

Investment



BREATHING LIFE BACK INTO BONDS

The incentives remain modest for companies to sell bonds directly to individuals. **Report: Anthony Sibillin**

- Less paperwork and a tax break are incentives the federal government hopes will help revive a moribund retail bond market.

Sceptics, however, believe the tax break is too modest to have individual investors selling shares and properties to buy bonds. They also say the paperwork is too onerous to have companies bypassing the mostly institutional investors to whom they sell bonds now.

Onerous paperwork is the reason retailer Woolworths has ruled out letting individuals buy any of the bonds it plans to issue locally over the next 12 to

18 months. Bond expert Stephen Nash agrees that the incentives announced in the May budget are “not enough to induce a behavioural change” on the part of investors or issuers. But as the head of the strategy and market development at FIIG Securities, which researches and trades bonds, he thinks the government, which has signalled it wants a “deep and liquid” local bond market, is unlikely to stop here.

“Further change is inevitable and will change the landscape of investing in Australia as tax distortions are gradually torn down,” he says.

In the meantime, investors will continue to miss out on a source of steady income that is widely available in most other developed countries.

A moribund retail bond market – five retail bond issues in the first 11 months of 2009 raised \$659 million, or just 0.87 per cent of all corporate issuance in that period – is one reason why self-funded retirees were so exposed to the

Retail bonds: Moves to revive market may not be enough

global financial crisis, the Organisation for Economic Co-operation and Development says. How? By forcing them to invest 57 per cent of their retirement savings in volatile shares, compared with an average of 36 per cent in 20 OECD countries.

In contrast, bonds let ordinary investors play banker to the big end of town, including the banks that for years have squeezed them on mortgage payments. As with a home loan, bonds yield a stream of payments for the life of the loan.

Traditionally, payments were based on a fixed percentage of the principal, but now they mostly include a variable component as well. For instance, the five-year retail bonds of gaming giant Tabcorp, issued last year, pay a fixed margin of 4.25 per cent plus the 90-day bank bill swap rate.

Unlike a home loan, however, investors get only the principal back at the end of the term.

Because companies are obliged to pay back bondholders before shareholders, the returns from shares should be higher to compensate shareholders for taking on more risk. The gross annual return from Australian shares over the 20 years to December 2009 was 9.7 per cent compared with 8.9 per cent for bonds, a new report by the Australian Securities Exchange and Russell Investments shows.

However, the report also shows that, over the 10 years to last December, growth oriented managed funds (75 per cent to 85 per cent invested in shares and other growth assets) returned 4.5 per cent, 1.2 per cent less than conservative funds (which are 25 per cent to 35 per cent invested in shares, with the balance in bonds and cash).

The superior long-term performance of shares is mostly credited to being more lightly taxed than bonds (see table, next page). After tax, investors in the top tax bracket would have received 7.8 per cent over the past two decades from Australian shares, which have had dividend imputation since 1987,

INVESTMENTS AT TOP MARGINAL TAX RATE

Asset class	Effective tax rate (approximate) %
Australian shares	20
Residential investment property	26
Australian REITs	26
International shares	30
Global REITs	39
Australian bonds	49
Australian cash	49

Source: Australian Securities Exchange/Russell Investments

compared with 4.5 per cent from bonds, which are slugged at an investor’s full marginal tax rate.

To deal with this bias against bonds and bank deposits, the recent review of the taxation system by Treasury secretary Ken Henry recommended the government apply a single 40 per cent tax discount to all forms of investment income.

The government balked at fiddling with the popular “negative gearing” of rental income and instead used the budget to unveil a 50 per cent tax discount on the first \$1000 of interest earned from bonds and deposits.

The budget also coincided with the Australian Securities and Investments Commission reducing the level of disclosure required for a retail bond issue. This means the content of a retail bond issue prospectus will be similar to that of a share issue, Blake Dawson senior associates James Morris and Bronwyn Kirkwood said in a client note.

But they also say that while these are welcome steps, on their own they are too modest to cause a leap in retail bond issuance. In the case of a top tax bracket investor, the 50 per cent discount will reduce their tax bill by a maximum of just \$230.

“In our view, this is unlikely to be a sufficient incentive to drive investor interest in the market in any significant respect,” Morris and Kirkwood write, especially as they can get a similar tax break on a term deposit protected by a federal government guarantee.

The same is true of issuers despite ASIC lightening the paperwork and the long-term advantages of borrowing directly from individuals.

These advantages include: paying a lower level of interest compared with that demanded by institutions, more than compensating over time for higher, initial set-up costs; borrowing for

longer terms, thus lowering refinancing risk; and issuing at par value (where retail investors tend to pay \$100 for a \$100 bond) instead of at a discount, which is usually the case with equity capital raisings.

However, in the minds of company treasurers these advantages will continue to be overwhelmed by the disparity in the disclosure requirements that remain for retail and institutional bond issues.

“Until that gap is reduced,” Morris and Kirkwood argue, “while pricing and liquidity in the wholesale bond market remain attractive for issuers and investors in those markets, many issuers are unlikely to discern sufficient benefit (other than, perhaps, diversification) from absorbing the additional cost and time involved in tapping retail investors.”

Others remain sceptical of the whole idea of retail investors buying corporate bonds directly.

“Corporate bonds are not a natural part of household portfolios,” says Sam Wylie, a senior fellow at the Melbourne Business School. Instead, households should buy units in a bond fund.

“The problem with direct ownership is that it takes a lot of bonds to achieve full diversification,” he says. “Whereas a portfolio of just 20 stocks diversifies away the non-systematic risk, a portfolio of 120 bonds is needed for the same purpose.”

Advocates of direct investment reply that bond funds do not offer the same income security as individual bonds. While the price of an individual bond can fluctuate over its term (bonds can be traded after they are issued, including on a central exchange such as the ASX), if held to maturity a retiree is almost assured of receiving a regular payment over the intervening period.

In contrast, funds buy and sell bonds as investors buy and sell units in the fund. This makes a bond fund more like a share fund than an individual bond, and with the same risks: of choosing a dud manager; of selling units at the wrong time.

FIIG’s Nash insists he is arguing for equal rather than special treatment for bonds. “Without taxation neutrality,” he says, “the allocation of assets will retain current distortions and the merits of different assets may remain effectively disguised by the taxation differential, which exists between asset classes, as identified in the Henry review.” **BRW**