THOUGHT
PIECE

IAM
INCOME ASSET MANAGEMENT

June 2024

Direct Investment vs Funds

By Darryl Bruce, Executive Director – Capital Markets

Once you have decided to invest in a particular asset class, then comes the decision on whether to invest directly or through a fund. Funds are seen as the more 'hands-off' approach i.e. you just leave it to the experts to invest, however, that comes with significant additional costs and loss of control. While investing directly keeps the control in your hands, it requires more time to research and make decisions on what to invest in. Which is the better approach?
Prior to moving into the world of direct bond investing in 2013, I was a corporate bond fund manager, so I have some experience from each side of the fence. Like most things in life there is no 'one size fits all' approach however if you are well informed then you are better placed to make the right decision for you.

The Case for Funds and Cost Considerations

Funds give smaller investors the ability to achieve a level of diversification that would be impossible to achieve if they were investing directly in bonds. Funds also ensure that you always have a professional overseeing your fixed income investments. This is of value to many who would consider themselves to be relative novices in the asset class.

For larger investors, even those who do consider themselves to be fixed income novices, I think a strong argument can be made for direct investment. As an asset class, fixed income is expected to offer lower and more stable returns than equities. I tend to describe a fixed income portfolio as one that does not need a lot of 'feeding and watering'. This is especially the case for portfolios that are heavily weighted to investment grade issues. Long term studies point to extremely low default rates in investment grade bonds. Personally I have been involved in a single investment grade default in the last 20 years – a hybrid issued by an Irish Bank. In comparison, a share portfolio is likely to require much more of an active management approach.

Does it really make sense to pay away a meaningful amount of your annual return if there is relatively little requirement for active management? It may do for some investors in an environment where investment grade bonds are yielding >6% however it may be harder to swallow if/when we return to a lower yield environment where the fee can cut meaningfully into the overall yearly return.

Of course there are also costs involved in direct bond ownership however they take the form of an upfront brokerage upon purchase and then a relatively modest annual custody charge. If we take the example of the NAB Tier 2 bond that was issued last week, investors paid a 0.25% facilitation fee and then will incur a custody fee of 0.1%pa until the call, which is the expected maturity, in 2034. Given the coupon of 6.34% direct investors will incur very minimal costs, as a percentage of the bond return, over the life of the bond.

Control and Crisis Management

Aside from the cost benefits I also like the control that direct investment gives investors and I don't think you need to be an expert to build a solid stable bond portfolio. The higher yield that is in a portfolio the greater the need for diversification, however, I think that the need for diversification in investment grade is as much about managing duration and maturity profiles as it is about managing credit risk. This is an area that your friendly IAM relationship manager can help you with!

Another area where control can be critical is during a crisis. I often advise investors to build portfolios that are 'crisis ready'. Try to make sure, as much as possible, that you are comfortable with the companies that are held in your portfolio. Not just comfortable during calm economic times but also comfortable when the next storm hits. We don't need to be able to predict the cause of the next crisis to accept that these conditions come along from time to time. If you hold bonds directly and you are confident in the ability of the issuers in your portfolio to ride out the storm then you have little to worry about. Yes, at times some of the capital price movements might be slightly uncomfortable, but if you are confident in the ability of the company to survive then just hold on while you continue to collect the income. In many ways, this is the time for those sitting on surplus cash to be putting new funds into the market. A lot of long-term bond investors will have stories of picking up bargains in such market conditions.

As someone who managed a bond fund through the GFC, I know that the experience for fund investors in a crisis can be materially different. If you are lucky enough to be in a top quartile performing fund you might be okay but if your fund is underperforming on an absolute, not just relative basis, life can be difficult. Often there will be redemptions as investors pull their money out. Fund managers will run down their cash holdings and may have to start selling assets to satisfy the redemptions. Being a forced seller in a weak market is a particularly unpalatable position to find yourself in. Managers will often sell their strongest positions, the ones where the valuations have held up the best. This makes sense however it results in a deterioration in the overall quality of the portfolio that you are invested in, which isn't a great position to find yourself in and at some point it might make sense to sell out yourself, almost certainly crystallising a loss in the process.

Certainty and Transparency in Direct Investment

Aside from issues around cost and control I also like the relative certainty of income and return of capital that can be achieved through direct investment. The predictability of the exact timing and amount of income is much more transparent through direct investment than it is in a fund.

Finally, the return of capital at a specific date in the future (the maturity date) is one of the great strengths of a bond investment. This is one that direct investors enjoy and can plan around. Whereas funds are normally invested in a broad range of bonds with issues maturing and funds being reinvested regularly but there is never a point where capital is returned at a predetermined price – 100 (par) as is the case with direct investment.

So, whilst funds can offer a useful entry point into fixed income and provide meaningful diversification for smaller investors, overall my preference is for direct investment. Investing directly in the underlying bonds provides certainty of income and return of capital at maturity on top of meaningful benefits around control and materially lower costs.

