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## Bonds Solutions Portfolio for Volatile Times

### Executive Summary

**Uncertain and Volatile Market** – Recent Japan earthquake and tsunami, MENA unrest and ongoing Europe debt crisis are likely to cause volatility in the equities market.

**Diversification in Global Bond** – Global bond has relatively low 5-year correlation with equities and commodities, making it a possible diversification tool for investors.

**Risk of Bond** – Bond is subjected to risk just like any other investments. However, it has lower maximum drawdown and volatility as compared to other equities indices.

**Bonds Solutions Portfolio** – Bonds Solutions Portfolio is a possible avenue for diversification, given its relatively low volatility (1.70%) and maximum drawdown (-1.11%) as compared to equities.

### Introduction

“Uncertainty is the only certainty there is, and knowing how to live with insecurity is the only security,” by mathematics professor and author, John Allen Paulos, describes the investment environment of today perfectly. No matter how reputable and experienced an investor is, events such as the MENA unrest and the Japan earthquake and tsunami are difficult for anyone to predict. As a result, the importance of portfolio diversification and risk reduction becomes even more evident in the current volatile market. Therefore, we would like to introduce the Bonds Solutions Portfolio which has registered a positive year-to-date (1.21%) and 1-year (4.60%) return as an avenue for diversification.

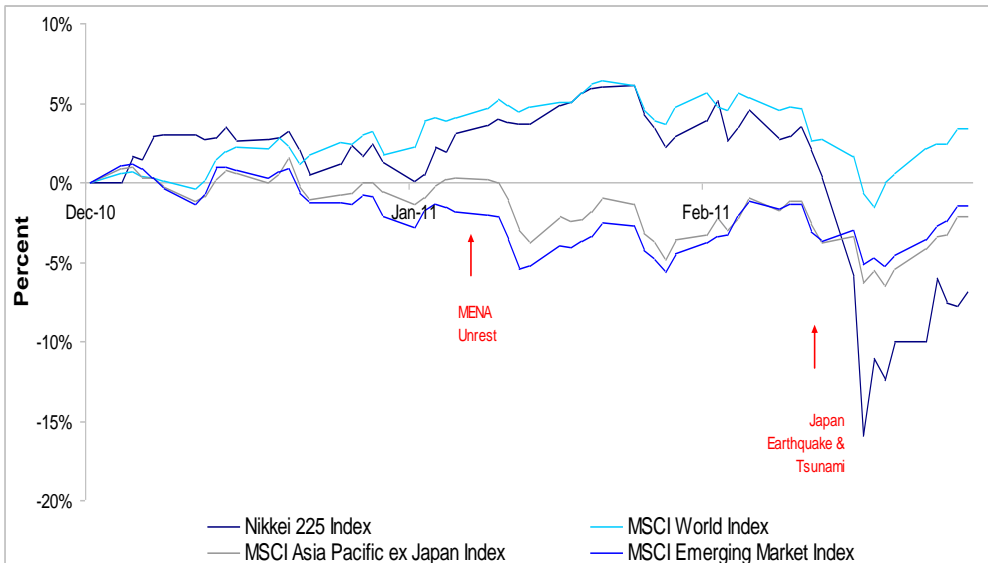
### Uncertain and Volatile Equities Markets

#### *Japan Earthquake and Tsunami – Resulted in Short-term Volatility in Market*

The recent Japan earthquake and tsunami resulted in panic selling in the equities market, causing the Nikkei 225 Index to register a two day drop of 16.1 percent since the disaster. The MSCI Asia Pacific ex Japan Index also fell 2.5 percent and MSCI World Index fell 3.3 percent in the same period. (Chart 1) Disaster like this brings to our attention the erratic nature of weather, which is beyond human control and prediction. In 2010, the Haiti earthquake resulted in about 250,000 casualties, while weather-related issues caused agriculture product supply shocks, pushing agriculture prices up and contributing to food inflation. While we certainly hope that weather related issues and natural disasters could be averted, we do not rule out the possibility that equities markets could experience short term volatility if similar events occur again.



**Chart 1: Year-to-date Return for Indices**



Source: Bloomberg, as of 25 Mar 2011

*Recent MENA Unrest and Japan Earthquake and Tsunami had adverse impact on equities market.*

### *MENA Unrest – Possibly Higher Downside Risk for Equities*

The MENA unrest sparked off in Tunisia and has spread to various countries such as Egypt, Yemen, Bahrain and Libya. In our opinion, the MENA unrest poses greater downside risk to global markets as compared to the Japan disaster due to its effect on oil prices. Middle East and Africa produced 42.30 percent of the world oil production in 2009 while Japan consumes 5.10 percent of world oil consumption according to BP Statistical Review of World Energy June 2010. As a result, possible further contagion effect in the MENA region could affect global oil supply by a greater extent and outweigh possible reduction of oil consumption in Japan.

