcast Episode 30: New Perspectives on Fixed Interest

Join **Emily Barlow (Perpetual Private)** accompanied by **Alex Ramsey (Infradebt)**, and **Matt Macreadie (Income Asset Management Group)** for an insightful discussion on fixed income investing.

They explore:

1. The pros and cons of direct investing versus funds and whether there is room for both approaches.
2. The role of green bonds and infrastructure debt
3. How investors should be positioning the defensive part of their portfolio
4. Areas investors should be avoiding at this point in the market cycle & more

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### Emily Barlow - Perpetual Private

Hello and welcome to episode 30 of the IMAP Independent Thought series podcast. My name is Emily Barlow. I am an Investment Director within Perpetual's Wealth Business and your podcast host.

Today I'm joined by Alex Ramsey and Matt McCready.

Alex is the Co-founder and Investment Director at Infradebt, a boutique infrastructure fund manager. Infradebt has been a long-term lender to projects supporting the energy transition, and have a range of specific strategies that assist institutional and wholesale investors to access the space.

Our other guest today, Matt, is the Executive Director of Credit Strategy and Portfolio Management at IAM Capital Markets & Asset Manager, providing clients with a platform to research and manage their income investments. In today's episode, we will be discussing fixed income and the range of implementation options available.

Alongside the pros and cons of each approach, we will also delve into the role of sustainable investing and resulting portfolio construction implications.

### Emily Barlow - Perpetual Private (01:20):

Over the last two years, we've seen interest rates climb sharply creating an asset class that is a lot more attractive than it was only a few years ago.

And as a result, investors have been increasing their allocations from, in most cases, underweight positions. With interest rates now expected to stay higher for longer, fixed income is likely back as a core part of most diversified portfolios for the foreseeable future.

Over a similar time horizon, we've seen the launch of many new strategies and more implementation options. So now with all this choice, there is a question of when you should be allocating to each of the different types of strategies and how.

So Matt, if we start with you, what are your views on the pros and cons of direct bonds and managed funds?

**Matt Macreadie - IAM (02:05):**

Thanks, Emily. And look it's interesting because bonds over the last few years haven't got a lot of airtime and it's great to see they're back in fashion, so to speak.

Investing directly or through managed funds for fixed income has advantages and disadvantages. While my preference is more for direct investment, there are times when choosing a fund to look after your fixed income portfolio makes a lot of sense. We offer both direct and managed funds here, and so it really depends on investors' preference. When you're looking at the pros and cons, you can boil it down to things like control, size, transparency, and fee structure. When you invest in direct bonds it's a lot like direct equities, that means you can choose the company bonds that you invest in. So, you get complete transparency in this regard. You can also build a portfolio that suits your investment goals.

**Matt Macreadie - IAM (02:56):**

Some clients will target risk around duration and credit. Some clients will target return and some clients will have certain cashflow needs that they need to manage. The good thing about direct bonds is that can be sold down in small parcels, providing liquidity if needed, you can generally go down to around \$50,000 in direct bonds.

The other thing is that with direct bonds, you only pay the brokerage fee. When you enter and exit a bond, (generally funds), you'll pay not only the brokerage, but you'll pay a management or performance fee. And the costs are a little bit higher on that sense. With direct bonds you'll also know what interest you'll get at a known certain date. You'll also know what funds will be returned at maturity.

When bonds mature in a managed fund, those funds are reinvested and that income doesn't come back to the investor, the income is absorbed into the fund, and the fund manager decides when to pay interest through its regular distributions.

**Matt Macreadie - IAM (03:52):**

Bond funds tend to advertise historical returns, and these historical returns might not always realize into actual returns. Now, managed funds do make sense.

For those people who are a bit time poor, it gives them the ability to invest their money into a fixed income allocation that can suit their needs. It can also be useful where people don't want to do the due diligence on certain credit securities.

