# economic & investment horizons

## Long-forgotten risk

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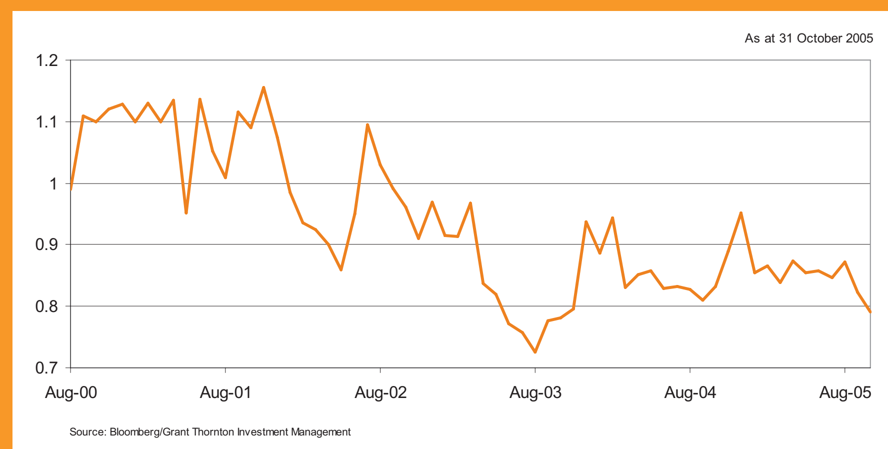
Analysts often look to the relationship between yields on corporate bonds and those of government bonds to ascertain investors' current sentiment towards the economy and financial markets. The spread, or difference, between yields on corporate debt, which is subject to default risk, and government bonds, which are basically free of such risk (for low sovereign risk countries like Australia), should, on the surface, simply reflect the risk of the corporate bond defaulting.

However, when we look closer at the gyrations of the spread over the economic cycles (widening during recessions and shrinking during expansions), often encompassing movements of as much as 10%, we can see that measures of a company's probability of default do not appear to be as variable as the credit spread, and that investors' attitude towards default risk, as well as the actual probability of default, is driving this spread.

So following a period of unsurpassed economic and financial market expansion in Australia, we find investors are now almost (alarmingly) blasé towards risk. As seen from the graph below, the risk premium that investors require from A-rated corporate bonds over the AAA-rated bonds has dropped to only 0.79 percent, a level that almost completely ignores the default risk. Such has been the length of the current period of expansion, investors in both equities and bonds have forgotten the pain of losing money (i.e. capital risk), just as they had done prior to the bursting of the dot-com bubble in March 2000.

So long as risks remain at bay, the current situation is sustainable. However, risks are growing larger on the horizon and the more investors continue to ignore them, the more they erode the premium, the sharper the pain will be when the risks do eventuate.

**Corporate bond spread (5 year A-rated) over government bonds (5 year AAA-rated) %**



## Investing for income..."boring" but vital

During a buoyant equity market environment, clients often question the need for interest bearing securities, regarding them as a "lazy use of assets". This question goes straight to the heart of the importance of our asset allocation strategy for achieving our investment objective for clients, that is **consistent**, **economically meaningful**, **low-risk annual returns**.

In setting our asset allocation regularly, we seek to identify areas of the economy and financial markets we believe will provide returns for investors, as well as identifying and balancing the medium to long-term risks. Our mandate is to protect capital in absolute terms. This sees us focussing particularly on protecting ourselves against the full effect of severe market behaviour. There are inherent risks in investing in equities, and whilst we acknowledge that equities are the primary vehicle to accumulate wealth, we require a buffer against market volatility, in the form of a stable and secure income stream. Whilst this buffer may seem "boring" in a rising stock-market, the market volatility at the beginning of October reminded us that this buffer is a necessity.

Due to the low interest rate environment for traditional longer-term securities (over two years to maturity), our means of availing ourselves to a secure income stream has incorporated shorter-dated AA-rated fixed income (through Bank Bills or the Macquarie Treasury Fund) and hybrid instruments (eg Westpac FIRSTS, St George Bank PRYMES). On a risk-adjusted basis, shorter-dated fixed income provides a greater yield than the equivalent longer-dated securities in the current environment. Hybrids generate a strong yield but carry with them some higher risk, which sees us capping our exposure to them at 40% of the total interest-bearing allocation and being primarily exposed to bank hybrids with superior credit rating.

With an income return for the 12 months to 30 June 2005 of 5.53%, the interest-bearing section of our portfolio will continue to be a very valuable and reliable contributor to our overall return, in good times and in bad.

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## Stockland: still going strong

Stockland Trust Group (ASX: SGP) has been a core holding in the Grant Thornton Investment Management Model Portfolio for over fifteen years. They are currently the second largest vehicle by market capitalisation in the Listed Property Trust (LPT) sector. Management's long term prudent style has seen consistent returns which focuses on passive property management (70% of assets) and property development (30% of assets).

Stockland was an early pioneer of the stapled security structure whereby investors acquire both a unit in the property trust and a share in the management and development company. Accordingly, investors receive both a distribution from the trust component and a dividend from the company. The unit and share cannot be separated.

With a diversified stream of cash flows derived from assets across retail, commercial, residential, industrial and hotel investments, SGP's passive property portfolio is well placed to absorb downturns in individual sectors. This has currently been evidenced by their ability to withstand the recent softening in residential land lots and high density markets.

SGP's profit after tax for the 2005 year grew by 13.5% to $517m, up from $456m the previous financial year. This growth was supported by strong returns from all major business segments despite some adverse market conditions. On a total return basis, that is, price appreciation plus distributions and dividends, SGP has returned 15.72% for the period 30 September 2004 to 30 September 2005.

Evidence of the superior returns SGP has provided to shareholders over the years compared to its peers in the LPT sector is provided in the graph below. With a low gearing ratio and proven management expertise we would anticipate Stockland's strong performance to continue into the future.