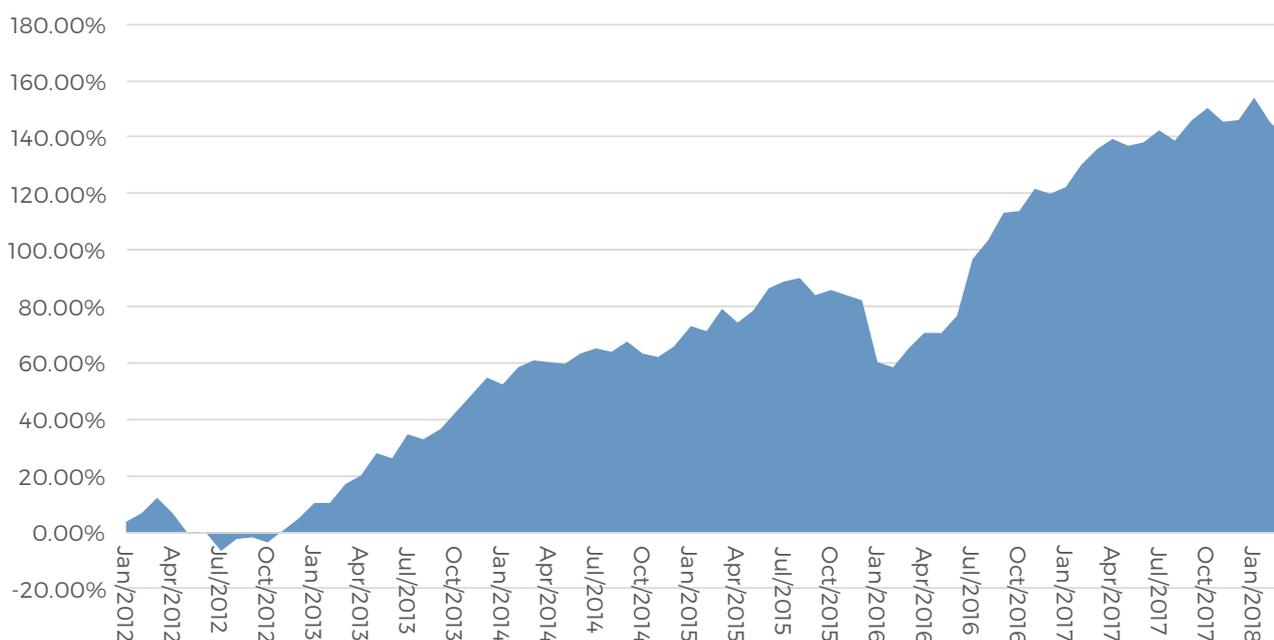


Why Bonds Are Risky

Performance Chart



Year	Heritage Global Capital Fund	MSCI World Index (SGD, Dividends Reinvested)
2012	+4.58%	+9.74%
2013	+47.98%	+31.57%
2014	+7.09%	+10.68%
2015	+9.91%	+6.63%
2016	+20.73%	+10.37%
2017	+11.80%	+13.64%
2018 (YTD)	-2.35%	-3.08%
Cumulative	+140.11%	+107.98%
Annualised	+15.04%	+12.43%

For the three months ending March 2018, Heritage Global Capital Fund has returned -2.35% in SGD terms. Our benchmark, the MSCI World Index (Rebased to SGD with dividends reinvested) returned -3.08%.

Since January 2012, the fund's investment strategy has generated a cumulative return of +140.11% and an annualised return of +15.04% net of fees. This compares with the MSCI World Index (rebased in SGD terms) which has returned a cumulative return of +107.98% and an annualised return of +12.43%.

Market Review

There are plenty of winners in the recent en-bloc wave. In 2017 alone, there were 26 successful en-bloc sale projects valued at SG\$8.02 billion. While 2018 to date, there has been 16 successful cases valued at SG\$5.89 billion¹. The sums of money involved are huge and with a lack of reinvestment opportunities in the property market, plenty of people are looking at other financial assets.

One such asset class are bonds. The starting point of bonds in an investor's portfolio can be summed up – bonds are thought to be safer and less volatile than stocks or REITs (another popular investment in Singapore).

In this memo, we are going to present a different viewpoint one that contends that bonds are nowhere near safe as people think them to be.

