Seeking visible yields

Fixed maturity investing melds positive aspects of direct bond portfolios and active management

By Rajesh Manwani

DEFINED or fixed maturity investing as a concept has been available to investors for a number of years, but it has become widespread in Asia only recently. At Credit Suisse, we have seen a significant increase in demand from investors for this style of investing, which is seen to provide a good blend of the characteristics of direct bonds and bond funds, which can be made available in a fund, discretionary mandate or certificate format.

Traditionally, investors like to have control over their investments and prefer high visibility of their expected returns and cash payouts. In the fixed income space, this manifests itself in a preference for a portfolio of direct bonds of companies that investors are comfortable with. Such a portfolio can provide the benefit of a regular stream of cash flows from coupons and full transparency of the holdings.

Since investors often intend to hold these portfolios till maturity, they tend not to mark-to-market their portfolios even though the prices of the direct bonds vary with the development of interest rates, credit spreads and company specific news flow.

One of the challenges of managing such portfolios is often insufficient diversification because of the large minimum sizes of bonds. Further, investors need to invest considerable time and have the skill for credit selection to avoid credit losses.

Actively managed bond portfolios (often in a fund format) provide one way to address these challenges. Here, a professional manager can manage a diversified portfolio by actively managing both the credit selection and the interest rate positioning of the portfolio. However, some investors may find this less appealing because they perceive lower visibility of their cash flows and higher volatility due to the impact of interest rate and credit developments on daily price fluctuations, compared to direct bond investing.

Buy-and-hold

Fixed maturity investing seeks to bring together positive aspects of both direct bond portfolios and active management. Here, professional portfolio managers construct diversified portfolios of bonds of similar maturity. The fund has a defined maturity date after which it liquidates itself and returns the assets to investors. Over the course of the life of the fund, it pays coupons received from the bonds back to investors at regular intervals. This structure provides investors with very good visibility on the maturity of the bonds, cash flows and an understanding of the interest rate risks from the outset.

Similar to direct bonds, investors tend to consider these as buy-and-hold investments, and tend to ignore the "noise" from daily price fluctuations. In that respect, fixed maturity investing can be seen as a hybrid of direct bonds and regular bond funds.

Another important factor in considering fixed maturity investing is the effective management of uncertain interest rates. The remaining maturity of the bonds gets shorter over time, resulting in a reducing exposure to interest rates and credit spreads, and hence reducing portfolio volatility over time.

With highly volatile equity markets and a perceived increased risk of bond defaults since the start of the year, we have seen investors moving towards safer assets with reasonable yields and reduced risk of default. This has been a trigger for significantly higher interest in fixed maturity investing. This strategy can also be applied in discretionary mandates with the additional benefit that investors can tailor the maturity, sector and geographical exposure across the fixed income universe.

The flexibility has been a big draw for our ultra high net worth client base. We have found that entrepreneurs, a client segment that Credit Suisse focuses on, rate the value proposition of fixed maturity discretionary mandates highly as it allows them to match the duration of their investments to their liabilities.

Risks

While fixed maturity investing has a strong appeal, other considerations should be kept in mind. There is an increased reinvestment risk compared with a traditional bond fund, as the funds are reinvested together. Further, similar to other forms of bond investing, any bond defaults result in losses of some of the invested capital.

Lastly, since the remaining maturity of the portfolio reduces over time, the portfolios will likely offer much lower expected returns and risks over time, especially closer to maturity of the fund.

In summary, if held to maturity, fixed maturity investing can bring possible benefits – higher visibility of returns, professionally managed diversified portfolios and reduced portfolio volatility – providing a very good bridge to investors who are used to managing their bond portfolios themselves, subject to considerations. W

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