Seed Weekly

Why You Should Consider Bonds

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Today I follow on from last week's report "What are Bonds?" to give a bit of insight on why investors should consider bonds in their portfolios.

Click to read What Are Bonds by Mike Browne >

For most of the 21st century SA government bonds haven't compensated investors adequately by way of yield pick-up when compared to 3-month cash rates. When you invest into a 10-year bond you essentially lock in rates for 10 years (and accept the attached risks), and you should therefore expect to be significantly compensated when compared to having your money available after only 3 months. The chart below shows how, for the first 2 decades of this century, investors into bonds that matured after 10 years only earned, on average, an extra 1% pa when compared to 3-month cash rates, hardly an attractive pick up.

What is also evident from the above chart is that the yield pick-up over the past couple of years has been sustained at an exceptionally high level, when compared to the first part of this century, on the back of the COVID pandemic market shakeout. In the first quarter of 2020, SA government bond yields shifted up on the back of the massive COVID sell off. At the same time short-term interest rates were slashed, and this is what has caused the major shift in this yield differential.

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Investors into bonds can now pick up yields way above cash rates and current levels of inflation. As previously mentioned, taking on the 'lock up' risk will result in daily capital volatility as the bonds mark to market, but investors with a reasonable investment horizon should be able to weather these shorter-term price movements with the understanding that the yield they lock in on purchase will be the return they earn if they hold the asset to maturity.

What's more, investors can use sell offs in the bond market to top up their holdings and lock in the higher yields (higher expected returns) in the process. Since the turn of the century the ALBI (All Bond Index) has generated average annual returns of 10.4%, with the worst 12-month return being -10.3%. Over this same period, the ALBI has been more than 5% from its highs just over 10% of the time (i.e. for around 90% of the time your total return from bonds will be within 5% of its all-time highs) and for investors that took the opportunity to invest in these periods their average annual return shifts up to 13.4% with a minimum 12 month return being 0.2%.

With the ALBI's current yield of 10.5% (10 Year Bond Yield @ 10.3%), local bonds are the perfect asset class for a Fund like the Seed Stable Prescient Fund that has a return target of CPI + 4% pa and a risk target of no capital loss over 12-month periods. With inflation currently under 6% the yield from the bonds covers the return target with a bit to spare (should inflation increase). Bonds also deliver positive rolling 12 month returns in excess of 90% of the time, so there is a high probability of meeting the Fund's risk target. As such, local bonds are the largest asset class in the Seed Stable Prescient Fund accounting for nearly 40% of the Fund's assets, and we expect them to be a large driver of returns for the foreseeable future.

Bonds are held in the Seed Income Prescient Fund to improve the rolling yield, but the weight is constrained to ensure the Fund's risk budget isn't breached. The Seed Balanced Prescient Fund currently has an overweight allocation to bonds, but this is tempered down as the Fund requires more equity exposure to do the heavy lifting to the Fund's higher return target.

All in all, bonds play an integral role in all three of our Reg 28 compliant Funds, but particularly so in the Seed Stable Prescient Fund.

Take care,

Mike Browne *CFA*
Portfolio Manager

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