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Bonds and money market assets – the difference is in the detail

At first glance bond and money market instruments seem fairly similar in that both asset types bear interest. However, the two assets are actually quite different.

Interest rate risk in money market funds and bond funds

Money market funds target interest income, while bond funds target both interest income and capital gains. The capital gains in bond funds are a result of interest rate (and therefore bond price) movements. For this reason bond funds take, on an order of magnitude, more interest rate risk than money market funds.

Duration of money market and bond funds

Duration is a measure of the sensitivity of price to changes in interest rates. For example, if an investor owned a bond with a duration of 6.0 and the interest rate rose by 1% the bond price would fall by 6%. The duration of money market funds is limited by the Collective Investment Schemes Control Act to 90 days, or a duration of 0.25 (years). By comparison, the duration of the All Bond Index (ALBI) – the benchmark for most bond funds – is 5.78, twenty-three times the maximum for money market funds.

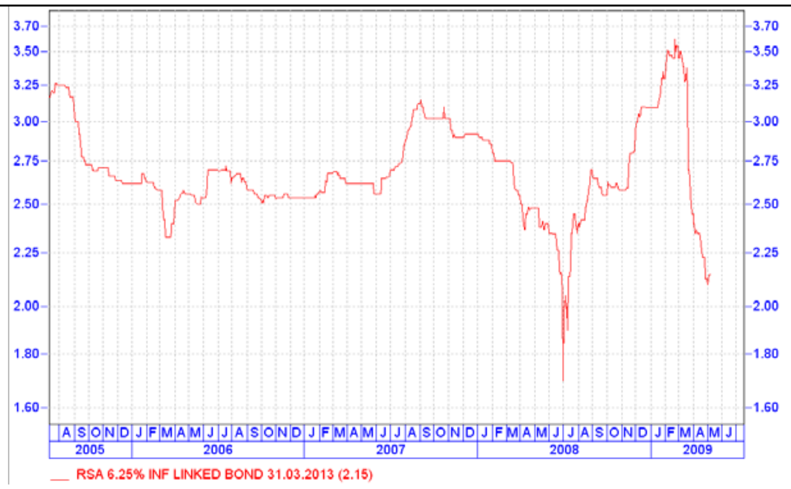
When bond fund mangers believe yields are high (i.e. yields will fall and prices will increase) they will lengthen duration to take advantage of the price increase they anticipate. Conversely, when they believe yields are low and bond prices are high, they will shorten the duration of the fund. The same applies to money market funds, but the impact is much smaller because of the duration limits.

How inflation expectations affect bond yields

Bond yields discount investors' real return requirements and inflation expectations over the term of the bond. The real return investors require varies depending on risk appetite, and is determined by factors such as the supply of new bonds and investor demand. Over the past 10 years South African bond investors have required a real return of about 3% on average.

The yield difference between nominal bonds and the inflation-linked bonds can be used to illustrate inflation expectations. A nominal bond pays a fixed coupon, while an inflation-linked bond pays a coupon linked to the inflation rate. The quoted yield on an inflation linker is the real return the bond will give above inflation over the life of the bond. The real return on inflation-linked bonds has recently declined from 3.4% to 2.1% as illustrated in the chart.

Real yield on the R189 inflation-linked bond



Bond funds will yield good total returns when bond prices move from discounting a high inflation rate to a lower one. In this instance bond prices will rally as yields decline.

South African bonds are currently discounting a long-term inflation expectation of 5.5% to 6%. At Allan Gray we believe that inflation is likely to exceed 6% in the long term. When the risks of inflation being either much higher or lower than 6% are considered, we think there is greater risk of inflation rising. A further consideration is that the borrowing requirement of the South African government is increasing. This may cause investors to demand higher real yields as the supply of bonds increases, placing downward pressure on prices.

We currently prefer the lower risk of money market assets to bonds

We have expressed these views in the Allan Gray Bond Fund's low duration of 2.96. Our cautious outlook for bond prices, and our belief that the risk of capital loss exceeds the potential for capital gains, means we prefer the lower risk of money market assets to bonds.

Commentary by Andrew Lapping, portfolio manager, Allan Gray Limited