



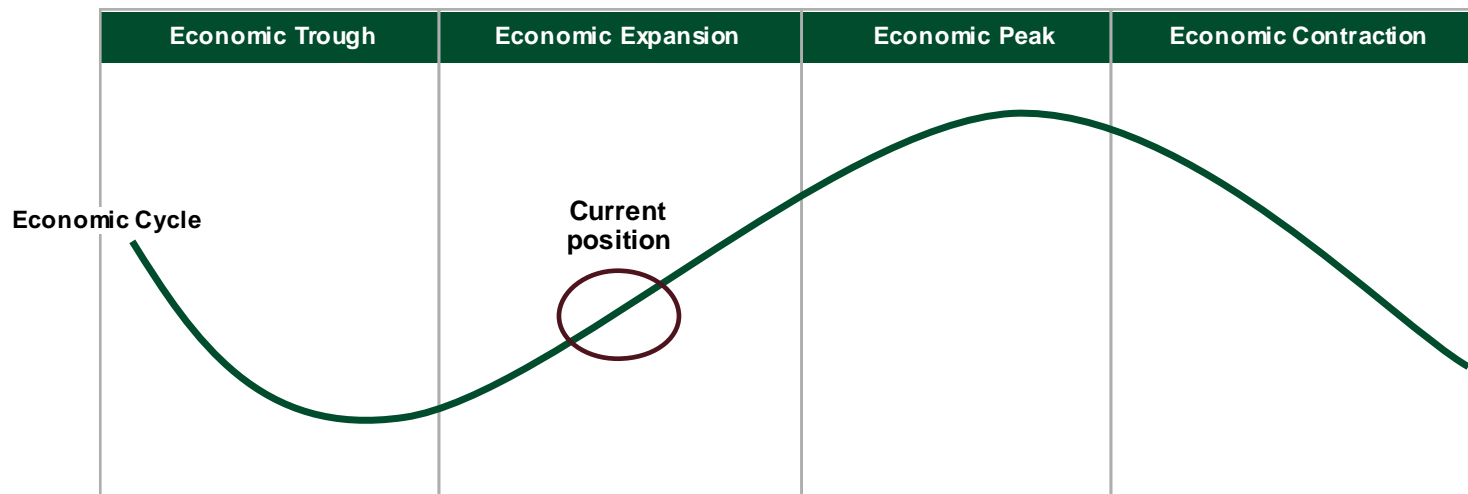
Why Buy Fixed Income Now?

Fixed Income Opportunities in a Higher
Interest Rate Environment

Question 1

You believe that we are currently in the 'Expansion' part of the economic cycle, can you explain the advantages of investing in fixed income at this stage in the cycle?

Macro Economic Outlook Overview - Our Approach



Investment Cycle	Business Trough	Economic Expansion	Economic Peak	Economic Contraction
Sectors	Asian Sovereign USD, Investment Grade Corporate Securities, Convertible Bonds	Local Currency Debt, Corporate Securities, Convertible Bonds	Switch to higher grade Asian and sovereign and G7	Investment Grade and Sovereign debt
Quality	Investment Grade	Non Investment Grade	G7, Higher grade Asian Credit	Investment Grade
Currencies	G7 and lower beta Asian Currencies	Higher Beta Currencies	Switch out of high yielding currencies	HKD, USD, YEN

Question 2

What benefits are there in having bonds as part of a diversified investment portfolio?

Why Fixed Income is Important to an Investor's Portfolio

Over last 10 years, Asian bonds have delivered similar returns to Equity with one quarter of the volatility

— Asia Bonds — Asia Equity — Bond Equity Blend — DJIA — US Aggregate Bond

10 Year Performance

	Return	Volatility
Asia Bonds	8.76%	5.85%
Asia Equity	10.36%	23.60%
50/50 Bond Equity Blend	9.56%	14.73%
Barclays US Aggregate Bond Index	5.85%	3.80%
Dow Jones Industrial Average	0.98%	15.65%

Volatility refers to the amount of uncertainty or risk about the size of changes in a security's value.

