



Fortune favours the brave

Canny investors can pick up higher yields but there are risks

JAMES DUNN



WITH term deposits paying 7 per cent under the government savings guarantee (until October next year), that is about where “sleep-at-night” money ends.

Out beyond that is high-yield territory, a place where investors can pick up higher yields, but with added risk.

Retail investment in the high-yield market is mostly in the listed hybrid securities market (so named because the securities are a mix of debt and equity). There are also some listed retail debt securities, although this market — after a promising rejuvenation with issues by Tabcorp and AMP last year — has not kicked on as hoped.

Most of the listed interest-bearing securities are floating-rate securities, which offer a yield that is based on a margin over the bank bill rate.

“At the moment, you’re easily getting low double-digit running yields, your income alone, from some of the hybrids,” says Brad Newcombe, senior research analyst at specialist fixed-income broker FIIG Securities.

“That’s in the corporate issues, which are a bit riskier. For the major bank hybrids, you’re looking at probably 7 per cent to 8 per cent running yield, 8 per cent to 9 per cent for some of the regional

banks and 10 per cent plus for some of the corporates.

“We view the major bank hybrids as being relatively safe, with a very small chance of non-payment of your distributions and even less chance that you will lose your money. Some of the corporate yields are quite a bit higher and obviously the higher the return the higher the risk.

“The point is that you can combine the different kinds of hybrids in a portfolio to generate a level of return for a level of risk that you’re comfortable with. For what we would consider as higher-risk, we could put together a portfolio that gave a yield of just over 14 per cent,” says Newcombe.

Steven Wright, director of the fixed-interest department at RBS Morgans, says this is the key: to think in terms of portfolio yield. “We have quite a few corporate hybrids on the ASX [Australian Securities Exchange] that are not investment-grade [that is, they are rated lower than BBB—by Standard & Poor’s or lower than Baa3 by Moody’s] and are thus higher yield than the bank hybrids.

“But if you add to that the fact that last year many of the corporate hybrids fell completely out of bed, they got so grossly mispriced, we have been able to ride the recovery in some of those, and there are still others that are way below fair value.”

Wright gives examples of the Nufarm Finance convertible note (NFNG), which is trading at \$75, and the Paperlinx hybrid (PXUPA), which is trading at \$61. “We’ve got a fair value on NFNG at about \$94, which translates to a yield to maturity of 32.4 per cent, if you bought that and held it through to maturity. Likewise, PXUPA

really got trashed when it stopped paying distributions last year, but it has reintroduced the distribution, and we think it’s worth somewhere around \$95-\$96. You would be looking at a yield to maturity of 39.6 per cent in that security.”

Wright says the same goes for some of the listed collateralised debt obligations, securities linked to the performance of a portfolio of corporate credit ratings. Australia is one of the few markets in the world where CDOs have been sold to retail investors: at one point, there were 12 CDOs listed on the ASX, having raised \$840 million from retail investors. But credit investment suffered a hammer blow in the global financial crisis.

“The CDOs generally, around the world, have a very bad reputation, but if you really look at them, most of the ASX-listed CDOs have done what they said they would do: they have paid their coupons, matured and they’ve been fine. There are still some out there at the moment where the yields don’t reflect the risk, and they’re definitely being used by those investors who are a bit more opportunistic, who understand these securities and haven’t been scared off by the hype because they’re offering some pretty attractive returns.”

An example of this kind of security is the Halcyon Notes (HLCHA), which matures next month. “The Halcyon Notes have constantly traded below issue price. They mature in August this year, when they will pay you back \$101. Westpac guarantees the capital, so you have no risk of losing your capital. You’re due to receive another distribution on August 1.



On an internal rate of return basis, at \$99.55, that's a return of about 18.8 per cent on an annualised basis."

The Nexus Bonds Series 3, which matures in December, is similar, he says. "It is trading on a yield to maturity of 17.8 per cent. Clearly there is a bit more risk attached to that than to the Halcyon Notes, because your capital isn't guaranteed, but for people who can look at the portfolio and understand that it can still withstand two or three defaults between now and December, that is an opportunity.

"If people don't understand these kinds of securities, they won't see the value. While you would be pretty foolish to invest all of your money in one of them, the point is that you should always be thinking about the portfolio yield. You can leaven some of the safer stuff — even a selection of term deposits — with some-



thing like that, and push up your portfolio yield," says Wright.

Newcombe says the corporate retail fixed-interest market has "not kicked on" as everyone hoped it might. "We had a couple of issues last year, the Tabcorp Bonds and the AMP Notes, and they've provided some pretty good returns. Tabcorp Bonds is 4.25 per cent over the bank bill swap rate, so it's about 9 per cent now; the AMP Notes are 4.75 per cent over swap, so about 9.5 per cent in the current environment.

"They've been good performers, but the problem was that both Tabcorp and AMP had to issue a full prospectus. A lot of potential issuers seem to think that it is easier to go to the banks for funds or the institutional bond market rather than go to the trouble of worrying about a retail bond issue.

"That problem has recently been rectified: the government and ASIC [the Australian Securities and Investments Commission] have brought out a 'short-form' prospectus standard. That's solved a lot of the problems, and we'd like to think in time this will bring about greater issuance of retail bonds, but while there are a lot of reasons for that to happen, it hasn't flowed through yet. At the same time, the only real hybrid issuers in the market have been the banks, Westpac, ANZ, CBA: there hasn't been anything in the way of corporate hybrids for 12 months."

