

SMART MONEY BUDGET AND YOU

Don't get too excited about retail bonds



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Investors are always on the hunt for new investments offering juicy returns. So it's hardly surprising that moves this week by the federal government and the Australian Securities and Investments Commission to help develop a retail corporate bond raised a few eyebrows. But before investors get too excited it's worth looking at the risks and returns. Not to mention the likelihood of the moves being successful.

First, bonds conjure up the idea of a safe investment. But that type of bond is issued by a government and although they are often referred to as "risk-free", investors can still lose money. Witness all the fears about sovereign risk these days. Corporate bonds are similar in that they also pay a coupon but the risks are entirely different.

Before exploring those risks, it's important to recap on what investors would expect to get from holding corporate bonds versus other bonds or even equities. For a start, corporate bonds and shares in the same company can become worthless if the firm goes bust.

Bonds are not as likely to lose all their value because, depending on what sort you buy, senior or subordinated, investors can rank ahead of shareholders in recovering assets from a failed company.

While both bonds and shares can stop paying coupons and dividends, share dividend cuts are more common than bond defaults, for legal as well as other reasons.



Scott Rundell.

In theory, the risks for corporate bonds are not as great as for equities but are greater than vanilla government bonds.

What about the returns? In Australia, the professional corporate bond market is quite small and the supply is dominated by the big banks and a number of foreign AAA-rated entities. The volume of real corporate issuance is quite small. In the US, it's a different story. Supply over a range of issuers is broad. Looking at the US market, it's easy to understand why investors get excited about corporate bonds.

Returns from US corporate bonds have actually beaten Wall Street over the past 10 years. Obviously, the bear market of 2008 hit equities quite hard, much harder than corporate bonds, which also suffered due to the credit crisis. Over the past decade, equities in the US have returned minus 2.7 per cent while corporate bonds delivered a 2.3 per cent return. Over a 20-year time frame, equities edged ahead, up 5.6 per cent, compared

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to 4.9 per cent from corporate bonds. It's interesting to note that US treasuries were up 5.7 per cent over a 10-year period and 6.8 per cent over the past 20 years.

Investors shouldn't get too excited about similar performance from a local retail market. There has been the odd deal and Tabcorp's issue has performed well, delivering what it said it would. Which is as good as it gets when it comes to bonds. Investors shouldn't be expecting capital gains, just a regular income, a higher than normal rate depending on the credit quality of the issuer and, of course, your money back at the end.

Peter Dorrian, head of PIMCO Global Wealth Management in Australia, says investors should

expect to receive a return higher than cash but lower than the long-term expected return from equities. "The main difference is there is less risk investing in bonds, so the short-term returns will be less volatile," he says.

PIMCO's Global Credit Fund, which enables investors to access a broadly diversified portfolio of corporate bonds from a wide range of countries and issuers, has delivered a return of more than 10 per cent a year over the past three years. "This has been a very strong period for the corporate bond sector, so a more likely longer-term return would be in the 8 per cent to 9 per cent per annum range," Dorrian says.

In the past, fixed interest has played three key roles in an asset allocation strategy: To diversify risk, to preserve capital and finally to generate income. Dorrian adds that the amount an investor should buy depends on when they may need to get their money back and their tolerance to risk.

Scott Rundell, head of credit research at ING Investment Management, reckons corporate bonds offer a return above less risky investments, such as term deposits and government bonds.

"To earn this additional return, an investor in corporate bonds will need to accept a range of potential additional risks, including issuer credit risk, term risk, liquidity risk, interest rate risk and documentation risk," he says.

Company balance sheets are designed such that a company's debt, the corporate bond, ranks higher than the company's shares, or equity, so the corporate bond offers the investor a much higher level of security with respect to coupon payments and the principal invested should the company suffer losses.

"The flipside is that the investor in a corporate bond will not benefit in the gains in a company's share price," Rundell says.

He also says corporate bonds are largely a way to diversify risk as well as improve the yield on fixed-income assets. "They may be considered an appropriate useful diversification away from having only traditional term deposits. The amount to buy largely depends on how much additional risk the investor is willing to accept." That risk is linked to the likelihood of the company going bankrupt.

As always, it would be prudent to diversify to minimise this risk. That could be tricky for local investors. The new rules make it easier for smaller companies to issue a minimum of \$50 million but these sorts of companies would struggle to do a deal in the professional market or get a loan from their bank. It's unlikely BHP Billiton and other well-known companies would tap the retail bond market. For that reason, retail investors would probably need some help doing their credit homework.

Ratings agencies have hardly covered themselves in glory over the past few years but their guidance might come in handy. Alas, credit ratings cannot be used because the agencies haven't applied for a licence from ASIC to provide them for securities in the retail market. For this reason, Perpetual credit analyst Vivek Prabhhu believes the absence of retail bond market credit ratings is "a significant impediment" to a fully functional market.

FIIG Securities managing director Jim Stening is optimistic that these changes will lead to a viable retail bond market and that, at the very least, they are a solid and important first step.