

If cash is king, who will see the emperor's new clothes?

**Peter Walsh**  
Director, Retail Business

PortfolioConstruction Conference 2008



# The Story

.....in 1837!



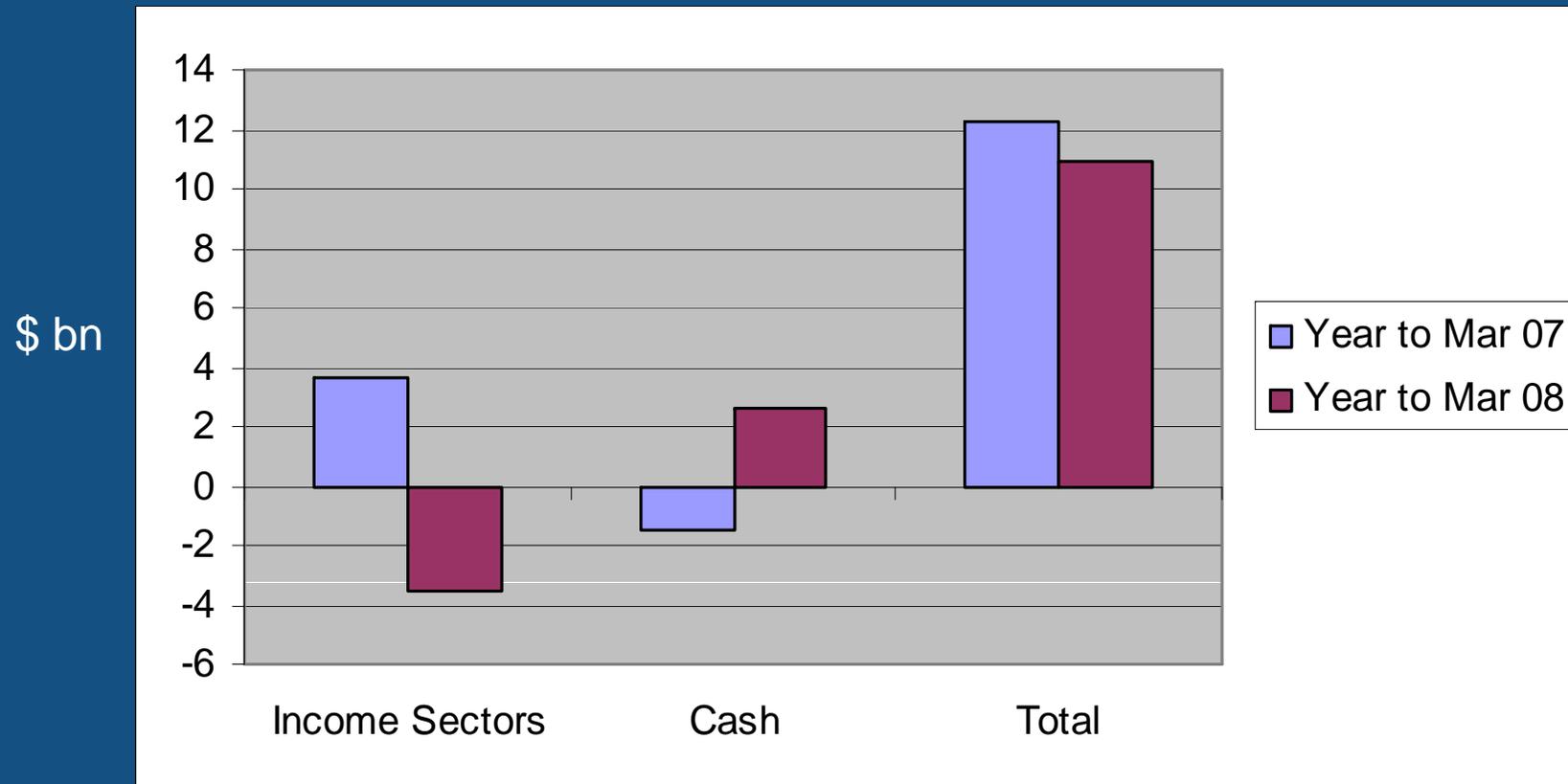
# The Story in 2008

- Where is all the money going?
- What opportunities exist in fixed income today
- What are the risks of fixed income, cash and term deposits
- How to position the risks, and opportunities, with clients