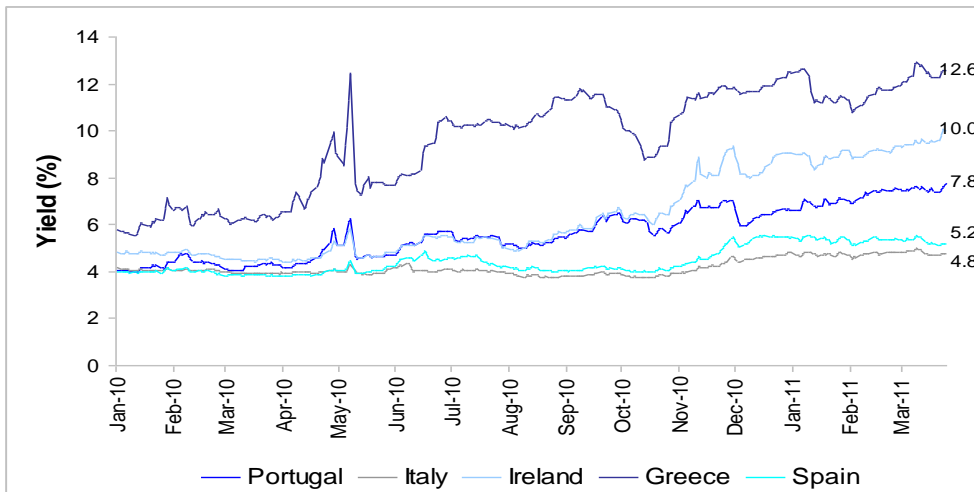
### *Ongoing Europe Debt Crisis – Affecting Risk Appetite in the Interim*

Aside from the natural disaster in Japan and social unrest in MENA, an ongoing debt crisis continues to affect the peripheral nations of Europe. On 25 March 2011, Portugal's credit rating was downgraded by Standard & Poor by two notches to BBB, following a two-notch cut by Fitch and downgrade by Moody from A1 to A3. The downgrades came after Portugal Prime Minister, Jose Socrates, resigned on 23 March after the parliament rejected his minority Socialist government's latest austerity measures. S&P said that 'the collapse of Portugal's government has increased political uncertainty, hurting market confidence and potentially raising refinancing risk'. On 29 March, S&P further downgrade Portugal and Greece by one notch to BBB- and BB- respectively. In Ireland, the government also intend to impose losses on some senior bondholders in Irish lenders to reduce the burden on taxpayers from a prolonged banking crisis, a senior minister said on 27 Mar 2011, as reported by Reuters.



As shown by Chart 2, the 10-year government bond yield for the Portugal, Ireland and Greece had recently risen above their peak in May 2010. The historically high government bond yield could mean that investors are pricing in possibilities of default, making refinancing increasingly difficult for the troubled European nations and worsening the situation. The European debt crisis is likely to continue affecting investor's decision and risk appetite in the interim, and could cause volatility in the market due to uncertainty regarding the matter.

**Chart 2: 10-Year Government Bond Yield**



*10-year government bond yield for the Portugal, Ireland and Greece had risen above their peak in May 2010 in recent months*

Source: Bloomberg, as of 25 Mar 2011

### Greater diversification when faced with greater volatility

Having witnessed factors that could continue to cause volatility in the equities market, investors could probably seek to reduce risk by diversifying their portfolios across different asset classes. Bond as an asset class has traditionally been thought of as less risky as compared to equities and commodities and we will next demonstrate why is this so.

The 5-year historical correlation between global bond and world equities, emerging market equities and Asia Pacific ex Japan equities is 0.05, 0.10 and 0.13 respectively. The low 5-year correlation between equities and global bonds of below 0.15 means that the bond price movement and equities index movements are relatively less positively correlated. This makes global bond a possible hedge against the volatility that could be present in the equities market and can probably help investors smoothen their portfolio returns over time.

Commodities, oil and gold had approximately 31.0 percent return, while agriculture futures, as represented by the Rogers Agriculture Index, had a 51.7 percent return over the past 1 year period. Global bonds have low 5-year correlation of below 0.25 against commodities, agriculture futures and oil prices and 0.38 against gold. While we feel that the commodities gain is supported by the rise in global industrial demand and weather-related supply issues, global bond can probably help to lower the risk of commodities investment with its low correlation.