1) High quality investment grade bonds provide low yields

First off, the relationship between risk and return is simple to understand for bonds. There are several points to take note of:

- The higher your interest, the more risk you take
- The risk can involve either default risk (losing your capital), or taking duration risk (the longer your bond takes to mature, the more sensitive it is to changes in interest rate)

So, for the average investor who wants to invest in high quality investment grade bonds with reasonable durations (3 years) is stuck with very low yields.

Investors can realistically expect something in the region of 2% to 3%.

¹ Refer to Appendix 1

2) High yielding bonds are far more dangerous than what people think

Most investors who invest in bonds are going after the “guaranteed interest” that bonds provide. Even with a SG\$1 million, a 2.5% yield will only provide SG\$25,000 in income that will be unsatisfactory to most people.

It is thus natural that investors would seek better returns by buying bonds with higher yields.

Unfortunately, there is no free lunch in the world. Every percentage point of interest more translates to more risk – even if it is not apparent to investors.

What this means is that investors are taking on a higher likelihood for their initial investment (the principal amount) being impaired down the road in exchange for 1% to 2% more interest a year.

This may all sound very theoretical – but sadly, it is not.

In the last few years, almost US\$15 billion² of bonds and loans have fallen into distress in South East Asia. The Oil & Gas industry in Singapore has been at the epicentre of this with many companies entering judicial management or being wound up.

3) Instruments that look safe may paradoxically be the most dangerous

Everyone knows that investing in stocks is “risky” because they are volatile. If you borrow on margin – well that’s as good as gambling.

The ironic thing is that high yielding bonds have the same characteristic. Many clients were told that the high yielding bonds were good collateral to use to leverage up – to buy even more bonds of the same company!

While it’s true that bonds are less volatile in price movements, they have a probability of defaulting. As in the situation above, investors who leverage up on their “safe investment” found themselves on the hook.

² Rescued Singapore Shipbuilder Buckles Under Debt Woes — <https://www.bloomberg.com/news/articles/2018-02-23/haunted-by-oil-slump-singapore-shipping-firm-buckles-under-debt>

Sadly, as many readers know, the above example is not theoretical at all – but a common enough example to what happened to many investors in bonds such as Swiber³.

Investors who thought they were being conservative by buying bonds instead of stocks suddenly found themselves on the hook for far more than their initial investments.

4) Certain characteristics about the Singapore bond market make it challenging for retail investors

Firstly, the high prevalence of retirees investing in these bonds has led to fragmented ownership. This problem becomes particularly acute during restructuring – as there is a lack of deep institutional knowledge.

Secondly, the retail market for bonds is woefully small and most bonds that are available require an initial investment of at least SG\$200,000 to SG\$250,000.

This makes it hard to form a diversified portfolio of bonds considering that if you had SG\$1 million, you would be stuck with only 3 – 4 bonds.

These bonds typically have very low liquidity and they only trade over the counter, resulting in large bid/ask spreads in the event that investors wish to cash out.

The Intrinsic Problem with Bonds (applicable to High Yielding Bonds)

Just because you're investing in a bond does not negate the need **for fundamental analysis**.

Companies typically raise money from the high yielding bond market for expansion. It can be a developer choosing to buy land, a manufacturer buying land and machinery for a factory or a shipping company buying ships and related vessels.

The common thing amongst these companies is that their business plan **must succeed** for them to generate the capital needed to repay back investors.

³ DBS was selling Leveraged Swiber Bonds to Clients (3 Takeaways from this Case Study) — <http://investmentmoats.com/stock-market-commentary/dbs-was-selling-leveraged-swiber-bonds-to-clients-3-takeaways-from-this-case-study/>

In others words, investors must be able to assess the likelihood of such projects being successful if they want to get their money back.

When we look at stocks, we look for companies with strong financial positions. We look for companies with fortress like balance sheets with strong cash flows.

Unfortunately, when you look at companies looking to raise debt through high yielding bonds – these requirements will be absent, which is the exact reason why are they forced to pay the high interest rates they do!

Investing in bonds introduces another complexity beyond investing in stocks that many investors seem to ignore.

The terms of the debt offering are highly important – especially the kind of covenants that are written in to protect debt holders in the event of distress.

For the average investor, understanding such prospectuses without prior experience is not recommended. Furthermore, in the unfortunate circumstance that a company enters into restructuring, investors will tend to be at an information asymmetry with management who has both the resources to marshal better legal teams and insider knowledge of the situation.