# Change in Net Fund Flows

12 months ending March 2007 and March 2008

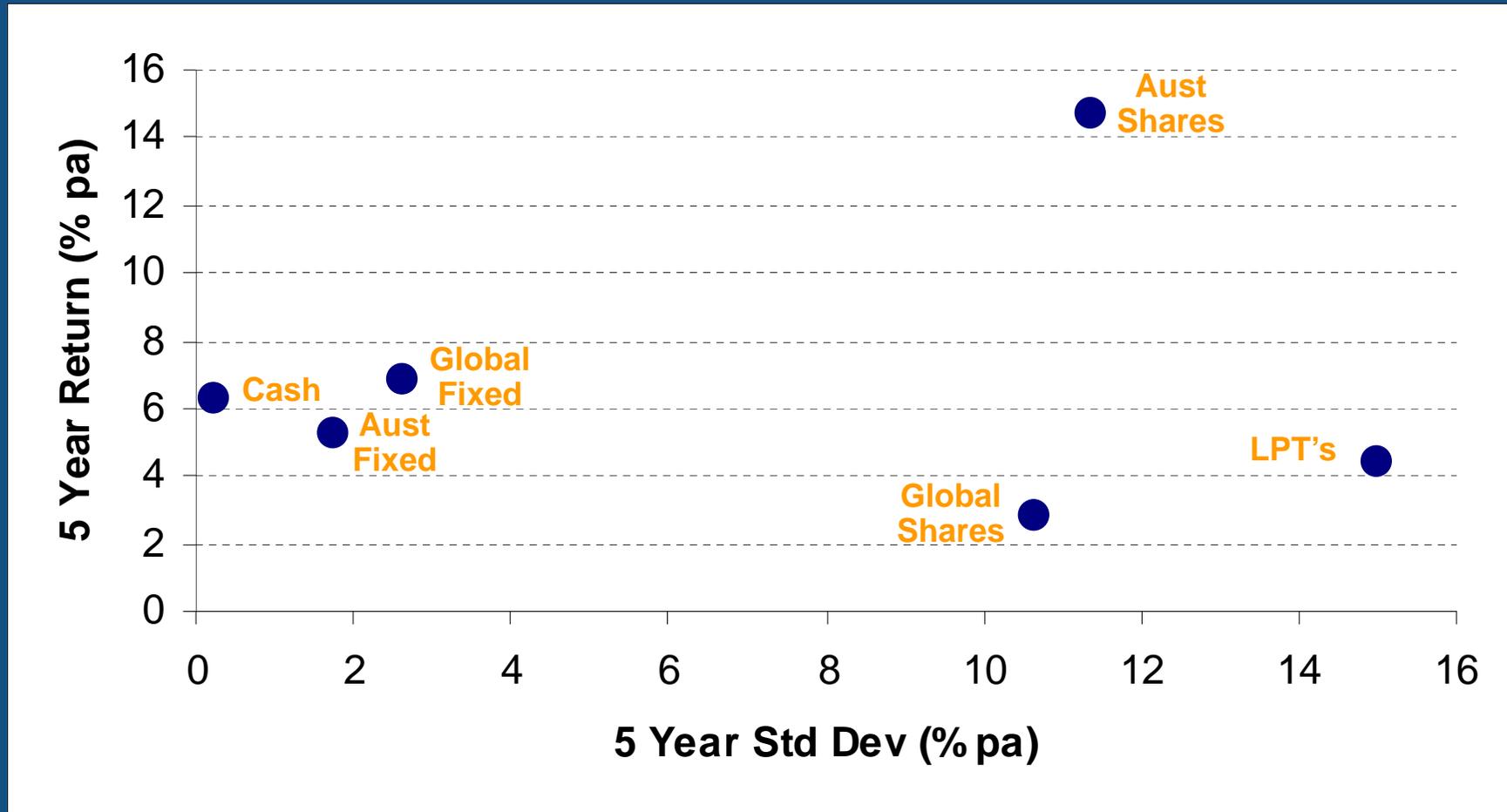


Source: Morningstar MSR. March 2007, March 2008



# Opportunities in Fixed Income

Risk/Return of major asset classes to July 2008



Source: Morningstar Direct



# Opportunities in Fixed Income

Correlation of major asset classes to July 2008

|                            |       |       |       |       |       |       |
|----------------------------|-------|-------|-------|-------|-------|-------|
| <b>Aust Shares</b>         |       | 0.59  | 0.65  | -0.44 | -0.39 | -0.42 |
| <b>Global Shares</b>       | 0.59  |       | 0.69  | 0.15  | -0.39 | -0.25 |
| <b>Listed Property</b>     | 0.65  | 0.69  |       | -0.00 | -0.42 | -0.14 |
| <b>Aust Fixed Income</b>   | -0.44 | 0.15  | -0.00 |       | 0.25  | 0.55  |
| <b>Cash</b>                | -0.39 | -0.39 | -0.42 | 0.25  |       | 0.19  |
| <b>Global Fixed Income</b> | -0.42 | -0.25 | -0.14 | 0.55  | 0.19  |       |