A **higher volatility** means that a security's value can potentially be spread out over a larger range of values. This means that the price of the security can change dramatically over a short time period in either direction.

A **lower volatility** means that a security's value does not fluctuate dramatically, but changes in value at a steady pace over a period of time.



Source: Bloomberg

*Volatility: Shown as standard deviation

Asian Bond: 50% HSBC Asian US Dollar Bond Index, 50% HSBC Asia Local Bond Index

Asia Equity: MSCI Asia Ex Japan Index. US Aggregate Bond: Barclays US Aggregate Bond Index. Return Period: Dec2000 to Jan 2011

Question 3

Can you start by talking us through how you use floating rate notes and high yield bonds to generate returns in a period of higher interest rates?

Six Tools

There are 6 key tools that fixed incomes managers can use to generate strong returns – even in a higher interest rate environment

Floating Rate Notes

High Yield Bonds

Shorter Maturity Bonds

Diversify Interest Rate Exposure

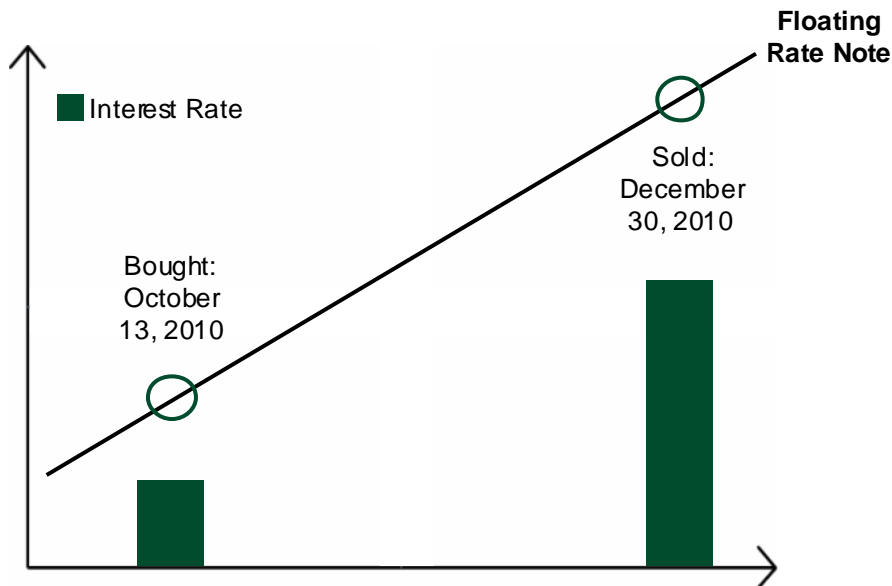
Appreciating Currencies

Convertible Bonds

Floating Rate Notes

A bond with a variable interest rate. The adjustments to the interest rate are tied to a certain money-market index.

- Increase Floating Rate note exposure when Interest rates rise
- Floating Rate Bond rise in value to reflect benefit of higher rates
- **Example:** China Development Bank