Research Report Disclosure

IAM Capital Markets Limited (AFSL 283119) ('IAM Capital Markets') is a financial service business and provides general financial product advice only. As a result, this document, the Content and the Reports are not intended to provide financial product advice and must not be relied upon or construed as such. IAM Capital Markets does not express any opinion on the future or expected value of any financial product and does not explicitly or implicitly recommend or suggest an investment strategy of any kind. The Content and the Reports provided in this document have been prepared based on available data to which IAM Capital Markets have access. Neither the accuracy of that data nor the research methodology used to produce the Content and Reports can be or is guaranteed or warranted. Some of the research used to create the Content and the Reports is based on past performance. Past performance is not an indicator of future performance. Any forecasts are predictive in character and based on specified assumptions generally available at the time and no reliance should be placed on the accuracy of any forecast information. The actual results may differ substantially from the forecasts and are subject to change without further notice. The data generated by the research in the Content or the Reports is based on research methodology that has limitations; and some of the information in the Content or the Reports is based on information from third parties. IAM Capital Markets does not guarantee the currency of the Content or the Reports. If you would like to assess the currency, you should compare the Content or the Reports with more recent characteristics and performance of the assets mentioned within it.
You acknowledge that investment can give rise to substantial risk and a product mentioned in the Content or the Reports may not be suitable to you. The Content and Reports have been provided or made available by IAM Capital Markets without taking account of your objectives, financial situation, and needs. IAM Capital Markets strongly recommends that you seek independent accounting, financial, taxation, and legal advice, tailored to your specific objectives, financial situation or needs, prior to making any investment decision. Neither IAM Capital Markets, nor any of its directors, authorised representatives, employees, or agents, makes any representation or warranty as to the reliability, accuracy, or completeness, of the Content and Reports. Nor does IAM Capital Markets accept any liability or responsibility arising in any way (including negligence) for errors in, or omissions from the Content and Reports. IAM Capital Markets, its staff and related parties earn fees and revenue from dealing in the securities as principal or otherwise and may have an interest in any securities mentioned in this document. Any reference to credit ratings of companies, entities or financial products must only be relied upon by a 'wholesale client' as that term is defined in section 761G of the Corporations Act 2001 (Cth). IAM Capital Markets does not provide tax advice and is not a registered tax agent or tax (financial) advisor, nor are any of IAM Capital Markets' staff or authorised representatives. IAM Capital Markets does not make a market in the securities or products that may be referred to in this document.
An investment in notes, corporate bonds, syndicated loans, or any debt instrument should not be compared to a bank deposit. Notes, corporate bonds, syndicated loans, or any debt instrument have a greater risk of loss of some or all an investor's capital when compared to bank deposits. IAM Capital Markets is not licensed to provide foreign exchange hedging or deal in foreign exchange contracts services. IAM Capital Markets may quote to you an estimated yield when you purchase a bond. This yield may be calculated by IAM Capital Markets on either A) a yield to maturity date basis; or B) a yield to early redemption date basis. Some bond issuances include multiple early redemption dates and prices, therefore the realised yield earned by you on the bond may differ from the yield estimated or quoted by IAM Capital Markets at the time of your purchase.
To the extent IAM Capital Markets has utilised research from BondAdvisor, the following Disclaimer applies. BondAdviser has acted on information provided to it and our research is subject to change based on legal offering documents. This research is for informational purposes only. We note that this security offering is only being made to investors who are not retail clients under the Corporations Act nor located outside Australia This information discusses general market activity, industry or sector trends, or other broad-based economic, market or political conditions and should not be construed as research or investment advice. The Content of this Report is not intended to provide financial product advice and must not be relied upon as such. The Content and the Reports are not and shall not be construed as financial product advice. The statements and/or recommendations on this web application, the Content and/or the Reports are our opinions only. We do not express any opinion on the future or expected value of any Security and do not explicitly or implicitly recommend or suggest an investment strategy of any kind. The Content and Reports provided have been prepared based on available data to which we have access. Neither the accuracy of that data nor the methodology used to produce the Report can be guaranteed or warranted. Some of the research used to create the Content is based on past performance. Past performance is not an indicator of future performance. We have taken all reasonable steps to ensure that any opinion or recommendation is based on reasonable grounds. The data generated by the research is based on methodology that has limitations; and some of the information in the Reports is based on information from third parties. We do not guarantee the currency of the Report. If you would like to assess the currency, you should compare the Reports with more recent characteristics and performance of the assets mentioned within it. You acknowledge that investment can give rise to substantial risk and a product mentioned in the Reports may not be suitable to you. You should obtain independent advice specific to your particular circumstances, make your own enquiries and satisfy yourself before you make any investment decisions or use the Report for any purpose. This Report provides general information only. There has been no regard whatsoever to your own personal or business needs, your individual circumstances, your own financial position or investment objectives in preparing the information. We do not accept responsibility for any loss or damage, however caused (including through negligence), which you may directly or indirectly suffer in connection with your use of this Report, nor do we accept any responsibility for any such loss arising out of your use of, or reliance on, information contained on or accessed through this Report.

The information in this website is for general information purposes only and does not purport to contain all matters relevant to any particular or financial instrument. It is not intended to be a recommendation, offer or invitation to purchase, sell or otherwise deal in securities or other investments. Before making any decision in respect to a financial product, you should read the relevant Financial Services Guide and Product Disclosure Statement available from IAM Group https://www.incomeam.com and seek independent and specific advice from an appropriately qualified professional. IAM Group shall not be liable for any errors, omissions, defects or misrepresentations in the information or for any loss or damage (whether direct or indirect) suffered by persons who use or rely on the information contained here.