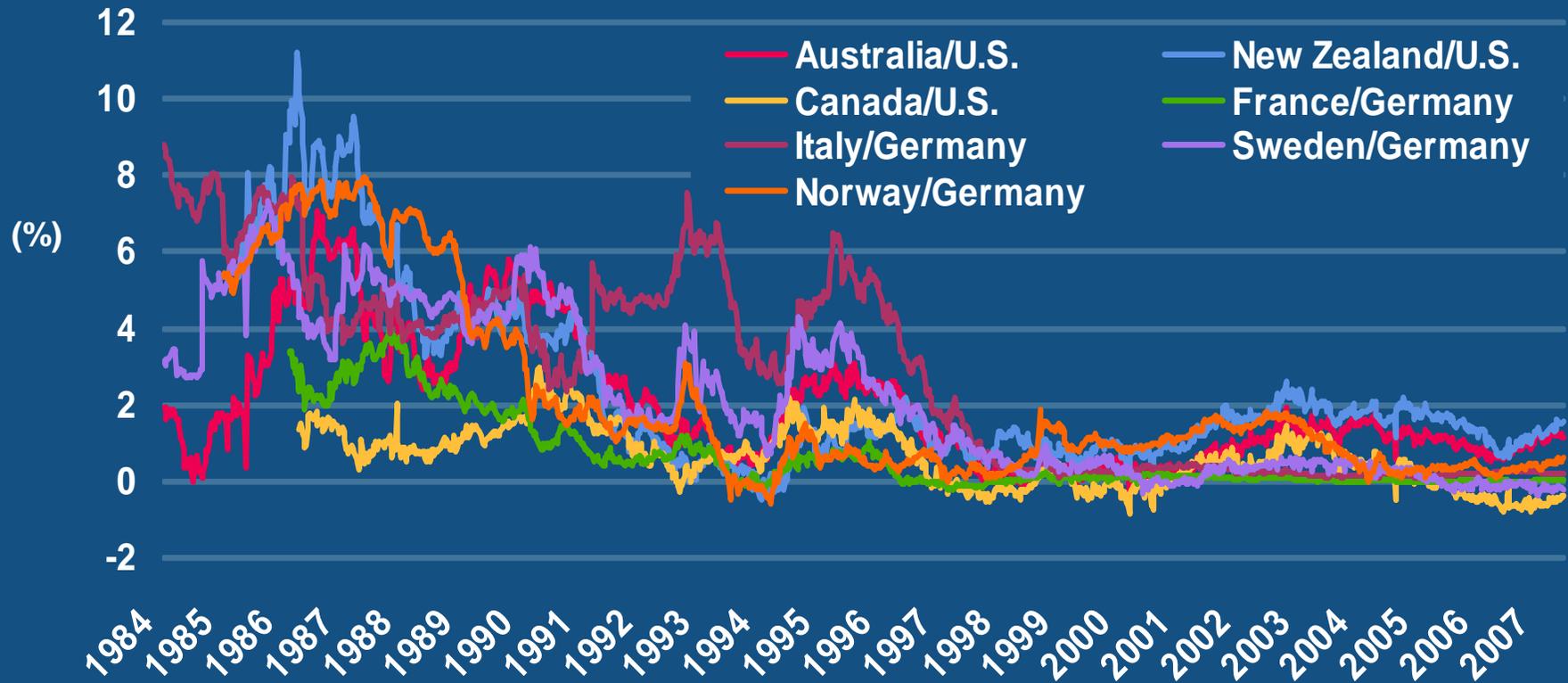
Source: Morningstar Direct



# Opportunities in Fixed Income

Diminished opportunities in country bets

TEN-YEAR SPREAD BY COUNTRY



Source: Datastream. For illustration only.

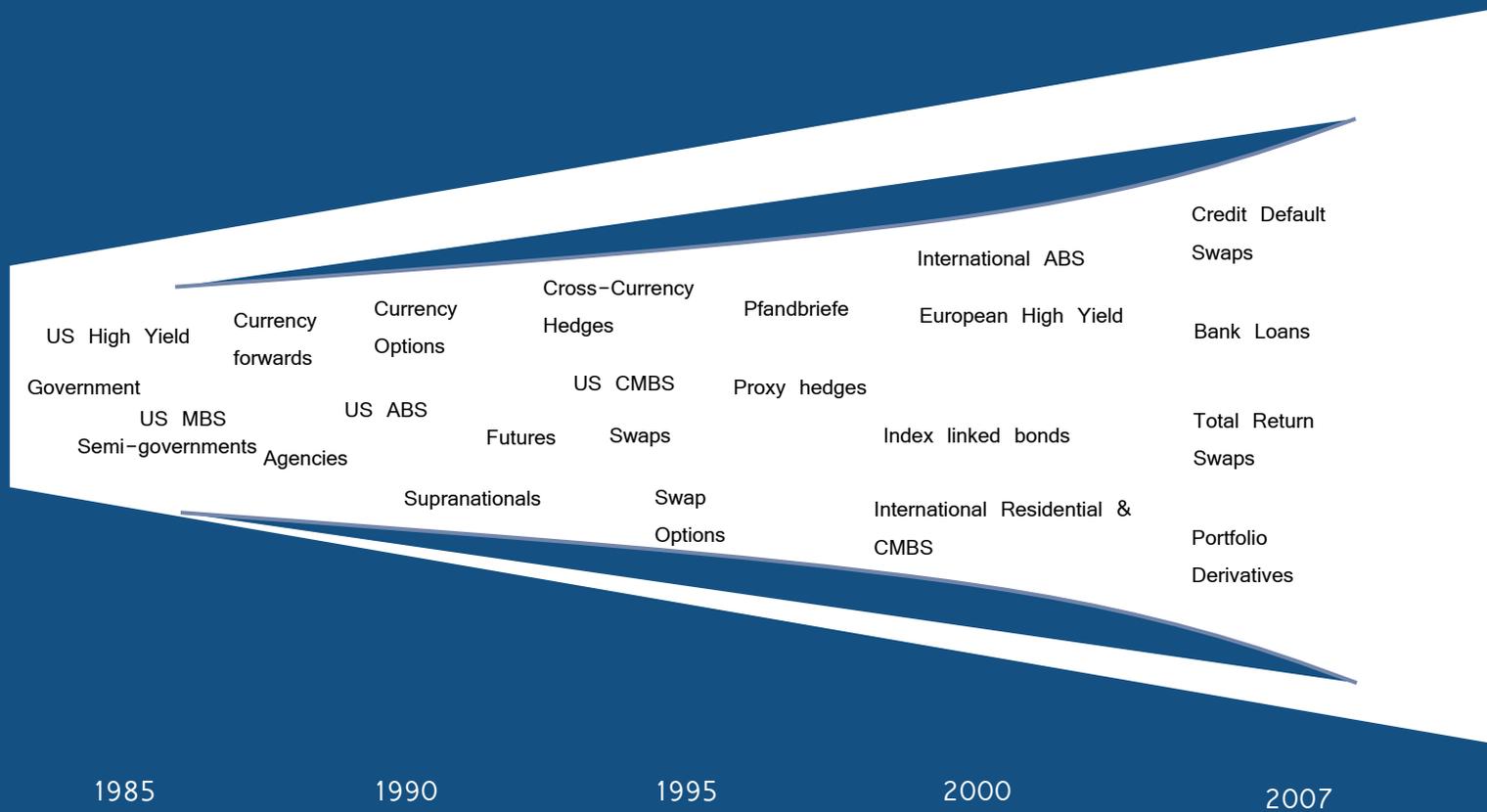
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# Opportunities in Fixed Income

## Income sectors are more complex

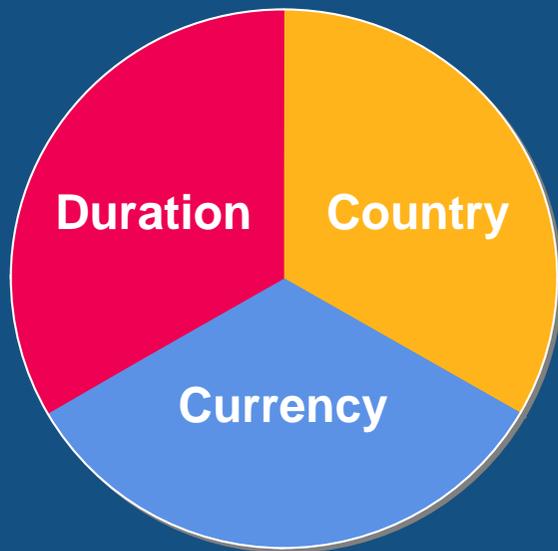


Source: Putnam Investments.  
Sector opportunities are shown for illustrative purposes only.



