Why Bother Investing in Government Bonds?

At this time of year many investors look back on the returns achieved in various asset classes in the previous year and reconsider their asset allocations. In 2018, Australian government bonds (+5.2%) soundly beat the ASX accumulation index (-2.8%). The gains for government bonds were driven by yields falling, with the 5 year Australian government bond yield now a miserly 1.84%. This is below the latest reading of consumer price inflation at 1.9%. Experienced investors know that switching their sector allocation to last year's winners is a recipe for underperformance, a contrarian approach is much more likely to deliver outperformance. Given all of this, is it now time to sell out of government bonds? What alternatives do investors have for the low risk allocation within their portfolio?

Common Reasons for Owning Government Bonds

The most common reason for having an allocation to government bonds is the expectation of a negative correlation in returns when riskier asset classes fall. This expectation is based upon good historical experience, in times when equities have materially fallen government bonds have typically delivered solid gains. If an investor is running a 60/40 equities/bonds portfolio, the gains from bonds are expected to provide a decent offset if equities enter a bear market (>20% fall). Many Australian investors (e.g. superannuation balanced fund allocations) have less than a 10% allocation to government bonds. For these investors **the hoped for bump from government bonds in a downturn will do little to offset the losses taken on the 80%+ of the portfolio invested in equity like assets**.

Based on current yields this portfolio protection expectation comes at a very substantial cost to long term returns. Current yields provide limited room for bond yields to fall further, meaning the upside for bonds in a downturn is unlikely to be substantial. In effect, **government bond investors are paying a high annual premium for insurance that is likely to have a limited payoff in a downturn**.

Another common reason for allocating to government bonds is their perceived low risk status. For countries like Australia and New Zealand, with relatively low debt to GDP ratios, this perception is reasonable. But for countries like Japan and Italy, there is material credit risk embedded in their government bonds. These countries have a long history of running deficits, rising debt to GDP ratios, poor demographics and no meaningful plan to ever reduce their debts.

When the next downturn occurs, there's a reasonable probability that investors bailout of these government bonds with debt defaults/restructurings required. Even the low risk perception of US government bonds is questionable after a decade of both major political parties supporting very high deficits. If the US government can't balance its budget now with a booming economy will it ever be able to?

A third reason put forward for holding government bonds is their liquidity during times of crisis. However, this is an apples and oranges comparison as **the proponents are arguing that government bonds are more liquid than shares, property and credit investments all of which have much higher expected returns**. A fairer comparison is to bank bills or term deposits. These have higher yields than a five year Australian government bond and also have good liquidity from their short dated investment terms. If the investment fees charged by a typical bond manager are included, the yield shortfall on government bonds is even higher.

Alternatives to Government Bonds

As the three main reasons for owning government bonds are weak, the obvious question is what are the alternatives? The answer will vary for investors, depending on their investor classification and their liquidity requirements. For investors classified as non-institutional (retail, SMSFs, not for profits, family offices) blackboard special term deposit rates of up to 2.75% are available. Building a ladder of maturities allows for a regular return of capital, maintaining good liquidity. Some online savings accounts have even higher rates, but these are often limited to smaller balances.

Investment Type	Suitable For	Current Yield	Maturity	Liquidity
Term Deposits	Non-Institutional	2.00-2.75%	1-60 months	Build a ladder of maturities for portfolio liquidity
Bank Bills/ Commercial Paper	Institutional	2.00-2.80%	1 day-12 months	Very good daily liquidity
AAA RMBS	Institutional	3.40-4.00%	1.8-3.0 years	Currently good, will reduce in a downturn

For institutional investors that cannot access regular term deposit rates, the primary alternatives are overnight accounts, bank bills and commercial paper. One month bank bills are currently paying 2.02%, with commercial paper paying a premium on top of this to account for the very small amount of credit risk involved. Unlike term deposits, banks bills and commercial paper can be traded on a same day settlement basis. Short dated, AAA rated, senior tranches of securitisation transactions yield around 2.80%. These typically have a weighted average life of 1-5 months.

Institutional investors looking for higher yields but with a similar credit risk and maturity profile to government bonds can also consider AAA rated residential mortgage backed securities (RMBS). These typically come with a weighted average life of 1.8-3.0 years and yields of 3.4%-4.0%. Liquidity on these instruments is currently good, but this will reduce if there is a downturn. RMBS is a good alternative for government bonds for investors looking at medium and long term holding periods. They won't provide an offset to equity losses in a downturn, but they can come with a yield of more than double government bonds. Based on the current starting position, **AAA rated RMBS returns will easily beat government bonds in a solid majority of years and over the medium and long term, without adding credit risk**.

Written by Jonathan Rochford for Narrow Road Capital on January 28, 2019. Comments and criticisms are welcomed and can be sent to info@narrowroadcapital.com

Disclosure