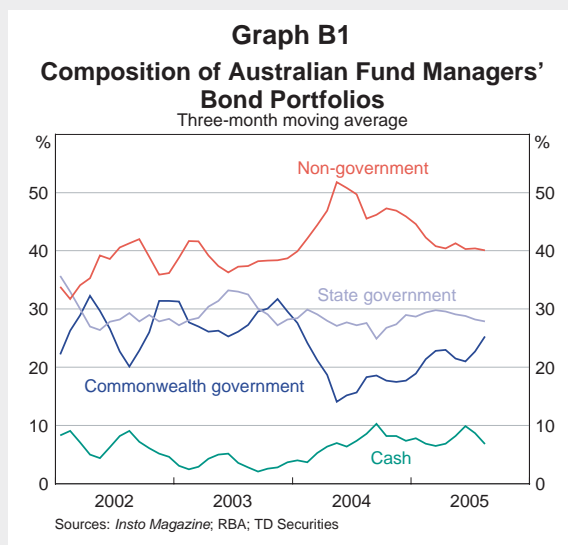


## Box B: Australian Fund Managers' Bond Portfolios

Fund managers are one of the main categories of investors in the Australian bond market. These institutions hold roughly a quarter of bonds outstanding in Australia, that is, around \$70 billion. Insurance companies and offshore investors each hold a similar share, while banks and other deposit-taking institutions hold a further sixth of outstandings. This box examines how fund managers have allocated their bond portfolios over recent years.<sup>1</sup>

The composition of fund managers' domestic bond portfolios was relatively stable over the course of 2002 and 2003; there was a small increase in the allocation to non-government bonds – mainly at the expense of cash – and there was some switching between Commonwealth and state government bonds. In early 2004 these institutions reduced their allocations to Commonwealth securities and switched to non-government bonds (in the face of strong demand from offshore institutions for Commonwealth securities) (Graph B1).



Over the past year, as spreads between non-government bonds and government bonds narrowed, fund managers have steadily rebalanced their portfolios towards Commonwealth Government bonds and away from non-government bonds. Growth in funds under management has meant that fund managers have still been net buyers of non-government bonds over this period, but to a lesser extent than banks and non-residents.

Consistent with this development, fund managers have also been progressively rebalancing their non-government portfolios towards bonds with higher credit ratings (Graph B2). During the second half of 2004, fund managers reduced their exposures to BBB-rated and sub-investment grade debt, and increased their exposure to A-rated debt. In 2005, they continued to reduce their exposure to BBB-rated and sub-investment grade debt, and switched out of A-rated debt and into AA-rated debt, as the relative pick-up on A-rated debt continued to decline. Over

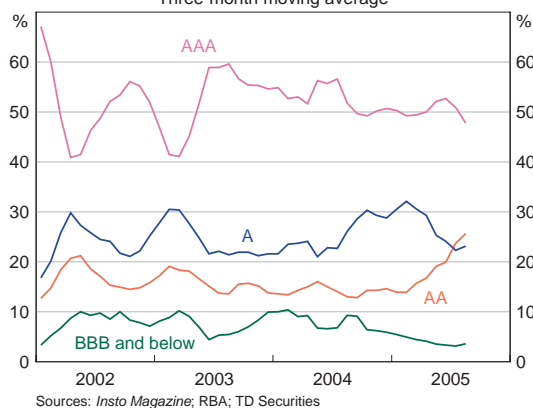
<sup>1</sup> The data used in this box were sourced from the Insto/TD Securities and the Stone & McCarthy Research/Deutsche Bank fund manager surveys. Survey participants include almost all of the large fund managers active in the Australian market. These managers also invest a sizeable proportion of life insurance companies' reserves.

the whole period, AAA-rated bonds have typically comprised about half of bond managers' non-government bond portfolios. Residential mortgage-backed securities have likely accounted for the bulk of these bonds.

Market commentary has suggested that fund managers' decision to reduce the credit risk in their bond portfolios did not reflect concerns that default rates would increase noticeably in coming months – corporate earnings remain strong, debt levels are low, and upgrades continue to outpace downgrades. Instead, it appears that fund managers have taken the view that high levels of global liquidity have depressed spreads to levels that no longer adequately compensate investors for the risk that they are accepting, even if that risk is not very high.

In addition to credit risk, fund managers are concerned with interest rate risk – the risk that changes in interest rates will adversely affect the value of their bond holdings. From mid 2003 to mid 2005, fund managers reduced the duration of their bond portfolios relative to their benchmark (which in most cases is the UBS Composite Index) (Graph B3). This broadly coincided with the inversion of the Australian yield curve, and probably reflected a view amongst fund managers that longer-dated bonds were expensive given the likely stance of monetary policy over coming years. Since August, bond yields have risen (prices fallen) and fund managers have lengthened their duration. ↘

**Graph B2**  
**Composition of Australian Fund Managers' Non-government Bond Portfolio**  
 Three-month moving average



**Graph B3**  
**Duration of Fund Managers' Bond Portfolios**