# Opportunities in Fixed Income

Top Down to Bottom Up



1000+ Securities



14000+ Securities



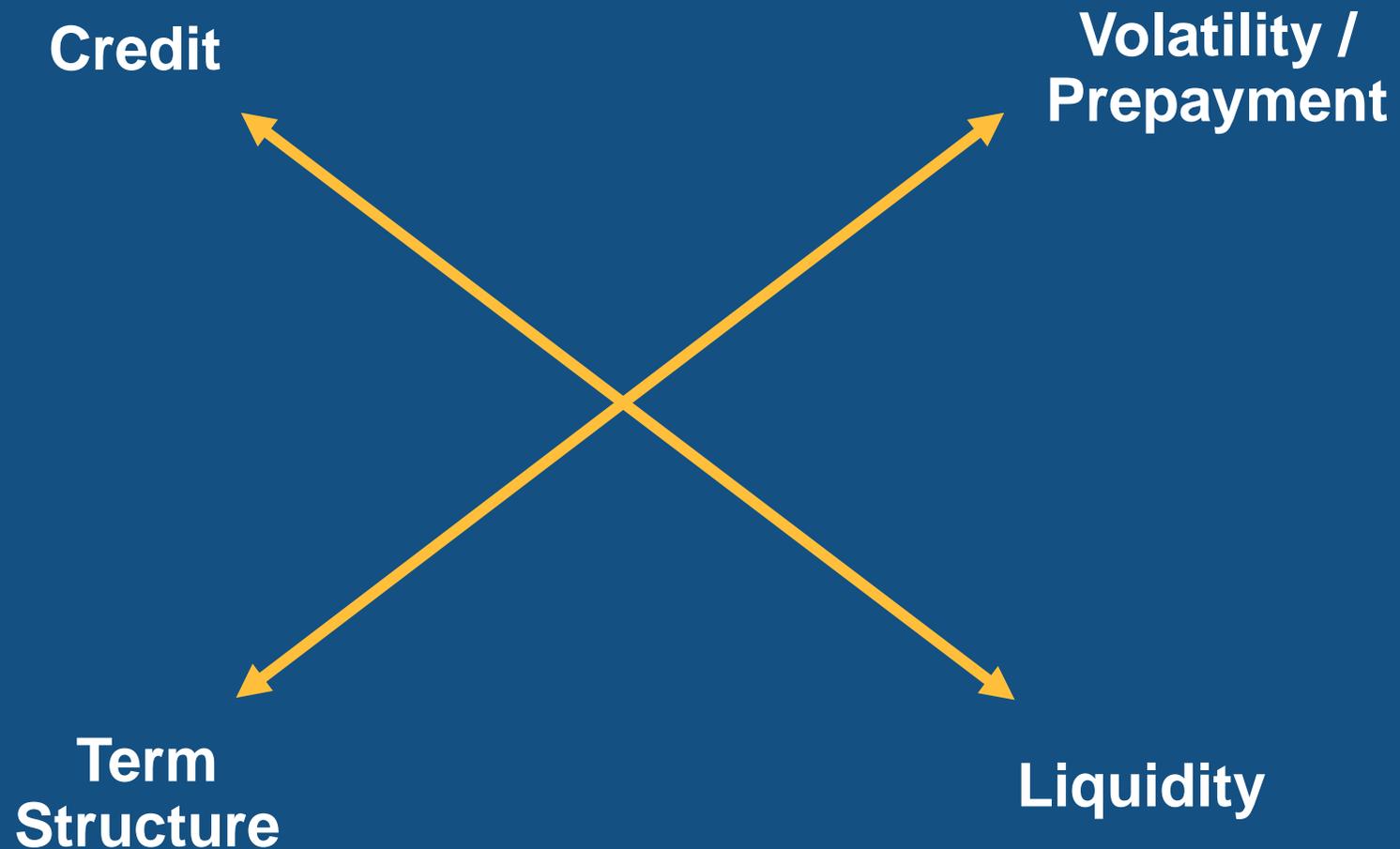
# Opportunities in Fixed Income

## Inefficiencies to exploit

- Currency – not all investors are return oriented and hence deviations from fair value exist
- Term structure – real v nominal rates, mispricing of volatility
- Credit – different models, different views on size, volatility and correlation of default rates
- Liquidity – sensitivity to ratings or short time horizons creates forced sellers

