ARE YOUR FIXED INTEREST INVESTMENTS SAFE?

What are the rules for safe fixed interest investing?

The 5 rules for fixed interest investment

The shocking meltdown of the NZ finance company sector, has many investors worried about the security of their own fixed interest investments and questioning what is the right strategy for their defensive investments. So what are the rules for safely investing in fixed interest investments?

1. Focus on the Return of Your Capital and not the Return on Your Capital

As simple and obvious as this may sound, it's the investors who are chasing returns on their fixed interest investments that have been drawn into the uncertain and for many, ultimately unsafe world of finance companies. As many have found out to their cost, the higher returns on these speculative bonds are woefully inadequate if these risks are brought to account through a receivership.

2. View Fixed Interest Investments as an Integral Part of an Overall Portfolio

Defensive investments' primary role in a portfolio is to dampen portfolio volatility (short term changes in value) and provide income. When viewed from this perspective, they allow the balance of the portfolio to be allocated to more volatile growth investments (that provide a good return for their additional risk) by maintaining the overall portfolio volatility within your comfort zone or tolerance for risk. This gives investors a higher portfolio return for the same or a lower level of risk.

3. Avoid Default Risk

Although there are higher returns from junk bonds and finance companies, these are a poor reward for the additional default risk taken on. International credit rating agency Standard & Poor's reports that Australasian non-investment grade bonds are over 40 times more likely to default over a 3 year period than investment grade bonds! And, in today's market, the additional return for this risk is less than 0.5% pa after tax.

Enough said. Stick to investment grade bonds with an S & P credit rating of at least BBB-. However, this is only the lowest investment grade rating and under normal circumstances, corporate bonds with a much higher credit rating of A or better are preferable.

4. Avoid Maturity Risk

It is beyond the scope of this paper to explain why but for a variety of reasons intermediate term bonds with maturities of 5 years or less are optimal and bonds with maturities of greater than 5 years should be avoided because of their increased volatility

5. Diversify Your Bond Investments

The rewards of diversification are the only "free lunch" for investors and this is as true for bonds as it is for any other asset class. The disaster of the NZ finance company failures is that for many investors, that was their portfolio!