

### Q&A with Michael Korber, Perpetual's Head of Fixed Income and Credit, and Portfolio Manager of the Perpetual Diversified Income Fund.

#### **Michael, in the current environment, what are some of the things you've been focusing on?**

The main thing we have been doing is working through the huge number of investment opportunities currently available in the market, many of which are high quality securities at extremely attractive prices.

As an example, AAA senior issued securities are now available at better spreads than listed hybrid securities which are further down the capital structure and often rated BBB, so we've been focused on selectively adding these opportunities to the portfolio.

We have also been looking at the quality of risk within the portfolio. Credit securities are now offering high margins above the cash rate right across the board, irrespective of quality.

That is, some securities are cheap because they are poor quality and ultimately might fail whilst some are quality assets which are cheap for other reasons such as liquidity or sentiment. We are therefore focusing our time looking for quality assets and avoiding assets which may have potential issues.

#### **What are some of the themes that have been dominating credit markets recently?**

Although it tends to be ignored in good times, many investors are now very much focused on the quality of the securities in which they are investing.

Some, however, are continuing to invest in quite obscure and longer dated securities in their desire for yield which, in our view, creates too much risk.

There still seems to be some investor insecurity in some parts of the credit market, which is partly due to the banking system being the centre of the storm, rather than the centre of stability.

This is especially the case within the residential mortgage-backed security market (RMBS), which is a big chunk of the overall credit market. Many investors still remain unsure about these investments, despite the quality of the underlying assets remaining high.

With government intervention helping to support the banking system and a continued global focus on debt reduction, we would expect investor confidence in credit markets to continue to improve.

#### **Has anything you've seen in credit markets over the past 12 to 18 months really surprised you?**

We have a strong belief that markets are cyclical and our experience tells us that the longer the up-cycle, the longer the down-cycle will be.

So while the recent downturn in markets didn't surprise us, how fast and how far they fell was certainly something we didn't expect.

We've also been surprised at how heavily exposed the whole financial system was to heavily layered, poorly understood structures that caused things to unwind.

When market conditions were relatively benign, investors continued to take increased risk for a relatively low return.

It's interesting to see that now many credit securities, in our view, are priced really well based on their expected return, these same investors are now 'gun shy' and just don't want to take advantage of this opportunity.

#### **There have been huge differences in the performance of income funds recently - how have you stayed so far ahead of competitors?**

Our active, risk-aware investment process has been a huge contributor, as it has allowed us to take market risk out of the portfolio by allocating funds to truly defensive holdings like cash.

Also helping our performance has been our strong focus on capital stability through only buying high quality issues higher up the capital structure, and actively diversifying our portfolio across sectors.

Our policy through the credit crisis of only buying shorter-dated securities that are issued by well-known companies has not only ensured our fund has remained liquid, it means we haven't been forced to 'cash out' at the worst possible time.

#### **With bonds now looking quite expensive, can you explain the significant short-term opportunity in credit markets that now exists?**

As you know, when interest rates are falling, fixed rate investments like bonds do really well.

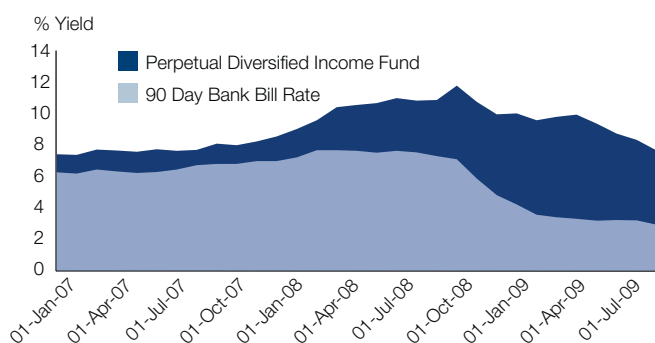
Now that it seems we are coming out of a downturn, bonds would appear to have had their run, as rates are more likely to rise rather than fall.

The current government deficit also means more government borrowing through the issue of securities, which will also put downward pressure on bond prices.

Credit markets on the other hand are, in our view, in a real sweet spot at the moment, with favourable pricing due to historically wide credit spreads.

The margin above bank bills on offer of approximately 5% is actually greater than the available bank bill rate of approximately 3% - the historical yield to maturity of over 8% of the Perpetual Diversified Income Fund is a great example of the expected opportunity in credit over a 2-3 year timeframe (see Chart 1 below).

**Chart 1 – Wholesale Diversified Income Fund – Yield To Maturity**



Source: Perpetual, Bloomberg. Historical yield to maturity is the likely return (including income and capital appreciation) if the current portfolio is held to maturity at that point in time. Past performance is not indicative of future performance. Data from 31 January 2007 to 31 July 2009.

This means investors are able to benefit from some certainty that, as debt securities within the Fund mature, both the regular distributions and the capital appreciation will enhance portfolio performance, offering a known return with equity-like premiums and a higher position in the capital structure than equity.

Should interest rates also rise in the future, floating rate credit portfolios like our Diversified Income Fund will also benefit as returns rise in line with these increases.

### And how well-positioned is the Diversified Income Fund to take advantage of this credit market opportunity?

We're in a really fortunate position with the Diversified Income Fund, as our high cash levels are allowing us to buy into the current market at extremely discounted prices and positive flows from investors means we are not a forced seller into the market at these levels.

We're also finding it a bit easier to invest now, as the financial crisis has meant identifying the winners and losers is much easier.

The risks are also more obvious, so we feel our quality portfolio is certainly well-positioned for the equity-like return opportunity that exists in credit markets in the short term.

### And finally, what do you think we'll see in credit markets in the medium term, particularly once the short term opportunity subsides?

As we move into the next stage of the interest rate cycle, we feel there will be a shift in the risk-pricing for fixed income securities.

While the short-term opportunity in credit markets certainly won't continue, even after this shift has taken place, we believe that credit spreads will still be much wider than they were before the global financial crisis.

We would also expect that the universe of securities will continue to expand, as more issues become available via governments and corporates continuing to raise capital.

While this certainly will generate more opportunity for investors, having a proven active management process will continue to be important, as this is what will generate returns over the long term.

Overall, we believe that credit funds will offer a better, more sustainable opportunity than bond funds over the medium term and remain confident that our Diversified Income Fund will continue to perform well over rolling three year periods.

This information was prepared by Perpetual Investment Management Limited (PIML) ABN 18 000 866 535, AFSL 234426 for financial advisers only. It is general information only and is not intended to provide advice to particular investors, or take into account an individual's investment objectives, circumstances or needs for investment. The relevant product disclosure statement (PDS), issued by PIML, should be considered before deciding whether to acquire or hold units in a particular fund. No company in the Perpetual Group (Perpetual Group means Perpetual Limited (ABN 18 000 431 827) and its subsidiaries) guarantees the performance of any fund or the return of an investor's capital. Past performance is not indicative of future performance.



#### Further information

**Adviser Services** 1800 062 725

**Investor Services** 1800 022 033

**Email** [investments@perpetual.com.au](mailto:investments@perpetual.com.au)

**www.perpetual.com.au**