**Table 1: 5-Year Correlation**

	World Equities	Emerging Market Equities	Asia Pacific ex Japan Equities	Commodities	Agriculture	Oil	Gold	Global Bond
World Equities	1	0.82	0.81	0.42	0.36	0.23	0.07	0.05
Emerging Market Equities	0.82	1	0.95	0.50	0.40	0.29	0.21	0.10
Asia Pacific ex Japan Equities	0.81	0.95	1	0.44	0.39	0.24	0.18	0.13
Commodities	0.42	0.50	0.44	1	0.63	0.81	0.39	0.21
Agriculture	0.36	0.40	0.39	0.63	1	0.38	0.31	0.18
Oil	0.23	0.29	0.24	0.81	0.38	1	0.26	0.10
Gold	0.07	0.21	0.18	0.39	0.31	0.26	1	0.38
Global Bond	0.05	0.10	0.13	0.21	0.18	0.10	0.38	1

Source: Bloomberg, as of 25 Mar 2011

Note: Indices used are MSCI World Index, MSCI Emerging Markets Index, MSCI AC Asia Pacific ex Japan Index, TR/J CRB Commodities Index, Rogers Agriculture Index, WTI Crude Oil Futures, Gold Spot \$/OZ, JPMorgan Global Aggregate Bond Index

### Risks in bonds

While we note the diversification benefit of bonds as an asset class, it does have its risks as well. Bonds are debt instruments, and are also subjected to risks like any other investments. Firstly, bonds are subjected to interest rate risk as bond price moves inversely with interest rate. Secondly, reinvestment risk is present, which refers to the risk of having to invest at a lower rate than the rate that the fund was previously earning. Thirdly, any rating downgrades by the major rating agencies could affect investors' confidence and consequently bond prices. Lastly, bonds are subjected risks evident in other investments such as default risks, inflation risks, liquidity risks and currency risks.

Historically, global bonds, as measured by JPMorgan Global Aggregate Bond Index, have 1-year and 5-year maximum drawdown of -6.11 percent and -9.55 percent. This means that in the past 1-year and 5-year period, an investor can lose 6.11 and 9.55 percent respectively from staying invested in the global bond index. However, as we can observe from Table 2, the 1-year and 5-year maximum drawdown is lower for the global and emerging bond indices as compared to other equities indices. In addition, the 360 days volatility and downside risks are also the lowest for the bond indices as compared to equities indices. A conclusion that we can draw from this table is that bonds as an asset class has lower volatility and therefore comparatively lower risks than equities.

*Global bond has low correlation against equities and commodities.*



**Table 2: Risks Measures**

Index	1 Year Max Drawdown	5 Year Max Drawdown	360 Days Volatility	Downside Risk
JPMorgan Global Aggregate Bond Index - Total Return Unhedged USD	-6.11	-9.55	5.51	4.70
JPMorgan Emerging Market Bond Global Total Return Index	-5.88	-29.27	4.54	5.17
Dow Jones Industrial Average	-13.05	-48.39	15.64	11.40
S&P 500 Index	-15.63	-51.52	17.41	12.70
FTSE Straits Times Index	-11.18	-53.80	13.69	10.25
MSCI World Index	-16.04	-54.87	15.90	13.40
MSCI AC World Index	-15.54	-55.50	15.65	13.47
ThomReuters/Jefferies CRB Index	-11.13	-57.69	17.12	12.09
MSCI AC Asia Pacific ex Japan Index	-18.59	-59.24	18.37	16.04
MSCI Emerging Markets Index	-17.85	-63.10	17.36	15.64
MSCI China	-16.12	-64.01	20.59	15.02

Source: Bloomberg, as of 25 Mar 2011

*Global Bond and Emerging Market Bond Index have lower maximum drawdown and volatility as compared to the other equities indices.*