We buy floating rate note bond on October 13. 100.60 that pays a coupon of 2.73%

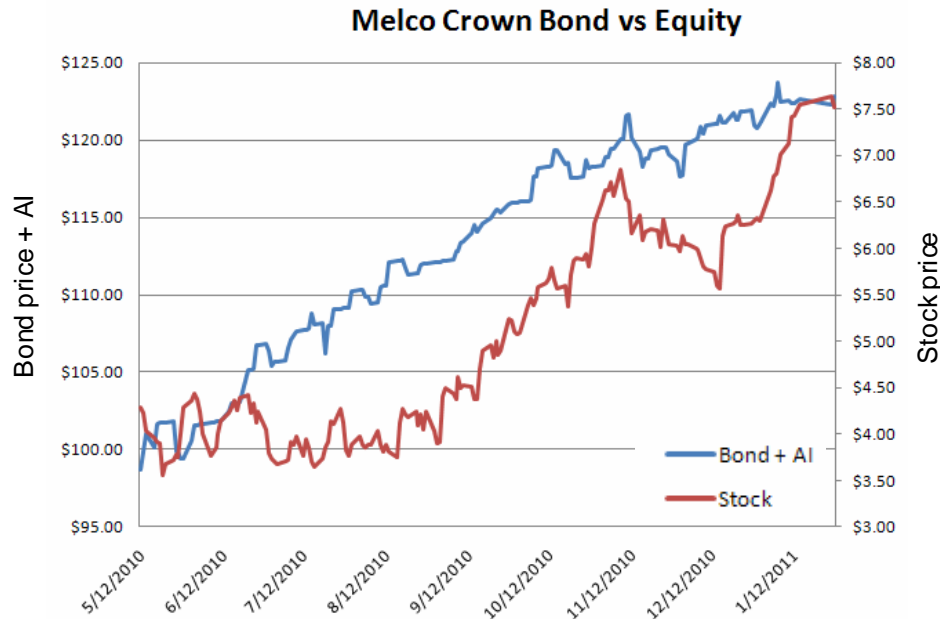
On December 30, sell some of the bond, because the value of the bond has gone up, with investors knowing the interest rate will be reset higher.

**Price bought: \$100.60
Interest Rates increased: 2%
Price sold: \$109.20
We profited: 9%**

High Yield Bonds

A high paying bond with a lower credit rating than investment-grade bonds

- Equity like returns with lower volatility
- Due to large credit spreads, high yield bonds are less sensitive to interest rate increases
- **Example:** Melco Crown (USD)
 - Melco Bonds move more similarly to stock than to interest rates



**US 10Y Treasury went up: 90bps
Melco HY Bond profited: 11.93%**

Period: August 2010 - Jan 2011

Question 4

What are the advantages of shorter maturity bonds in this environment?

Switch to Shorter Maturity

When buying Credits in a rising rate environment, favor shorter maturity bond of same issuer

- The prices of bonds closer to maturity have less price sensitivity than longer bonds (lower duration)
- Gains from coupon and credit spread tightening are able to offset the impact of higher rates
- **Example:**

Hutchinson Whampoa			Hutchinson Whampoa	
Coupon	Matures	VS	Coupon	Matures
6.5%	2/13/2013		5.75%	9/11/2019

- From Sept 30 to Jan 31, US 10 year Treasury yields rose 85bp
- US Treasury bonds with 8.5 years to maturity returned -4% for the period
- Though credit spreads tightened, Hutchinson Whampoa 5.75% 9/11/19 returned -1.25% for the period
- With tighter credit spread and short duration, Hutchinson Whampoa 6.5 % 2/13/13 returned 0.9% for the period

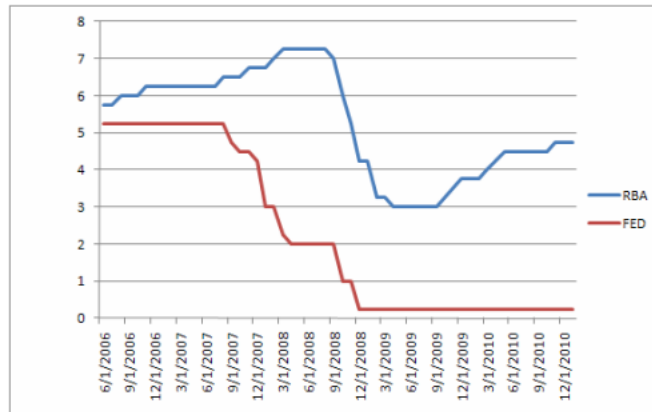
	Price as of 9/30/2010	Price as of 1/31/2011	Change in Credit Spread	Holding Period Return
Hutchison Whampoa 6.5 2/13/13	110.30	109.15	-25	0.91%
Hutchison Whampoa 5.75 9/11/19	111.30	108.00	-47	-1.25%
Treasury 3.625 8/15/19	110.05	104.33	0	-4.08%