The high yield part of the market is a little bit more complex, and it can help to have a fund manager maintaining and controlling this. At this point in time in the cycle, people looked for that 60/40 portfolio, which is considering a fixed 60% allocation to fixed income and a 40% allocation to equities. In our view that 60% fixed income bonds allocation should have a mixture of direct and managed funds.

**Emily Barlow - Perpetual Private (04:43):**

Great. Thanks Matt. Very comprehensive start. Alex, did you have anything that you wanted to add to that? And I'll be in particular be interested on your thoughts on the role of green bonds and infrastructure debt and in particular how advisors should be thinking about this in relation to other fixed income assets.

**Alex Ramsey - Infradebt (05:02):**

Yes, I'm quite aligned with Matt's comments and, and continuing on from his points. So just in terms of fixed income in and of itself obviously covers quite a wide spectrum with different risks: credit risks, interest rate risk, and liquidity characteristics.

And the point to draw is that investors should assess bonds or funds or managed fixed income strategies against each of these factors, and whether the proposed investment has the right characteristics for the proposed role that it's going to play within their portfolio.

One thing I'd just emphasise here though is, I would encourage investors to look at the risk characteristics first and then ask the question of whether the return is appropriate for the risk rather than getting drawn into a debt investment just because of the headline return.

**Alex Ramsey - Infradebt (05:51):**

And this is where green bonds can become harder. And particularly for those clients that have a particular ESG focus. You know, in terms of recent history, generally we've seen these issuances are very heavily sought after across the investment space, whether it be institutional or that wholesale investor. And effectively what we're seeing in this green bond space is the return being bid down relative to issuers of the same equivalent credit rating. And this is the so-called green premium.

So, then switching across to infrastructure debt and the role that it can play. One thing I'd just point out is that on a risk basis, infrastructure debt performs really well. And I'd also mention that Moody's did a longitudinal study that they issued in 2018, and they looked at infrastructure issuers from 1983 through to 2017, and it covered over 2 trillion US dollars of issuance.

**Alex Ramsey - Infradebt (06:56):**

And they found that for the same credit rating, infrastructure issuers have a lower default rate and most importantly have a much lower loss given default. And this is direct lending to infrastructure projects that are ESG screened can really deliver for investments.

So these are for those investors that want to access ESG characteristics in that fixed income part of their portfolio. This can really work, as you can get the same infrastructure characteristics from the borrower, from the underlying borrowers or the issuer.

And you get to throw in the ESG routes, but due to its specialized nature, this is direct directly lending to infrastructure projects that specialized nature means that you can still capture a decent illiquidity premium in the underlying loans.

**Emily Barlow - Perpetual Private (07:47):**

Thanks, Alex..... Matt, I know that you also build green bond portfolios for your clients and Alex has just mentioned the RI or green premium and perhaps that you

are paying for going green with bonds with perhaps the exception of infra debt. Are you finding the same, are there opportunities that you are seeing in this space?

**Matt Macreadie - IAM (08:09):**

Yes I think Alex is right there. So in terms of an IRI premium, I think we're distinguishing between two asset classes within the fixed space, the investment grade and high yield or unrated space.

I think the latter provides more of an opportunity in this market, and where I'd be recommending investors place their capital over conventional investment grade bonds.

In the Australian market the problem has been too much capital put by the banks and institutional funds pension funds into the investment grade space... seeking kind of insufficient sustainable assets and that's forced prices higher and therefore returns lower.

The flip side is so-called "dirty assets", valuations on those prices have fallen quite significantly. A good example is two debt issues from Woolworths and Coles. Both are from the same sector, both have similar asset backing, both are investment grade, but one of them is sustainable due to the use of clean energy, while the other is not.

**Matt Macreadie - IAM (09:09):**

The sustainable deal is currently paying 50 basis points or 4.5% less than the other deal in secondary trading. So that lower return or risk payoff is sometimes called the "Greenham factor".