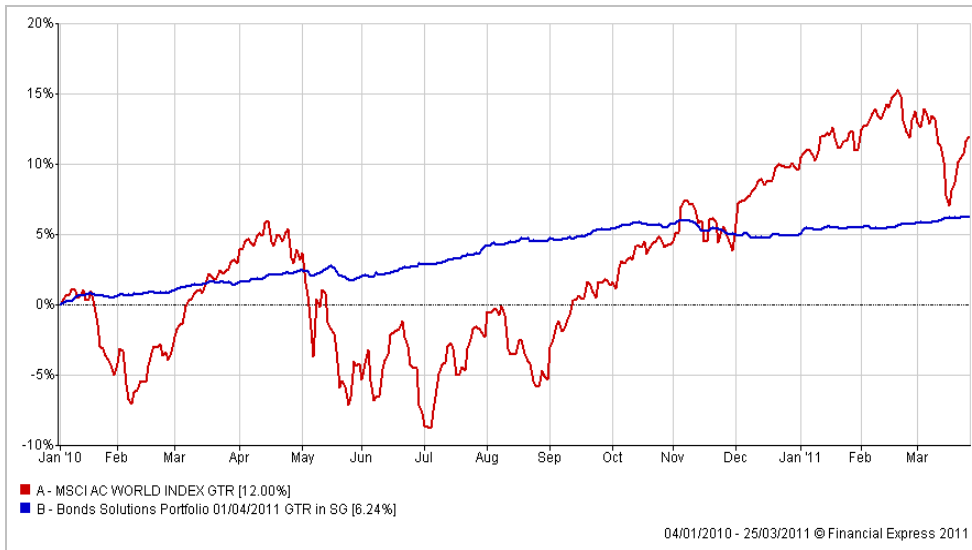


### Bonds Solutions Portfolio

The Bonds Solutions Portfolio seeks to maximize returns while minimizing risks. This portfolio was inception in January 2010 and would only be invested in the realm of fixed income (i.e. government bonds, treasury bills, etc.) and have zero exposure in the equity markets.

Chart 3 shows the performance of Bonds Solutions Portfolio (blue) and the MSCI AC World Index (red) since the inception of Bonds Solutions Portfolio. As shown in the graph, the MSCI AC World Index has significantly higher fluctuations, demonstrating higher volatility and risk in the equities market. Bonds Solutions Portfolio, on the other hand, has been on a relatively stable upward trend and has gained 6.24 percent since its inception. While the Bonds Solutions Portfolio did not outperform the general equities market, we feel its lower volatility can help investors lower their overall portfolio risks in the long term.

**Chart 3: Performance (4 Jan 2010 – 25 Mar 2011)**



*The Bonds Solutions Portfolio observed a relatively stable upward trend while the MSCI AC World Index observed significantly higher fluctuations.*

Source: Financial Express, as of 25 Mar 2011  
Returns are computed based on local currencies

Table 3 shows the Bonds Solutions Portfolio’s returns and risks measures as of 25 March 2011. It has registered a 4.6 percent 1-year return and gained 1.21 percent on a year-to-date basis. As for risk level, it has 1-year volatility of 1.7 percent and maximum drawdown of -1.11 percent.

**Table 3: Return and Risk Measures**

Name	1 Mth Return	3 Mth Return	YTD Return	1 Yr Return	1 Yr Max Drawdown	1 Yr Volatility
Bonds Solutions Portfolio	0.45	1.26	1.21	4.6	-1.11	1.7

*The Bonds Solution Portfolio had a 1-year return of 4.6 percent and 1-year volatility of 1.7 percent.*

Source: Financial Express, as of 25 Mar 2011



The Bonds Solutions Portfolio currently consists of eight bond funds and a money market fund as shown in Table 4. The funds were chosen with the objective of minimizing risk while maximizing returns. The DBS Enhanced Income Fund and UOB United SGD Fund invest mainly into short-term bonds and money market instruments, reducing the portfolio's interest rate risk exposure. The Fullerton Asian Bond, Fullerton Short Term Interest Rate and DWS Lion Bond Fund invest mainly into investment grade bonds and lower the portfolio's exposure to default risks.

Overall, the Bonds Solutions Portfolio has a low, if not minimal, exposure to European sovereign debts. We take note of the recent Portugal downgrades, spike in yields across the peripheral sovereign debts as well as other ongoing concerns which can be impediments to the peripheral debts in the near term. However, the recent performance of the Bonds Solutions portfolio was not significantly affected as displayed in Chart 3. In addition, the portfolio is steered towards Asian corporate bonds and has less exposure to European sovereign debts, so we expect the portfolio to be relatively less affected by the Europe debt crisis.

**Table 4: Components**

Categories	Funds	Allocation (%)	1 Year Return	3 Year Return (Ann.)
<b>Bonds</b>				
Asia Pacific	Fullerton Asian Bond	14	6.64	---
Global	DWS Lion Bond Fund	18	2.74	3.09
Global	UOB United International Bond Fund	10	6.4	3.84
SGD	DBS Enhanced Income Fund	11	2.58	1.66
SGD	Fullerton Short Term Interest Rate	10	5.03	---
SGD	LionGlobal Singapore Fixed Income Investment	14	4.35	4.03
SGD	UOB United SGD Fund	18	5.08	5.92
<b>Cash &amp; Equivalent</b>				
SGD	Phillip Money Market Fund (Cash Component)	5	0.6	0.93

Source: UT Research and Financial Express, as of 25 Mar 2011

### Conclusion

In our view, the equities market is likely to be volatile given the ongoing MENA unrest, uncertainty regarding the containment of nuclear activities in Japan and the Europe debt crisis. As a result, investors should consider greater diversification to smoothen their portfolio earnings over time. Bonds Solutions Portfolio is a possible avenue for diversification, given its positive year-to-date and 1-year return and relatively low volatility and maximum drawdown relative to equities.



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