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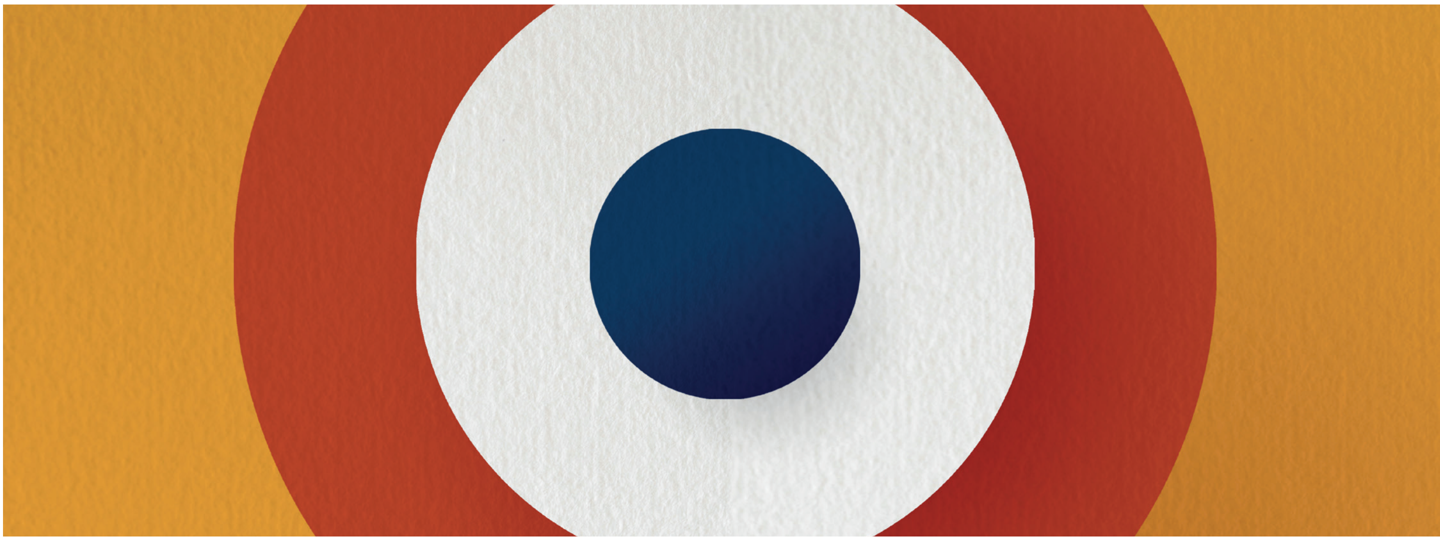


Target-maturity bond funds: Understanding their appeal and challenges

Connie Chou, Head of Global Asset Allocation and Fixed Income, Eastspring Investments, Taiwan

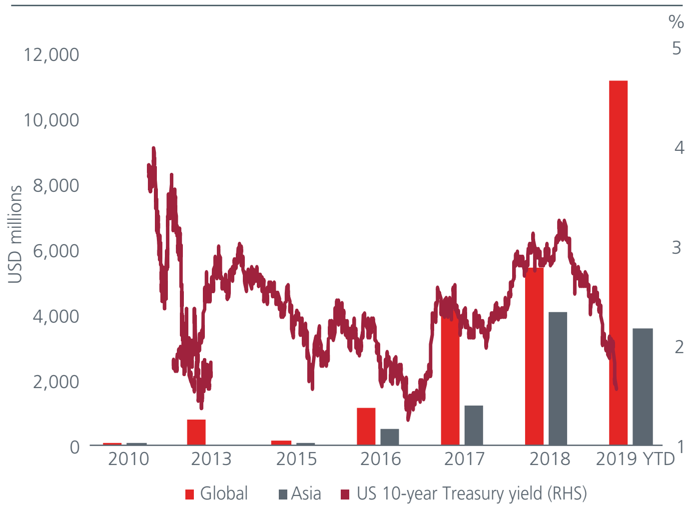
Given their attractive yields and fixed maturities, investors are increasingly looking to target-maturity bond funds to meet their retirement and other financial goals. Going forward, regulators, distributors and investors all have a part to play to lay the groundwork for more sustainable growth.