Ending Comments

Record low interest rates have spurred one of the greatest bull markets in bonds in the history of financial markets. As interest rates start to moderate however, we would sound a note of caution on bonds as an asset class – especially the high yield market.

Additionally, we recently did 2 radio interviews with MoneyFM 89.3 on OKP Holdings ([link](#)) and the Luxury Watch Industry ([link](#)). Enjoy!

Appendix

Date	Project Name	Tenure	Size (in sqft)	Price (in SGD millions)	PSF
Dec-17	Vista Park	99 Leasehold	319,000	\$418	\$1,096
Dec-17	Apartment 8	Freehold	9,665	\$22	–
Dec-17	Parkway Mansion	Freehold	39,000	\$147	\$1,536
Dec-17	Derby Court	Freehold	19,000	\$74	\$1,390
Dec-17	Jervois Green	Freehold	27,000	\$53	\$1,601
Dec-17	Royalville	Freehold	174,000	\$478	\$1,960
Nov-17	Crystal Tower	Freehold	60,000	\$181	\$1,840
Nov-17	How Sun Park	Freehold	55,000	\$81	\$1,092
Nov-17	Mayfair Gardens	99 Leasehold	208,000	\$311	\$1,244
Nov-17	Casa Contendere	Freehold	38,000	\$72	\$1,638
Oct-17	Dunearn Court	Freehold	19,000	\$36	\$1,371
Oct-17	Changi Garden	Freehold	200,000	\$249	\$888
Oct-17	Florence Regency	99 Leasehold	389,000	\$629	\$842
Oct-17	Normanton Park	99 Leasehold	661,000	\$830	\$969
Oct-17	Amber Park	Freehold	214,000	\$907	\$1,515
Sep-17	Jervois Gardens	Freehold	34,000	\$72	\$1,373
Sep-17	Nanak Mansions	Freehold	110,000	\$201	\$1,409
Sep-17	Sun Rosier	Freehold	146,000	\$271	\$1,325
Aug-17	Yio Chu Kang	99 Leasehold	14,000	\$8	–
Aug-17	Tampines Court	99 Leasehold	702,000	\$970	\$676
Jul-17	Serangoon Ville	99 Leasehold	297,000	\$499	\$835
Jul-17	The Albracca	Freehold	23,000	\$69	\$1,409
Jul-17	Lotus at Pasir Panjang	Freehold	89,000	\$121	–
Jun-17	Eunosville	99 Leasehold	377,000	\$766	\$909
May-17	Rio Casa	99 Leasehold	396,000	\$575	\$706
May-17	One Tree Hill Gardens	Freehold	39,000	\$65	\$1,664
Total Value				\$8,105	

Figure 1: 2017 En-bloc Projects (Source: StackedHomes)

Date	Project Name	Tenure	Size (in sqft)	Price (in SGD millions)	PSF
Apr-18	The Estoril	Freehold	84,600	\$224	\$1,654
Mar-18	Ampas Apartments	Freehold	30,239	\$95	\$1,073
Mar-18	Fairhaven	Freehold	16,660	\$57	\$1,629
Mar-18	Makeway View	Freehold	41,582	\$168	\$1,626
Mar-18	Pacific Mansion	Freehold	128,352	\$980	\$1,806
Mar-18	Katong Park Towers	99 Leasehold	140,758	\$288	\$1,280
Mar-18	Goodluck Garden	Freehold	360,130	\$610	\$1,100
Mar-18	Eunos Mansion	Freehold	111,735	\$220	\$1,118
Mar-18	Toho Mansion	Freehold	47,660	\$120	\$1,805
Mar-18	Hollandia	Freehold	53,505	\$183	\$1,703
Feb-18	Brookvale Park	999 Leasehold	373,008	\$530	\$932
Feb-18	Cairnhill Mansions	Freehold	43,103	\$362	\$2,311
Feb-18	Riviera Point	Freehold	14,579	\$72	\$1,461
Feb-18	Pearl Bank Apartments	99 Leasehold	–	\$728	\$1,515
Feb-18	City Towers	Freehold	104,532	\$402	\$1,847
Jan-18	Park West	99 Leasehold	634,000	\$841	\$850
Total Value				\$5,881	

Figure 2: 2018 En-bloc Projects (Source: StackedHomes)

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