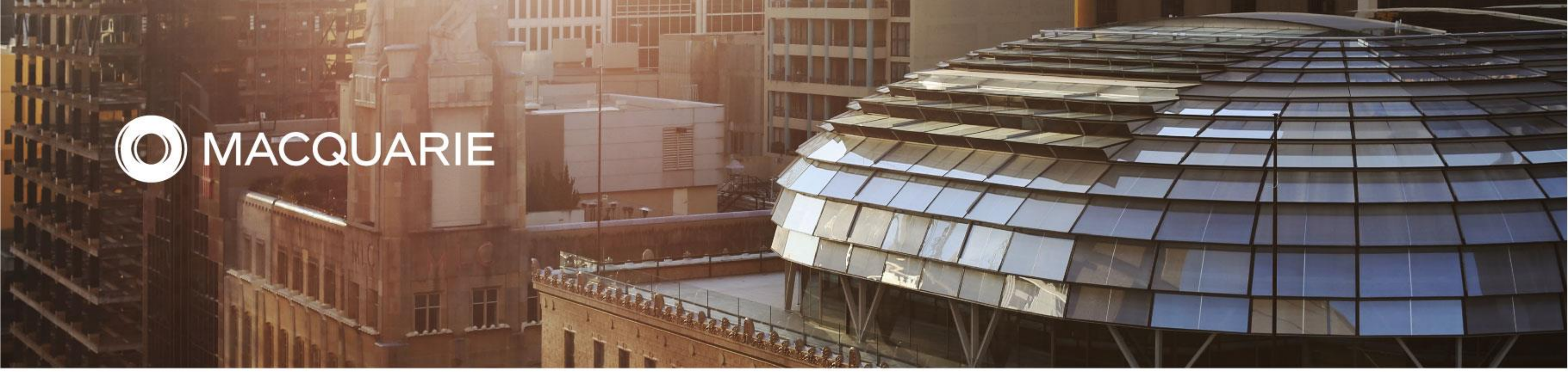


Investment Strategy Update #135

Time to lock in peak fixed income yields

- Yields available across fixed income investments are at their highest levels in over a decade, not just on an absolute basis but also risk-adjusted versus other traditional income yielding investments such as equities, property or bank hybrids.

- It is now possible to earn over 4.0% for cash deposits, around 4.5% for short-dated term deposits, 4.0% for sovereign bonds, 9.0% plus in high yield and in excess of 10.5% for private credit.

  Investors have a small window to take advantage of peak rates and lock in yields before they fall. It is likely that short rates are close to cycle highs and rising economic growth risks mean long rates are also likely to move lower in coming months. Investors should be trying to maximize the yield component of their fixed income portfolio with the added benefit of income stability and limited refinancing risk.

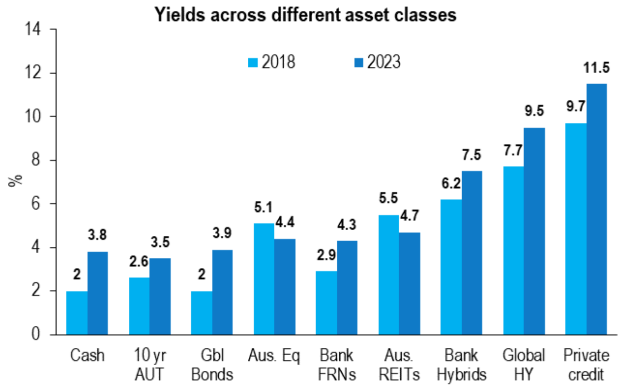
- It is now possible to construct a portfolio of low risk fixed income investments to achieve a 4% income objective by investing only in Australian sovereign bonds and floating rate investment grade credit where income/yield levels are locked in at the time of investment. This is comparable to the dividend yield on Australian equities (~4.4%) but with substantially less risk, greater income certainty and capital stability.

- For investors who want even higher yields modest exposure in high yield and/or private credit can be included that will generate returns comparable to bank hybrids but with far less volatility.

Fixed income yields are at decade highs

Yields in global and Australian government bonds are at some of their highest levels in close to a decade following the rapid increase in risk-free rates over the past 12 months. In addition, yields have not only increased across fixed income, but across almost all “yielding” assets - Equities (4.4%), Australian REITS (4.7), and Bank Hybrids (7.5%) although on a risk-adjusted basis (compared to guaranteed income levels and downside risk) fixed income looks exceptionally appealing.

Fixed income now offers very attractive yields



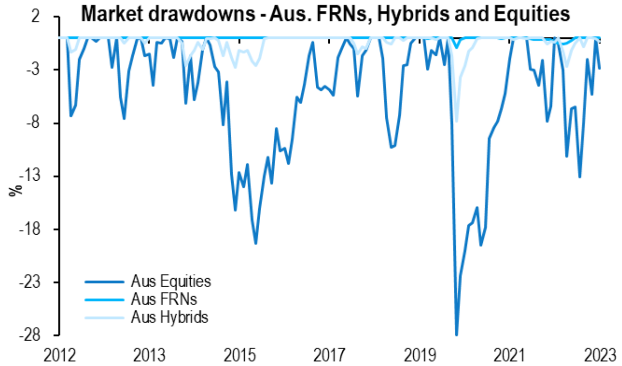
Source: Factset, MWM Research, March 2022

Why fixed income now?