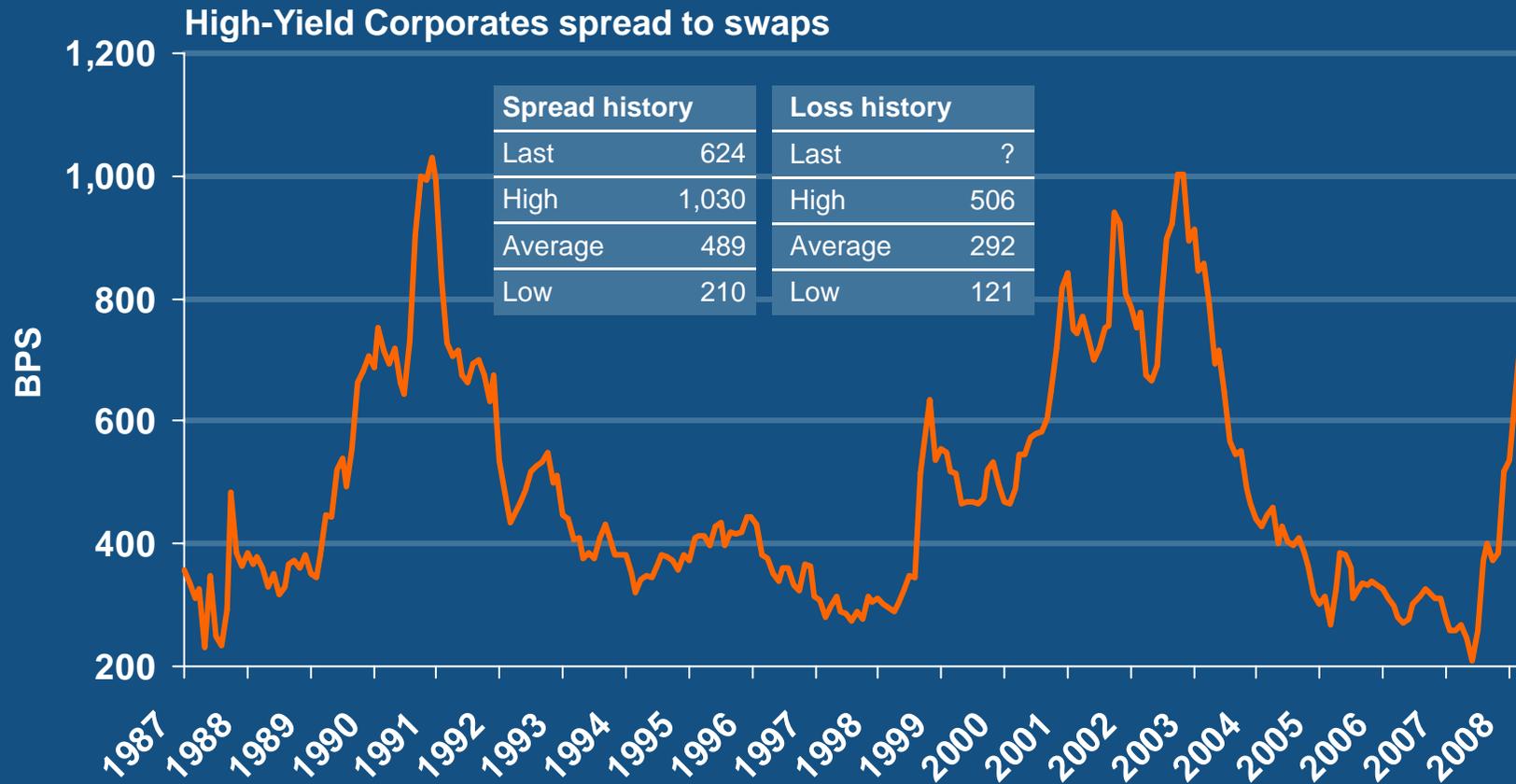


# Risks of Income Investments



# Risks of Income Investments

## Liquidity risk v credit risk

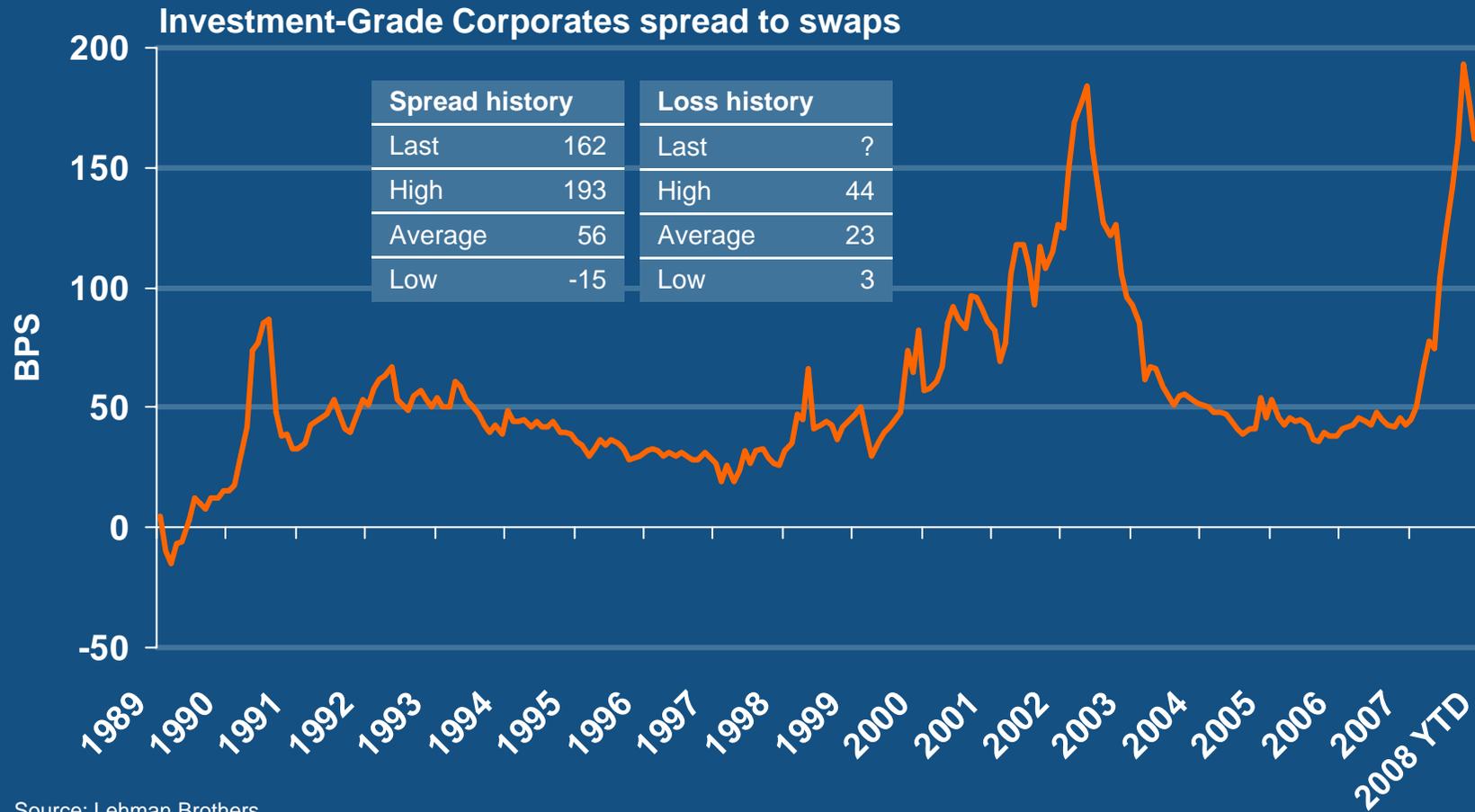


Source: Lehman Brothers.