On the other hand, when we look at the level of capital into the high yield and unrated space targeting sustainable assets, it's been nowhere near as large or of the same degree or magnitude. Some of these lenders we're seeing in that high yield space energy retailers, wholesale trading businesses these businesses are starting from scratch. They're trying to focus on the energy transition and then move into storage and generation over time.

But for those investors who have the ability to conduct kind of the appropriate credit due diligence, and I'll note this, then they can get returns of circa 13% to 15%, which is a healthy kind of RI premium for fixed income. But you do have to go down the credit risk spectrum to access that.

**Emily Barlow - Perpetual Private (10:12):**

Okay. So would it be fair to summarise that by saying in the investment grade type market you are preferring conventional bonds, but through the high yield part of the market, that's where you would go for your green bonds?

**Matt Macreadie - IAM (10:28):**

Bonds? That's correct. Yes, I'd be in the conventional part. I'd be overweight the non-green bonds in the investment grade space, and in the high yield space I'd be overweight the green style bonds.

**Emily Barlow - Perpetual Private (10:40):**

Great, thanks Matt. And I would say this poses a question around portfolio construction more broadly and as we've discussed, there are different pros and cons from some of these different sub-asset classes. And each does have a role to play, which may or may not be appropriate for different types of investors.

Alex, do you have any thoughts on how investors should be positioning the more defensive parts of their portfolio?

**Alex Ramsey - Infradebt (11:03):**

Yes, I think you need to think about that defensive party portfolio in multiple buckets and so simplistically we could have that that high. The first part, if you want to think in three buckets that the first bucket being highly defensive, highly liquid assets that are available for immediate liquidity requirements, this could be something as simple as just cash and term deposits or highly liquid bond funds.

Then you could look at the second bucket being duration. So for long duration government bonds, you would hold these on theory that as bond yields fall during equity market crisis and your equity market crisis you'll pick up a small capital gain and that should be also relatively liquid through the same event.

Having said that obviously in the last 12 months that hasn't really played out where we've had rising equity markets and rising bond yield.

**Alex Ramsey - Infradebt (11:56):**

It hasn't really delivered that sort of diversification benefit that you might otherwise have hoped for. But then if we just switch down to the third bucket, and that's the defensive yield harvesting bucket.

We're not trying to step down in credit quality necessarily, but we are looking at liquidity within our buckets and our strategy is pursuing defensive assets with a medium duration, where the primary objective is to earn higher yield on that portion of your defensive assets that don't need that daily liquidity.

And touching on what Matt was talking about in that classic portfolio construction, is say the 70/30 or 60/40 asset allocation split between defensive and risk assets... traditionally these buckets fit within that.

The point I'd make out is that you can have that third bucket, that defensive yield harvesting bucket sit within that defensive component, the 30 or 40% because you don't need necessarily liquidity on the full 30 to 40%.

And, obviously talking my own book, but infrastructure debt with its extremely strong credit performance, medium duration and the yield pickup for liquidity is a natural fit for that bucket.

**Emily Barlow - Perpetual Private (13:18):**

Great. Thanks Alex. So where advisors may have been historically thinking about fixed income as a single asset class, perhaps there's a case for splitting that out into sub-asset classes with private credit being one we haven't touched on yet, but we will come back to that in a minute.

And before that, Matt, I want to touch again on direct investing in bonds. Now we've already talked the pros and cons of managed funds versus investing directly, but I wanted to go into more specifically on concentration risk.

And when you think that that makes sense, how many bonds do you need for it to be a suitably diversified portfolio?

And you mentioned already that you can access it from as little as \$50k, but what is the minimum for a diversified portfolio?

**Matt Macreadie - IAM (14:07):**

Yes, thanks Emily. Yes, so direct bond investing, the way we look at it is from a concentration perspective. Default rates on investment grade bonds in Australia are very low. In fact, it's basically zero.

