UOBAM SGD bond fund thrives on credit plays

| BY KELVIN TAN |

To accomplish her fund's investment objective of generating better returns than Singapore-dollar (SGD) deposits, in an environment where interest rates are currently yielding close to nothing, Joyce Tan, who manages the United SGD Fund, could simply invest all of her fund's assets in low-risk money-market and short-term interest-bearing debt instruments.

But the fixed-income portfolio manager and a director at local fund house UOB Asset Management (UOBAM) likes to go one step further to reap higher returns for her fund's investors. Tan adds to her portfolio a carefully selected group of investment-grade credits, which are essentially high-quality corporate bonds. And in recent years, that strategy has paid off handsomely.

Over the past three and five years, the United SGD Fund was the best performer in its fund category, turning in stellar gains of 18.8% and 26.2%, respectively (as at April 1). Those gains seemed to have been achieved without taking on excessive risks, judging from the three-year volatility level of Tan's fund, which is among the least volatile unit trusts in the SGD bond fund category (see table for more information).

"We place emphasis on adding value through credit selection based on our strong fundamental bottom-up research, which analyses credit quality, security structure and relative valuation. This is supplemented by a disciplined top-down strategy encompassing macroeconomic and market analyses that include duration, currencies and country/sector allocation," says Tan on her fund's good performance in recent years. "We also adopt diversified strategies combined with active risk management to generate sustainable total return."

The United SGD Fund, which had $451 million of assets under management as at end-February, won two awards at *The Edge*-Lipper Singapore Fund Awards 2011 for best fund in the SGD bond fund category over three and five years.

Still bullish on credits

Despite the surge in global corporate bond prices over the past 24 months, Tan is still finding good value in some credits, particularly those of big corporations in the financial-services industry. "We continue to favour large corporations with good liquidity, low leverage and which have a good track record. The global economy recovered in 2010 and is transiting into expansion in 2011," she says.

Like equities, corporate bonds tend to do well in an expansionary economic environment, in which companies thrive in terms of profitability. Default risk by bond-issuing companies is reduced with improved economic outlook and that supports credit investment, explains the UOBAM fund manager. "Coupled with ample market liquidity, credit spread is also expected to tighten."

The United SGD Fund's biggest holdings include fixed-income securities of financial institutions such as Japan's **Sumitomo Mitsui Financial Group**, Australia's Westpac Capital and ANZ Capital, Hong Kong's **Bank of East Asia** and Singapore's commercial real estate company Savu Investments.

Regional exposure

Despite being an SGD-focused bond fund, Tan's unit trust has only a quarter of its assets invested in Singapore-based bonds. The rest of the fund's assets are spread across a portfolio of international bonds, including those of South Korea, Hong Kong, Japan, Malaysia and the US.

According to Tan, there are several reasons for the international positioning of her fund's portfolio. Firstly, UOBAM has "a strong team" of 18 analysts who cover bond issuers across Asia, the emerging markets as well as developed markets. "This enables the fund to tap investment ideas from a wide universe of credits," she says.

Secondly, investing in bonds across a number of Asian countries and the US generally gives good diversification to her fund, Tan explains. "We endeavour to invest mainly in good-quality credits that are rated 'investment grade' by rating agencies or internally via our credit-scoring system. As such, we need to look beyond Singapore-based issuers."

Besides, bonds of other markets, especially the developed world, also offer good liquidity in the secondary fixed-income market. "Liquidity in the secondary market is dependent on factors such as the size of issuance, diversity of investor base and availability of secondary broker prices. Liquidity is typically better in the eurodollar debt market, as implied by the bonds' lower bid/ask spread," Tan observes.

Lastly, relative yields of eurodollar bonds are more attractive than low-yielding SGD-denominated ones, she says. "Issuers in the eurodollar debt market need to price their bonds reasonably to compete against issuances from their regional peers. Secondary pricing is also more reflective of fundamental differences among credits, taking into account demand and supply considerations."

Despite her fund's significant investments in non-SGD fixed-income securities, Tan assures that all foreign currency exposure will be hedged to the SGD, which has been strengthening over the past 18 months. "This hedging against the volatility of foreign exchange movements helps provide investors with a stable return over cash alternatives such as deposits, via careful selection of credits," she says.