Question 5

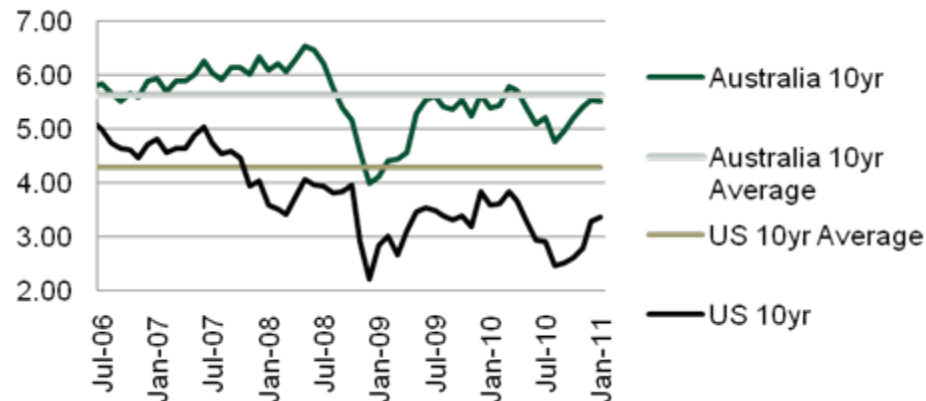
Some investors may not realise that you can also generate good returns from diversifying interest rate exposure and from appreciating currencies in the current economic environment, can you explain how this works?

Diversify Interest Rate Exposure

Australia is further along in rate hike cycle than the US



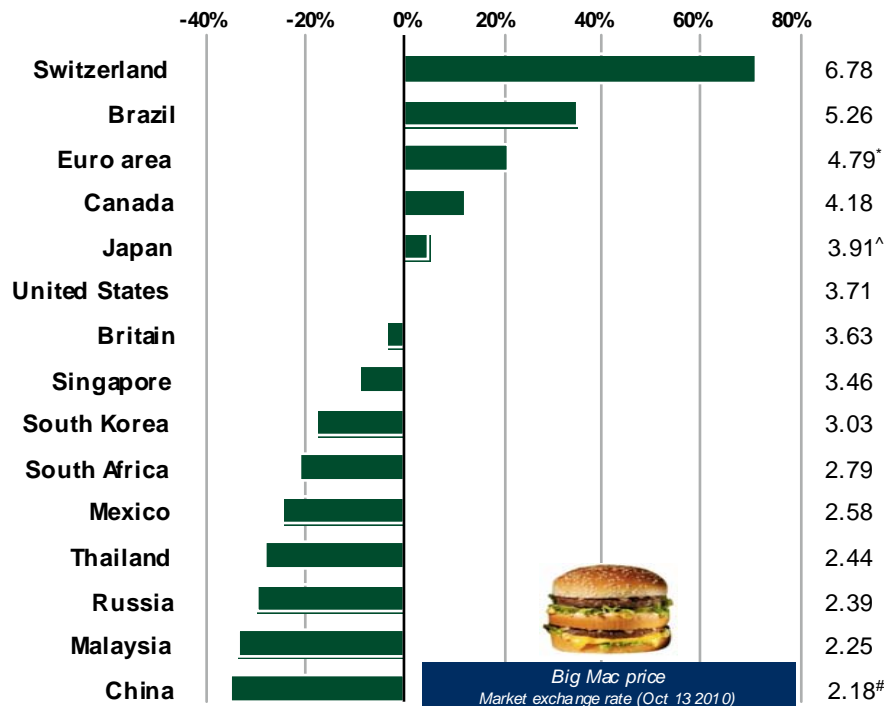
Australian government bonds are already at long term average yield - good time to enter the market