# Risks of Income Investments

## Liquidity risk v credit risk



Source: Lehman Brothers.



# Risks of Income Investments

## Liquidity risk v credit risk

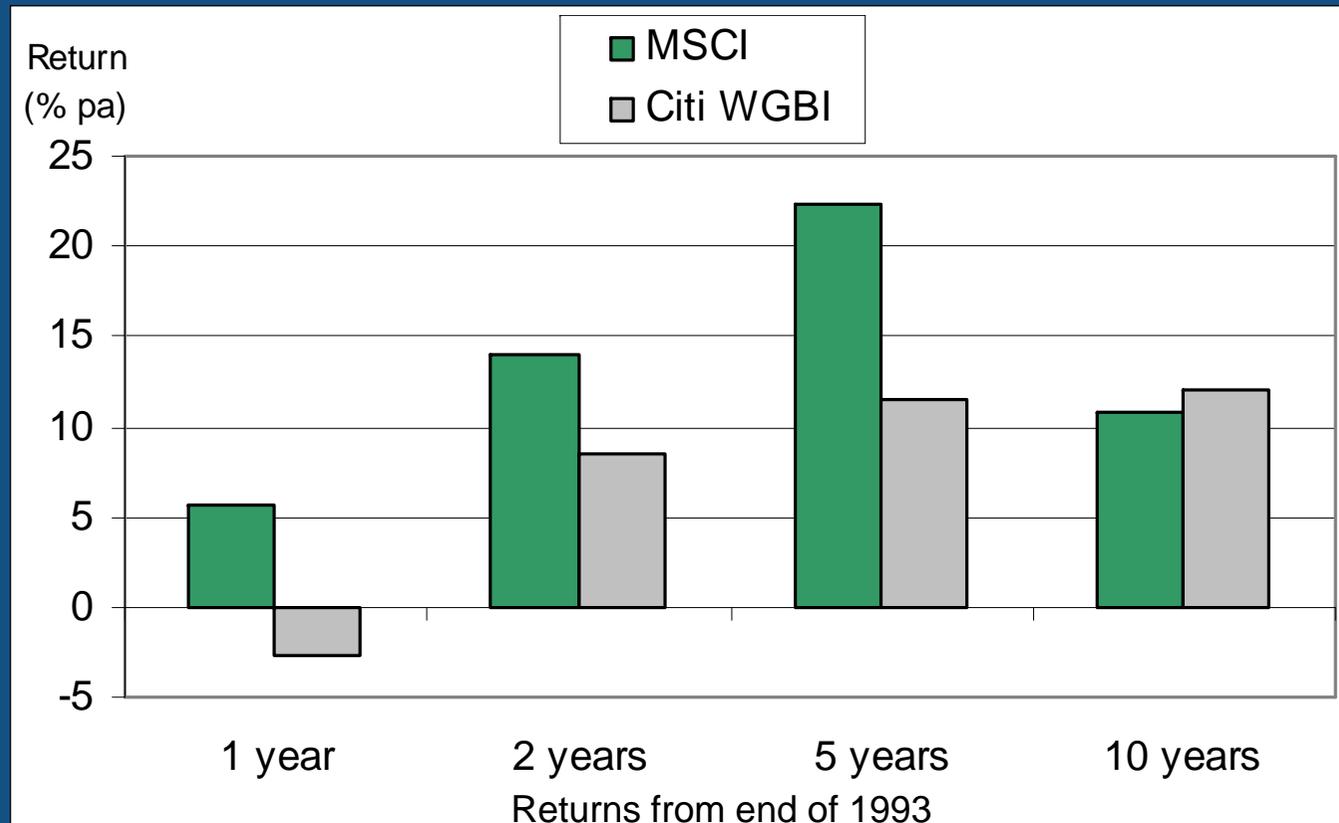


Source: Lehman Brothers.