If you look at S&P's historical default study and you have to go back 5 to 6 decimal places to actually get a number there. So default risk is very low. And from that point of view, because default risk is low, we feel that you can have a fairly concentrated direct bond portfolio. The minimum size we say is \$50 K, so we suggest if minimum is \$50 K per bond, we think that having five bonds at \$250 k is prudent for appropriate diversification.

**Emily Barlow - Perpetual Private (14:53):**

Great, thanks Matt. So I've already mentioned private credit, but Alex, this is an asset class that has seen massive growth over the past few years and in itself is a very diverse asset class.

Where are you seeing the opportunities and are there areas investors should be avoiding at this point in the marketplace?

**Alex Ramsey - Infradebt (15:13):**

Yes, the flows into the sector have been really, really strong. And being a fixed income investor that taking that more bearish view, that does make lend me more to being more contrarian.

Obviously with the rise in base rates, the absolute return level is very compelling.

But what I would argue and where I'd have concern at the moment is that competition to deploy capital in this space does mean that whilst the sticker price or the yield might look okay, where I'd be getting concerned is in around things like coverage, and also just the broader general covenants that lenders are being signed up to.

The point is if you took a contrarian view, then credit quality does matter, and I would advise people to really focus on that.

**Alex Ramsey - Infradebt (16:18):**

I think the other thing you could think about though within the broader private credit space is to then look within sectors, and within that context you want to be looking for sectors where demand for capital is high or higher than supply of capital.

And this is where we certainly do see real opportunity. Taking say for instance the energy transition and even just here in Australia the short term focus and goals (taking the current government's target of 82% renewables by 2030), in terms of capital deployment, that's about a \$70 to \$80 billion spend in just the next 6 years.

Or if you want to put that into capacity terms, that's about 30 gigawatts of wind, solar, and storage or batteries. You know, not all of these projects will necessarily be great from an equity step for the equity investors in project in these projects. But it marks this flow.

There are lots of attractive risk adjusted returns for lenders, who can navigate the complexity and assess the risks of each of these projects through this interesting period we're about to embark on.

**Emily Barlow - Perpetual Private (17:38):**

Thanks Alex..... Matt, do you have any thoughts on, on private credit?

**Matt Macreadie - IAM (17:43):**

Yes I think private credit is a very interesting space, and as we were talking about the different buckets within that 60/40 portfolio, I think private credit should fit within that 60% allocation alongside investment grade bonds and cash.

It definitely has a place, with private credit you can access issuers that you don't see in the bond market. A lot of them are floating rates, so they give you a different type of income exposure.

And, generally the covenants and clauses in private credit are structured by the banks originally, so they tend to have better credit to protection than what you see in the investment grade credit space.

I definitely see a place for private credit in an optimal portfolio.

**Emily Barlow - Perpetual Private (18:25):**

Matt, you mentioned covenants. Is that something unique to Australia or do you see the strength of covenants globally as well as just in Australia?

**Matt Macreadie - IAM (18:33):**

I think people talk about this “cove light structure” in the US and that's where it came out of. When a bond or loan goes bad, you look to covenants to try and protect your capital, right? And that's really your final step, once you've looked at your asset recovery, you want to ensure there are strong covenants in the documentation, because they protect you as an investor.

So it really matters in that high yield or unrated space where you're dealing with a lot more complex issuers that maybe have a riskier profile.

So it's important to consider within the risk profile.

**Emily Barlow - Perpetual Private (19:11):**

Thanks, so I'd like to finish on the market outlook and where you both see opportunities across both the shorter and the longer term.

Matt, if we start with you, what is it that you are excited about and is there anything that's making you nervous?

**Matt Macreadie - IAM (19:26):**

Yes, I'll start with the “excited” in the short term. We have recently announced partnerships with Netwealth and HUB24 to offer small bond services to investors.

This is really exciting for us, because it comes at a time where yields are fairly high, but at the same time inflation globally looks like it's peaked.