Newcombe says FIIG's answer to the issue dearth was its launch earlier this year of its Direct Bonds service, which gives ordinary investors — at least, those with \$50,000 to invest — access to the high-yielding investment-grade corporate bond market, which usually requires a minimum investment of \$500,000 face value. "We did Direct Bonds because the hybrid market has stagnated, and the retail bond market has not had the kick-on that we had hoped for. We're seeing the demand, but we've directed it into

those institutional bonds through Direct Bonds," he says.

"We've put investors into low-risk Telstra bonds, for example, for further diversification, and also started to dial up the return, using bonds like Suncorp, Rural Bank and Sydney Airport. They're yielding in the 8 per cent to 8.8 per cent range, and extended that even higher with major international names, like Swiss Re and AXA, which will give you 11 per cent to 12 per cent. Combining those with some of the corporate hybrids can give you quite a wide range of risk-return equations [see accompanying portfolios]," says Newcombe.

And then there is the other main source of high yield: corporate dividends. "If you're looking for yield, you can't forget the stock market," says Carey Smith, research analyst at broking firm Alto Capital. "If you look at Telstra, for example, it's forecast to pay about 28c in dividends this year. At \$3.19, that's a yield of 9 per cent right there. And if you gross that up for franking credits, that's offering you 12.5 per cent."

Smith says an investor wanting an income portfolio, including franking credits, could easily achieve 7 per cent to 8 per cent from the portfolio. You might have Telstra in there, giving you 12.5 per cent, but a portfolio yield coming in at about 7.5 per cent. You would use a Challenger Infrastructure Fund, which is giving you 14c on \$1.29, so there's 10.8 per cent right there. Then you balance that out with some other yields that you believe to be achievable, as I've done with the attached portfolio.

"The point is that these are not the highest yields available on the market, but rather dividends I believe are maintainable. If they come in better than that, that's a bonus."

This means looking at a company's track record of paying dividends, its dividend cover and discarding any rogue

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STEVEN WRIGHT



yield figures you see (the share price might have fallen out of bed, or the dividend expectation is too high.) “You’ve got to be confident that the companies can pay the dividends when they’re supposed to. For example, you would have to feel pretty confident that Telstra is going to pay 28c. Some analysts are forecasting 29c to 30c next year, but be conservative: even if it drops to 26c, you’re still getting over 10 per cent on a grossed-up basis.”

If you’re picking up the dividend in-

come, says Smith, you don’t have to worry about the share price on a day-to-day basis. “Over the long term, the share price will probably benefit you, but you can afford to ignore that,” he says.

The really great thing about using shares for income is that over a long holding period, the rising dividend can start to generate almost incredible yields on the original purchase price. Take that National Australia Bank prospective dividend of \$1.50, for example: had you

bought NAB for \$7 in 1992, that dividend of \$1.50 represents a yield on your investment of 21.4 per cent.

And if those NAB shares happen to be held in a self-managed super fund that’s paying you a pension — and is untaxed, but receives a refund of the franking credits it cannot use — that yield becomes 30.5 per cent.

How’s that for high yield?



ASX Income portfolio

Stock	Code	Price (\$)	Forecast dividend (c)	Franking (%)	Nominal yield (%)	Grossed up yield (%)	After-tax yield to	
							46.5% taxpayer (%)	19% taxpayer (%)
CHALLENGER	CHF	1.29	14.0c	nil	10.8	10.8	5.8	9.1
DOWNER EDI	DOW	3.54	25.0	nil	7.1	7.1	3.8	6.0
NAB	NAB	22.94	150	100	6.5	9.3	5.0	7.8
QBE	QBE	17.65	125	20	7.1	7.7	4.1	6.5
TABCORP	TAH	6.35	55.0	100	8.7	12.4	6.6	10.5
TELSTRA	TLS	3.18	28.0	100	8.8	12.6	6.7	10.6
WESTFIELD	WDC	12.16	90.0	nil	7.4	7.4	3.9	6.3
AVERAGE YIELD FOR EQUAL WEIGHT PORTFOLIO					8.0	9.6	5.1	8.1

FIGG Securities sample portfolios

Issuer	Type	ASX code	Maturity/ call date	Return (%)*
LOW RISK				
TELSTRA	Bond	n/a	15 April 15	6.0
GE CAPITAL	Bond	n/a	15 March 19	7.0
ANZ	Hybrid	ANZPA	15 Dec 16	8.2
CBA	Hybrid	PCAPA	6 Apr 16	10.4
WBC	Hybrid	WCTPA	30 June 16	9.9
PORTFOLIO RETURN				8.3
MEDIUM RISK				
SUNCORP	Bond	n/a	23 Sept 14	8.8
RURAL BANK	Bond	n/a	12 Feb 15	8.5
SYDNEY AIRPORT	Bond	n/a	20 Nov 20	8.0
AUSTRALAND	Hybrid	AAZBP	Perpetual	11.7
BENDIGO & ADELAIDE BANK	Hybrid	BENPB	15 June 15	10.1
PORTFOLIO RETURN				9.4
HIGH RISK				
SWISS RE	Bond	n/a	25 May 17	11.7
AXA SA	Bond	n/a	26 Oct 16	11.9
GOODMAN GROUP	Hybrid	GMPPA	21 Mar 13	22.0
MULTIPLEX	Hybrid	MXUPA	Perpetual	11.8
SEVEN GROUP	Hybrid	SVWPA	Perpetual	13.0
PORTFOLIO RETURN				14.1

* Yield to maturity

Source: Alto Capital