# Positioning risks with clients

## Returns following the 1994 bond crisis

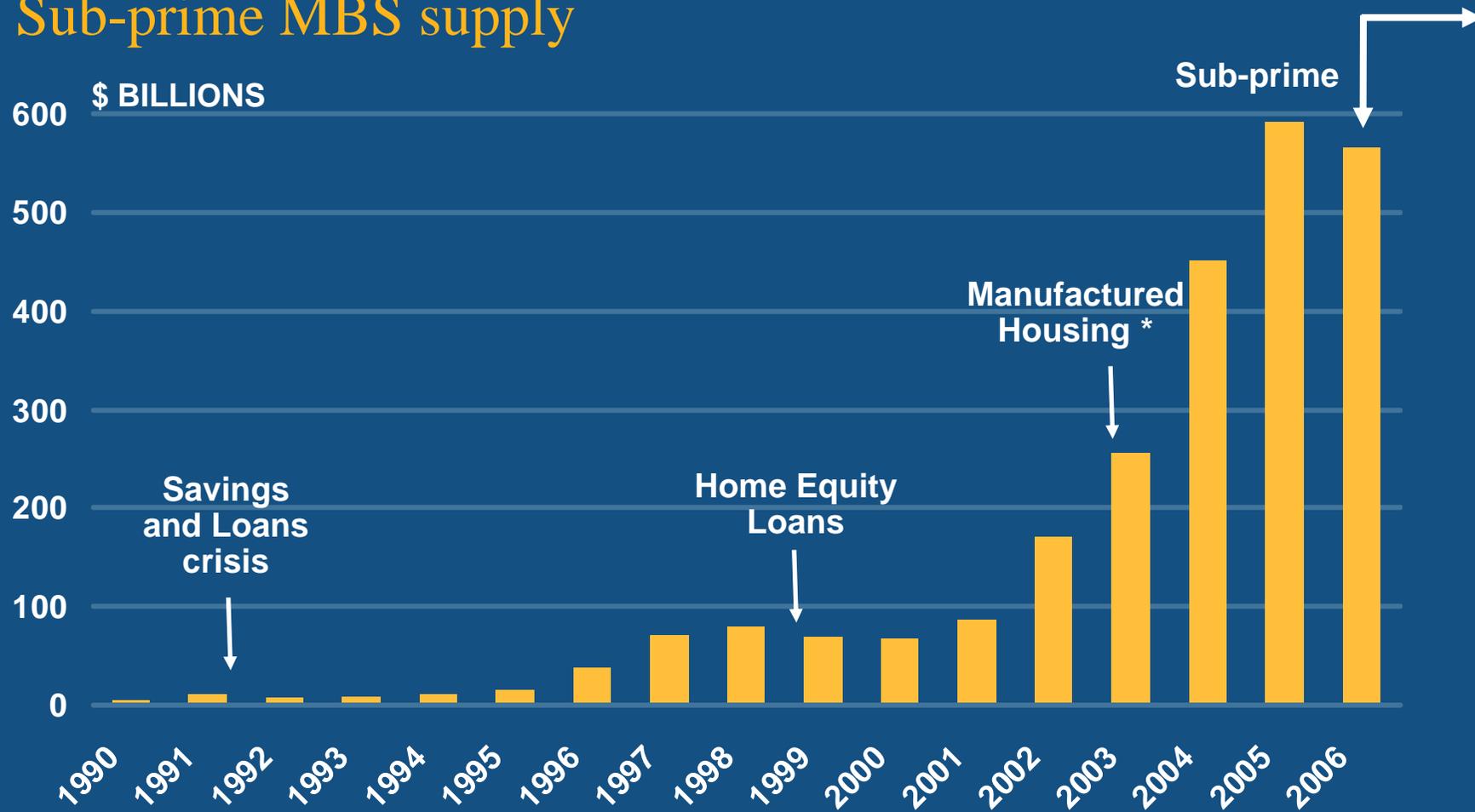


Source: Macquarie Capital Securities



# Positioning risks with clients

## Sub-prime MBS supply



Source: UBS.

\* Manufactured Housing is classified in a separate category



# Positioning risks with clients

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INVESTOR EDUCATION

## Alternating Bond Market Leadership

Annual returns for key indexes (1996–2007) ranked in order of performance (highest to lowest).

