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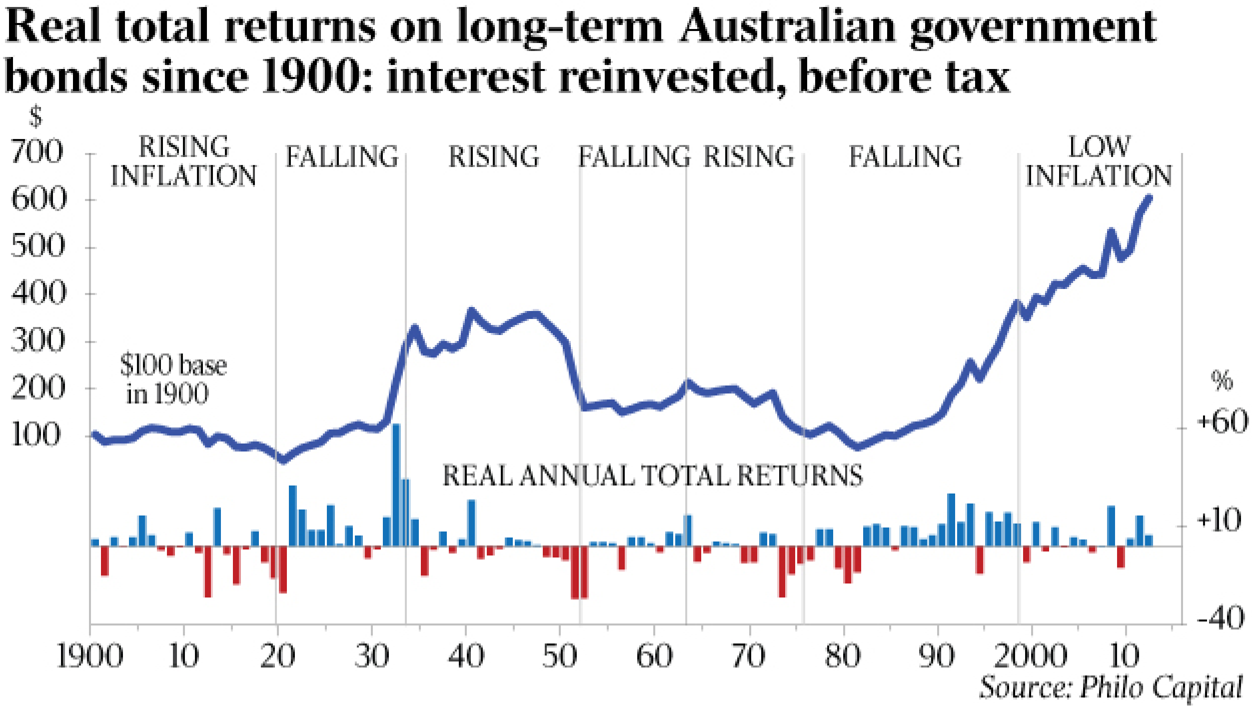
Bonds that tie us to inflation cycle

DON STAMMER The Australian April 30, 201312:00AM



Source: The Australian

FROM time to time, famous writers, even those who'd never set foot in this country, have made interesting comments on Australia. John Maynard Keynes in his General Theory of Employment, Interest and Money, published in 1936, outlined the damage our preference for highly centralised control of wages risks could cause to employment.

Benjamin Graham's book, The Intelligent Investor, was first published in 1949 and is ranked by Warren Buffett as "by far the best book on investing ever written". I was reminded recently that this book, though usually seen as the foundation of value analysis of shares, includes a comment on a US investor holding Australian government bonds issued in 1946 and yielding 3.25 per cent, coincidentally the same as the market yield on an Australian government bond at time of writing.

Graham observed: "The (US) purchasers of the Australian issue must have told themselves that the bonds were practically riskless, presumably on the ground that Australia was a far different kind of debtor than Italy or Brazil." Sounds familiar. Graham's concern was with the risk of default, the risk that investors not receive the interest and the repayment of principal they'd been promised.

As it turned out, the risks for holders of Australian bonds (who lost 50 per cent in real terms between 1940 and 1950) came from inflation and higher interest rates -- and US investors also suffered a 30 per cent devaluation of the Australian dollar.

Over the past century or so, returns on Australian government bonds have been through two very big cycles. The chart, prepared by Ashley Owen at Philo Capital, shows the cumulative real (or inflation-adjusted) total returns on a holding of 10-year Australian government bonds that's rolled over each year. These are pre-tax returns to a resident investor.

The first cycle ran for almost half a century. It bottomed in the early 1920s and peaked (more correctly, plateaued) in the second half of the 1930s, when real returns were boosted by the deflation associated with the great depression.

The second big cycle in real returns on bonds has been going on for about 65 years, though with some shorter-term wobbles on the way. Real returns on long-dated government bonds were generally negative from the 1940s to the 1980s, mainly because inflation was at times much higher than investors had expected; also, higher interest rates lowered the value of bonds already issued.

Since the 1980s, the trend in real returns on government bonds (especially long-dated ones) has been strongly positive, thanks to the combination of high interest rates in the 1980s and early 1990s, the subsequent falls in interest rates and generally low inflation.

Australian government bonds should be seen as "riskless" in the sense that an investor holding them can be confident of receiving the regular interest payments and repayment of principal but "risky" when inflation and variations in market interest rates come along.

There is strong prospect we'll experience cyclical increases in inflation and in interest rates on government bonds in the next year or two -- and cause real returns, especially on long-dated government bonds, to turn negative again.

Even then, government bonds (and other interest-bearing investments such as quality corporate bonds and bank deposits) would retain an important role in portfolios as a counterweight to cyclical declines in share prices.

Investors need to bear in mind these three points. Historically, the cycle in real returns on government bonds is wide and long-lasting. Investors seeking protection against the ravages of inflation need to hold inflation-linked bonds rather than conventional bonds. And when interest rates generally are increasing (and long-dated bonds are falling in value) investors need to actively manage their bond portfolios -- or find a fund manager to do it for them.

Don Stammer is an adviser to the Third Link Growth Fund, Altius Asset Management and Philo Capital. The views expressed are his alone.