Target-maturity bond funds or Fixed Maturity Products (FMPs) are not new investment products. However, their ability to pay out regular income and the attractive yields lifted their popularity after 2016 when bond yields dived on the back of economic worries. See Fig. 1. With 10-year Treasury yields currently hovering around 1.64%[1] on the back of growth concerns, target-maturity bond funds are likely to continue to appeal to investors looking for regular income.

MIDDLE GROUND

Target-maturity bond funds seek to strike a middle ground between bonds and bond funds. They typically pay out regular income (e.g. monthly or quarterly), similar to bonds and bond funds. However, similar to bonds, they mature on a specified date. This means that at a pre-determined maturity date, the target-maturity bond fund seeks to return investors their share of the net asset value of the portfolio. Target-maturity bond funds achieve this by investing in a portfolio of corporate or sovereign bonds that mature around the same time, close to the fund's maturity date.

Fig. 1. Growth of Fixed Maturity Strategies versus bond yields[2]



Having a fixed maturity date helps overcome the objection that some investors have towards bond funds (which have no maturity dates). As such, target-maturity bond funds appeal to investors who are looking for a steady income and some certainty in the timing of the return of their principal to help fund an expected need e.g paying for children's education, buying a home or starting retirement. To better meet their ongoing financial commitments, some investors also invest in a number of target-maturity bond funds with different maturity dates. This strategy is known as "laddering".

Yet unlike bonds, target-maturity bond funds offer investors greater diversification by investing in a portfolio of bonds which can range across different credit ratings, sectors and geographies, although the amount would depend on the specifications of the target-maturity bond fund. This helps to reduce default risks linked to single issuers and/or credit risks linked to single bonds. Again unlike bonds, target-maturity bond funds taps on the resources and experience of portfolio managers who would perform credit analysis, selection, active management and ongoing monitoring of the bonds in the portfolio. Target-maturity bond funds also offer economies of scale which most investors are not able to achieve on their own.

WHAT INVESTORS NEED TO LOOK OUT FOR

While target-maturity bond funds have many attractive features, there are caveats too. For one, investors should note that target-maturity bond funds are not capital-protected or capital guaranteed. A negative credit event (e.g. default by a bond issuer, bond restructuring or distressed sale), for example, can impair the net asset value of the portfolio. In this scenario, investors may not receive their full principal at maturity. That said, the fund manager can mitigate this risk through extensive research and ongoing monitoring of the bonds. Hence the experience and track record of the fund manager matters.

The target-maturity bond fund's target yield is also not guaranteed. Some bonds in the portfolio, for example, may mature a few months before the target-maturity bond fund's maturity date, leaving cash in the portfolio. This could affect the portfolio yields in the final year. The fund manager can mitigate this by trying to closely match the maturities of the underlying bonds to the target-maturity bond fund's maturity date. The fund manager can also monitor the market on an ongoing basis to look for attractive reinvestment opportunities.

A target-maturity bond fund may include riskier and lower rated bonds to achieve a higher yield. This risk is rising since bond yields have fallen 124 basis points over the last 12 months[3]. Hence instead of chasing the highest headline yield, investors should ensure that they are comfortable with the credit ratings of the underlying bonds in the target-maturity bond fund. Fig 3. compares the features between target-maturity bond funds, bond funds and bonds.

ASIA'S EXPERIENCE

The popularity of target-maturity bond funds in Taiwan can be attributed to investors' growing retirement needs, as well as a flight to safety amidst market headwinds. While the market turbulence in 2016 had discouraged some investors from investing, the need for income has remained strong – hence the shift towards more defensive and income producing investments.

Taiwan first launched fixed maturity bond funds in Aug. 2016. From just one product in 2016, the number of fixed maturity bond funds grew to 15 in 2017, with the combined asset size rising to NT$32.68 billion (USD 1.10 billion). As of end-2018, Taiwan has launched 41 target-maturity bond funds with NT$142.07 billion (USD 4.61 billion) in combined assets. By end of June 2019, assets have risen to NT$242.4 billion (USD 7.80 billion)[5]. Today, Taiwan accounts for 36% of total global target-maturity bond fund assets under management or 82% of total Asia target-maturity bond fund assets under management.