|                                   | 1996                                   | 1997                              | 1998                                   | 1999                                  | 2000                                  | 2001                              | 2002                                   | 2003                                  | 2004                                  | 2005                                  | 2006                                  | 2007                                  |
|-----------------------------------|--|-----------------------------------|--|---------------------------------------|---------------------------------------|-----------------------------------|--|---------------------------------------|---------------------------------------|---------------------------------------|---------------------------------------|---------------------------------------|
| HIGHEST RETURN                    | Emerging Market Bonds<br>29.79%        | Emerging Market Bonds<br>37.98%   | Global Bonds (unhedged)<br>29.23%      | Emerging Market Bonds<br>15.34%       | Emerging Market Bonds<br>31.93%       | US Bonds<br>17.72%                | Global Bonds (hedged in A\$)<br>11.57% | Euro High Yield<br>13.71%             | Euro High Yield<br>28.00%             | Emerging Market Bonds<br>19.98%       | Euro High Yield<br>13.69%             | Australian Cash<br>6.77%              |
|                                   | Australian Bonds<br>11.87%             | Global High Yield<br>37.56%       | US Bonds<br>15.49%                     | Australian Cash<br>5.07%              | US Bonds<br>31.45%                    | Global High Yield<br>11.00%       | Australian Bonds<br>8.87%              | Global Bonds (hedged in A\$)<br>6.59% | Global Bonds (hedged in A\$)<br>8.92% | Global High Yield<br>10.70%           | Mortgage Funds<br>6.47%               | Global Bonds (hedged in A\$)<br>6.63% |
|                                   | Global High Yield<br>10.37%            | US Bonds<br>33.67%                | Euro High Yield<br>14.33%              | Global High Yield<br>3.57%            | Global Bonds (unhedged)<br>21.50%     | Global Bonds (unhedged)<br>10.24% | Global Bonds (unhedged)<br>5.93%       | Mortgage Funds<br>5.67%               | Global High Yield<br>8.78%            | US Bonds<br>9.46%                     | Australian Cash<br>6.00%              | Mortgage Funds<br>6.55%               |
|                                   | Global Bonds (hedged in A\$)<br>9.48%  | Global Bonds (unhedged)<br>25.83% | Global Bonds (hedged in A\$)<br>10.08% | Global Bonds (hedged in A\$)<br>0.28% | Global High Yield<br>18.99%           | Emerging Market Bonds<br>10.09%   | Mortgage Funds<br>5.54%                | Australian Cash<br>4.90%              | Emerging Market Bonds<br>7.55%        | Global Bonds (hedged in A\$)<br>6.62% | Global High Yield<br>5.81%            | Australian Bonds<br>3.46%             |
| Australian Cash<br>7.57%          | Australian Bonds<br>12.23%             | Australian Bonds<br>9.54%         | Australian Bonds<br>-1.22%             | Australian Bonds<br>12.08%            | Global Bonds (hedged in A\$)<br>8.29% | Australian Cash<br>4.77%          | Australian Bonds<br>3.05%              | Australian Bonds<br>6.96%             | Australian Bonds<br>6.22%             | Mortgage Funds<br>6.22%               | Global Bonds (hedged in A\$)<br>4.41% | Global Bonds (unhedged)<br>-1.70%     |
| Global Bonds (unhedged)<br>-2.74% | Global Bonds (hedged in A\$)<br>10.71% | Australian Cash<br>5.14%          | US Bonds<br>-5.04%                     | Global Bonds (hedged in A\$)<br>9.74% | Mortgage Funds<br>5.87%               | Emerging Market Bonds<br>2.05%    | Global High Yield<br>-1.04%            | Mortgage Funds<br>6.07%               | Australian Bonds<br>5.79%             | Australian Bonds<br>3.36%             | Australian Bonds<br>4.41%             | Euro High Yield<br>-3.57%             |
| US Bonds<br>-2.95%                | Australian Cash<br>5.63%               | Global High Yield<br>1.07%        | Euro High Yield<br>-5.74%              | Mortgage Funds<br>6.54%               | Australian Bonds<br>5.45%             | US Bonds<br>0.23%                 | Emerging Market Bonds<br>-5.14%        | Australian Cash<br>5.62%              | Australian Cash<br>5.73%              | Australian Cash<br>2.33%              | Emerging Market Bonds<br>-0.75%       | US Bonds<br>-3.98%                    |
|                                   |  | Emerging Market Bonds<br>-4.09%   | Global Bonds (unhedged)<br>-9.81%      | Global Bonds (unhedged)<br>-9.81%     | Australian Cash<br>6.27%              | Australian Cash<br>5.24%          | Euro High Yield<br>-3.14%              | Global Bonds (unhedged)<br>-15.91%    | Global Bonds (unhedged)<br>5.03%      | Global Bonds (unhedged)<br>2.07%      | Global Bonds (unhedged)<br>-0.75%     | Emerging Market Bonds<br>-5.60%       |
|                                   |  |                                   |  | Euro High Yield<br>-2.10%             | Euro High Yield<br>-5.30%             | Global High Yield<br>-5.33%       | US Bonds<br>-22.20%                    | US Bonds<br>0.29%                     | Euro High Yield<br>-4.59%             | US Bonds<br>-2.94%                    | US Bonds<br>-2.94%                    | Global High Yield<br>-7.39%           |

- **Lahman Global High Yield Index A\$** provides a broad-based measure of the global high-yield fixed income markets in Australian dollar terms.
- **Lahman Global Aggregate Hedged A\$** is an unmanaged index of global investment-grade fixed-income securities hedged in Australian dollars.
- **Lahman Global Aggregate Index A\$** is an unmanaged index of global investment-grade fixed-income securities expressed in Australian dollar terms.

- **Lahman Aggregate Bond Index A\$** is an unmanaged index of US investment-grade fixed income securities expressed in Australian dollar terms.
- **Lahman Emerging Markets Index A\$** is an unmanaged index of the fixed and floating-rate USD-denominated US Emerging Markets Index and the primary EUR and GBP-denominated fixed-rate Pan-European Emerging Markets Index expressed in Australian dollar terms.

- **Merrill Lynch Euro High Yield Index 3% Constrained A\$** is an unmanaged index of investments in high-yielding, non-investment-grade debt obligations issued by Europe-domiciled corporations or those whose revenues stem largely from Europe expressed in Australian dollar terms.
- **Morningstar PGW Tir Mortgages Index A\$** is an unmanaged index of investments in the mortgage bond markets expressed in Australian dollar terms.

- **UBS Australian Composite Bond Index** is an unmanaged index tracking the performance of the Australian fixed income asset class. The UBS Australian Composite Bond Index covers 277 securities with a market value of A\$175 billion.
- **UBS Australian Bank Bill Index** is an unmanaged index tracking the Australian cash and fixed interest markets.

Data is historical. Past performance is not a guarantee of future results. It is not possible to invest directly in an index.

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# Positioning risks with clients

- Every sector finishes in the Top 2 as well as the Bottom 3 positions – diversification matters.
- Global Bonds (Hedged in A\$) outperform Australian Bonds 9 of the past 10 years - they can't be ignored!
- High Yield is as likely to finish at the top of the table as the bottom – Credit bets it can't be your only diversifying idea!
- The average difference between best and worst sectors in any one year is over 24%!



# Summary

- Money in cash and term deposits has to come out at some point
- These still have risks and may not be the best long term strategy for clients
- The opportunities in the new world of Fixed Income have never been better!
- Now is the time to position the risks, and the opportunities, with astute clients



# Questions

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# Putnam's Worldwide Income Fund

- World-class fixed income capabilities
- Captures the entire “wheel” in a risk controlled manner
- Positioned as an alternative to global fixed Income funds with more diversification than other income / yield funds
- Targets Cash plus 3% pa over rolling 3 year periods
- Diversified by credit quality with high average (typically A)
- Highly rated by Research Houses



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**Let's start thinking about...**

**This session was:**

- 1. awful**
- 2. mediocre**
- 3. good**
- 4. excellent**

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**Time's Up!**

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