No fear of higher rates

While some bond fund managers are fretting about the prospects of higher global interest rates, Tan doesn't seem to be too concerned. That's because her fund invests mainly in short-duration bonds with less than three years to maturity. "Any price decline for short-dated bonds will be less versus long-dated bonds in the event of rising interest rates," she says. Interest rates generally have a negative correlation with bond prices and higher rates tend to cause price depreciation of fixed-income securities.

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In addition, Tan tells *Personal Wealth* that the maturity profile of bonds in her portfolio is "laddered" to take advantage of rising interest rates. "The bond portfolio consists of different maturities, ranging from one to three years. In the event that interest rates increase over time, the monies from the matured bonds may be reinvested at the higher interest rates for the next three years," she says. "These strategies enable the fund to take advantage of rising interest rates while mitigating mark-to-market risk."

In any case, Tan doesn't believe that interest rates in Singapore and the US will increase significantly over the next few quarters. Indeed, any surge in local interest rates will be triggered by an upward movement in US rates, which are determined by the US Federal Reserve's monetary policy.

"Based on our in-house econometric model, changes in US interest rates contribute 82% of the change in Singapore interest rates. On the other hand, US interest rates are highly correlated to the Fed's policy as well as US inflation," Tan says. She doesn't think the Fed will hike rates unless the US unemployment rate hits 7.5% or below. The unemployment rate remains high currently, at about 9%, the UOBAM fund manager points out.

For sure, the US economic recovery is now "on a firmer footing and overall conditions in the labour market appear to be improving gradually", but it would be "some time away before the Fed reconsiders its current policy stance", she says, adding that US core inflation continues to be low, at 1.1% versus the Fed's target of 2%. "Commodity prices have risen significantly since the summer, and concerns about global supplies of crude oil have contributed to a sharp run-up in oil prices in recent weeks." Nonetheless, inflation over the longer term is likely to remain at moderate levels, Tan notes.

"The current Fed rate is at 0% to 0.25%, which has remained the same since March 2009. Any monetary tightening is not expected until we see a steady decline in the US unemployment rate to below 7.5% and an increase in US core inflation to above 2%. As such, we should see Singapore interest rates hovering at the current low levels for some time," she says. And a benign interest-rate environment should help the United SGD Fund generate better returns than SGD deposits for its investors.

"The fund returned a total of 1.2% for January and February 2011. Barring a sharp upward spike in interest rate, the negative impact from a steady rising-interest-rate environment on the fund is expected to be fairly muted," says Tan. E

Performance and volatility of SGD bond funds

	THREE-YEAR VOLATILITY* APRIL 1, 2008 TO APRIL 1, 2011 (%)		THREE-YEAR RETURN APRIL 1, 2008 TO APRIL 1, 2011 (%)		FIVE-YEAR RETURN MARCH 31, 2006 TO APRIL 1, 2011 (%)	
NAME	VALUE	RANK	VALUE	RANK	VALUE	RANK
Horizon Singapore Fixed Income Enhanced SGD	0.17	6	7.46	7	13.78	8
Fullerton Short Term Interest Rate A	0.06	10	16.69	2	24.02	2
United SGD Fund	0.09	8	18.80	1	26.18	1
PineBridge Intl Funds – Singapore Bond	0.27	2	10.39	5	19.11	7
LionGlobal Singapore Fixed Income Investment A	0.14	7	11.90	3	21.37	3
Legg Mason Western Asset Singapore Bond A	0.24	3	9.48	6	19.70	6
ABF Singapore Bond Index	0.22	4	7.15	8	20.32	4
United Singapore Bond Fund	0.17	5	11.41	4	20.15	5
DBS Enhanced Income SGD	0.07	9	5.11	9	11.56	9
PRU Income X	0.51	1	-15.33	10	NA	NA
Bond SGD Average	**0.19**		**8.31**		**19.58**	

** Volatility is the standard deviation of performance for the previous 36 months. The higher the value, the riskier the fund.*

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