So from here, if yields do come down, you'll see a lot of capital gains on a lot of those fixed rate securities. The fact that we now have access to a wide range of investors by the platforms through a direct bond service is pretty exciting in the short term.

Especially for investment grade or high quality bonds. I think where I'm kind of nervous in the short term is probably around the political or global situation.

The Israel / Iran conflict recently, and what I think that is that global markets haven't really priced in the effect of big political or global conflict.

**Matt Macreadie - IAM (20:27):**

And what tends to happen when this is priced in is that government bonds or duration does very well, but also investment grade tends to outperform high yield in that environment because of safer credit quality ability to absorb losses and those tend to do better.

So that's probably where I'm nervous in the short term.

I think on the longer term, the big thing a lot of people are trying to get their heads around (and there'll be winners and losers from this) is artificial intelligence, and the digital economic revolution. And sustainable investing will also play into the global economy. And because there's no history that can be relied upon, it's hard to build a picture of the future and how economic growth, bond returns, credit spreads will all play into portfolio management.

**Matt Macreadie - IAM (21:23):**

So at the moment you can see that there'll be winners and losers in this sector.

A good example was the working from home trend and how that will impact employment trends and things like office property.

The other thing is the impact on employment in the tech sector and those service sectors. This could play into lower growth into the future potentially if that occurs, which means bond yields drop again.

But I think the bottom line is holding. AI or digital technology assets is a good hedge and a good long-term play. So in our local market, there's bonds that are issued by NextDC which is a data center operator, and Goodman Group, which is a logistics operator. And we think these type of positions could do well in the future.

**Alex Ramsey - Infradebt (22:16):**

Yes, what am I excited about at the moment?

Well, we've recently launched along with Australian Ethical, the Australian Ethical Infrastructure Debt Fund. And in terms of opportunities that are looking really good at the moment, we're seeing quite a lot of opportunities... particularly there's lots and lots of issuance in the spaces that we operate in terms of really large projects.

But we're also seeing quite a lot of opportunity with smaller projects and that's actually quite important to underlying investors. We certainly do invest in large syndicated facilities, but for the smaller projects they tend to fly under the radar of the larger project finance banks, and offer really attractive risk adjusted returns.

**Alex Ramsey - Infradebt (23:09):**

In terms of where I'm seeing risks, touching on today's inflation rate, but inflation more broadly, not just here, but obviously places like the States is a concern. And this I think is indicating that we've potentially got a situation where it's certainly higher for longer. Inflation running at 3, 4, 5% on a long run basis.

And for that reason it means potentially higher interest rates moving forward. And this is exacerbated by relatively very high government deficits that are being run around the world again, particularly say focusing on the US.

I actually wrote about this in a newsletter article about six months ago, but where some academics had done research at looking at threshold points of inflation and they found that as you cross certain barriers just in absolute inflation levels through time, particularly as you break through that 5, 6, 7, 8, 9 and above percent, they actually found on their study looking at OECD countries over the last 50 years, that it

actually takes quite a long period of time, in the order of many, many years to actually reign that inflation back into target bands.

**Alex Ramsey - Infradebt (24:31):**

And the higher you break through the threshold points and the further you go, the longer it takes is basically the outcome of that study.

Obviously that has an implication for capital markets more broadly in terms of inflation running higher. It has its own implications too in the sectors that we look at.

For example the energy transition in itself (irrespective of where you invest in that supply chain) is a very capital intensive activity. And views on where interest rates are now, but also where they will be through particularly over that medium to longer term really does impact the number of new projects coming to market and the timing of when those projects will hit the market.

**Emily Barlow - Perpetual Private (25:13):**

Great. Well Alex and Matt, I think we've run out of time. Thank you so much for your insights. It's been a great discussion on what is a very topical and diverse asset class for our listeners.

We hope you've enjoyed the conversation. Perhaps it's even fueled some ideas on how you think about bonds in the context of your clients' portfolios.

We hope you can join us next month for what I'm sure will be another great discussion. Thank you.

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