There are several reasons why investors should consider fixed income investments now:

1. **Cash rates are close to peak:** Cash rates have moved up rapidly from historical lows but are getting close to peak. Macquarie expects the RBA cash rate to reach 4.1% by May with rate cuts coming in early 2024. 10-year yields are currently trading at yields around ~3.5%, which means this income level is guaranteed for 10 years. While higher rates may be available on shorter term investments like term deposits (average ~4% for 12 months), those without the need for access to capital should consider locking in higher rates on offer for longer term bonds and mitigating refinancing risk.

Bank debt drawdowns much lower than in hybrids/equities



Source: Bloomberg, MWM Research, March 2022

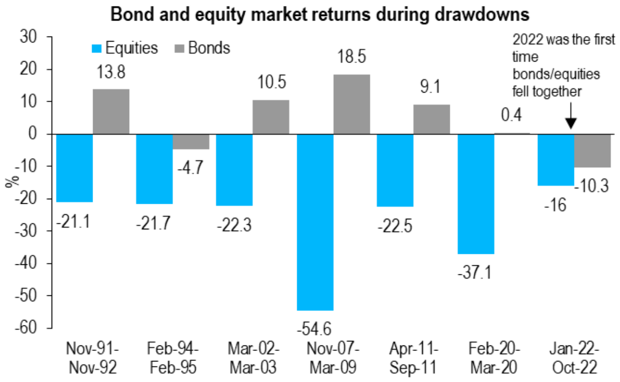
2. **Limited volatility and risk of capital loss:** Despite annual volatility in bonds reaching around 6% in 2022, historically, the average volatility in Australian bonds tends to be around ~4%pa versus Australian equities at ~14%. The significantly lower volatility of fixed income implies a smoother income level as well as greater capital stability particularly relative to equities and hybrids.

3. **Safe-haven status**: In addition to providing attractive absolute yields, when yields fall due to market stress and/or economic growth disappointment, this provides a capital boost to total portfolio returns. 2022 was the first time in history that bonds did not provide a positive return during an equity bear market. These conditions are unlikely to be repeated particularly given the higher starting point, which provides room for yields to fall, in turn providing greater potential for portfolio protection.

Achieving income objectives

Constructing a fixed income portfolio to achieve a range of different income objectives is the simplest it has been for many years. In general, when constructing an income portfolio, we set out to achieve the required level of income with as little variability as possible. The investment horizon and liquidity requirements of different investor objectives determines the degree of capital volatility that is acceptable and the nature of the underlying investments.

Bonds traditionally act as a safe-haven during equity drawdowns



Source: FactSet, MWM Research, March 2023

Investments and objectives for income requirements

Income Objective	4% pa	6% pa
Tolerance for volatility	Low	Med-High
Liquidity requirements	High	Low-Med
Types of investments	Cash, Aus. Govt Bonds, AUD Bank Floating Rate Notes	Cash, Govt Bonds, AUD Bank Floating Rate Notes, High Yield, Private Credit
Investment time frame	3yrs +	5-7years +

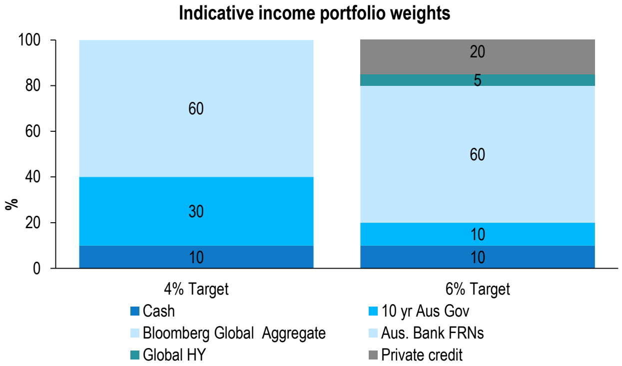
Source: MWM Research, March 2023

It is possible to construct a fixed income portfolio that would be 100% cash and yielding 3.5% or as high as 8-10% should it sit at the riskiest end of the fixed income spectrum. For the most risk averse, we think 4% yields in short, dated term deposits with rollover risk is still highly appealing. However, we would be looking to lock in 4%+ yields for a longer period of time. Below we outline how simple it is to currently construct a fixed income portfolio that would yield 4% or 6%. Other options are also available depending on an individual's risk-return objectives.

1. **Income objective ~4% pa**: can be achieved by investing in a portfolio of cash, government bonds as well as highly rated Australian bank floating rate notes. This portfolio can be highly liquid, as well as showing limited volatility to capital given the limited exposure to both interest rate and credit risk. In addition, there is the potential for yield/income pick up due to active management.

2. **Income objective ~6% pa**: in addition to a portfolio of cash, government bonds as well as highly rated Australian bank floating rate notes, adding global high yield and/or private credit can boost yield even further. The proportion invested into these higher risk investments should be determined by the individual investor's need for liquidity as well as tolerance for mark-to-market volatility given the investment in high yield.

Portfolio construction to achieve income of 4-and-6% pa.



Source: MWM Research, March 2023

Macquarie WM Investment Strategy Team

Investment Strategy Update #135 finalised on 20 March 2023

Recommendation definitions (Macquarie Australia/New Zealand)

Outperform – return >3% in excess of benchmark return

Neutral – return within 3% of benchmark return

Underperform – return >3% below benchmark return