Appreciating Currencies

Asian Currencies are still undervalued based on the BIG MAC Index. Asian Currencies should continue to be a strong contributor to portfolio returns in 2011

Big Mac index, local-currency under(-) / over(+) valuation against the dollar, %



* Weighted average of member countries

^ Average of four cities

Average of two cities

DECREASE the weight of an **OVER-VALUED** Currency

INCREASE the weight of an **UNDER-VALUED** Currency

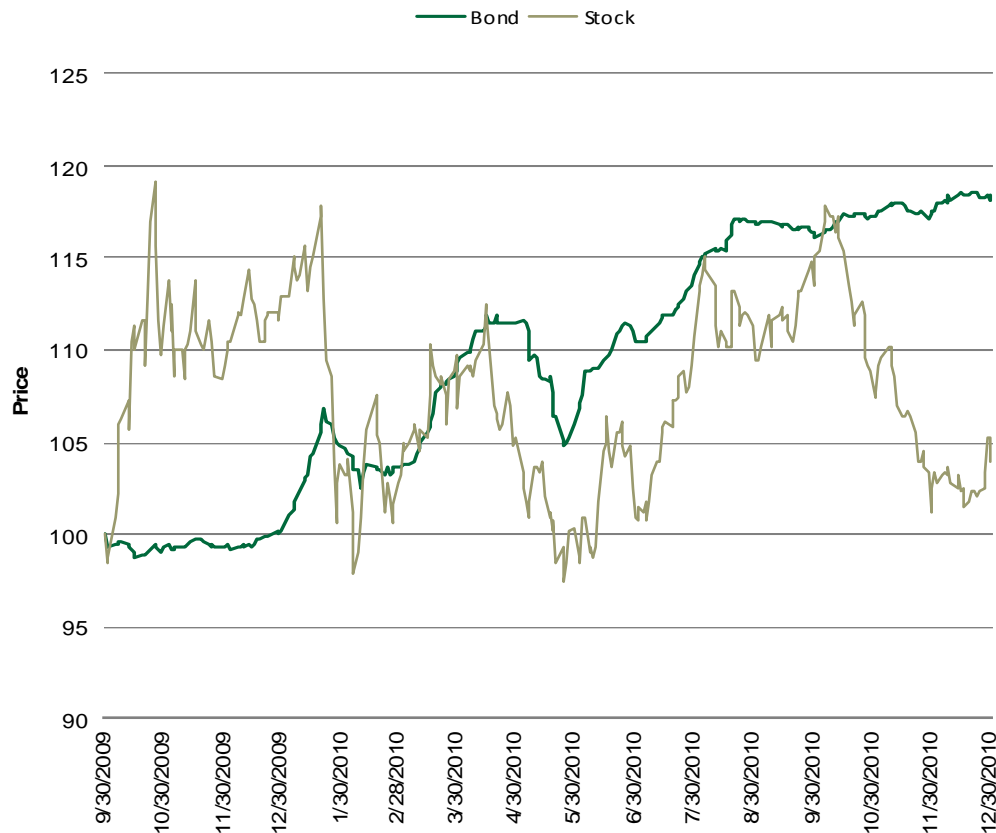
Question 6

And finally, another tool in the fixed income manager's tool kit is a convertible bond, how do you use convertible bonds to generate returns when interest rates are rising?

Convertible Bonds

Convertible bond is a bond that can be converted into a predetermined amount of the company's equity at certain times during its life (at the discretion of the bondholder).

Capitaland (Convertible Bond vs Equity)



- Convertible bonds provides equity-like returns, but with less price volatility
- Trades both relative to equities and fixed income markets
- Greater downside protection than equities

Source: Bloomberg

15 The above is for illustrative purposes only and does not constitute to any recommendation to invest in the above mentioned securities.

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