Fig. 3. Comparison between target-maturity bond funds, open ended bond funds and bonds[4]

	Target-maturity bond funds	Open ended bond funds	Bonds
Income	Seeks to pay regular income, based on a target yield	Seeks to pay regular income, based on a target yield	Pays regular coupons, if there is no negative credit event
Yield	Target yield is not guaranteed. Interest income from the underlying bonds may be affected by negative credit events. Proceeds from bonds which mature or are called back before the fund's maturity date may also be reinvested at a lower yield	Target yield is not guaranteed. Portfolio yield may fluctuate according to the portfolio holdings and market conditions, including interest rate trends	Bond provides certainty of yield if held to maturity and there is no negative credit event
Principal	Although there may be daily fluctuations in the net asset value, the investor gets back his investment principal if the fund is held to maturity and there is no negative credit event	The investor is subject to fluctuations in the net asset value and returns are subject to the fund manager's expertise as well as market conditions, including interest rate trends	Although there may be daily fluctuations in the bond's net asset value, the investor receives the face value of bond if it is held to maturity and there is no negative credit event
Diversification	Diversification helps reduce exposure to single issuer default risks and single bond credit risks	Diversification helps reduce exposure to single issuer default risks and single bond credit risks	Investor is fully exposed to single-issuer default risks and/or single bond credit risks.
Professional expertise	Benefit from the fund manager's credit selection skills, active management and ongoing monitoring	Benefit from the fund manager's credit selection skills, active management and ongoing monitoring	Investor conducts own research and monitoring
Liquidity	Investors can typically redeem their investments on a daily basis based on the net asset value, although redemption fees may apply for early redemptions.	Investors can typically redeem their investments on a daily basis based on the net asset value.	Bonds may be volatile and difficult to sell if liquidity falls, especially in a period of market or issuer specific stress

With target-maturity bond funds in Taiwan currently offering an average yield of 3%[6] against domestic fixed deposit rates of <1.1%[7], investor demand is likely to remain strong.

Besides target-maturity bond funds, target-date bond funds are also gaining traction in Taiwan. The Securities Investment Trust and Consulting Association (SITCA) is testing a two-year pilot programme targeting 10,000 investors using the government-backed online distribution platform. The programme has attracted more than 110,000 local investors to sign up as of July 2019, when the scheme closed to new applications. The programme aims to understand investors' pension investment needs, and if the SITCA pilot is successful, it may create further demand for target-date funds and/or target-maturity bond funds in Taiwan.

Other regulators in Asia are also turning to target-maturity bond funds or target-date funds to promote retirement savings. In South Korea, the Financial Services Commission raised the equities allocation limit of target-date funds to 80% in September 2018, giving asset managers more flexibility to meet investors' needs. Over in Korea, target-date funds reached USD1.3 billion in 2018. Meanwhile, the China Securities Regulatory allowed asset managers to launch pension target funds, including target-date and target-risk funds of funds in March 2018. The number of approved pension target funds in China grew from one in August 2018 to 40 by early 2019.

EVERYONE HAS A ROLE TO PLAY

Asia's population is aging rapidly. By 2030[8], Asia is forecasted to account for over 60% of the total global population that is aged 65+ years. At the same time, this aging population is expected to fund their retirement needs against a backdrop where global interest rates are likely to remain low or move down, rather than up.

Investment solutions such as target-maturity bond funds or target-date funds can help meet the region's pressing retirement needs. However, for the growth in these solutions to be sustainable, regulators, asset management companies, distributors and investors all have a role to play.

Regulators are increasingly requiring asset management companies to provide greater transparency in their prospectuses and sales materials. This includes stating the target-maturity bond fund's credit quality and liquidity risks as well as highlighting potential risks of paying out income from the fund's capital, details about fees and penalties for early redemption etc. Distributors and investors too must play their part. Besides investor education, distributors need to help their clients appraise the suitability of such solutions for their individual needs. For investors, in assessing how these solutions fit in their portfolios and meet their financial goals, they need to understand the potential risks, and not just the benefits.

Sources: [1]Bloomberg. 13 August 2019. [2]Lipper, Eastspring Investments. 30 June 2019. Bond yields – 10 US Treasury Bond Yield, Bloomberg. [3]Bloomberg. 13 August 2019. [4]Eastspring Investments. August 2019. [5]Securities Investment Trust and Consulting Association (SITCA) and cMoney data. June 2019. [6]The maturities of target-maturity bond funds in Taiwan are between 4 to 7 years with most funds having maturities of 6 years. Yields of target-maturity bond funds that hold emerging market debt can have higher yields of 5%~6%. [7]1-3 year fixed deposit rates [8]Deloitte: Voice of Asia demographics

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