

EUREKA *report*



Why bonds outperform term deposits

By Elizabeth Moran
September 20, 2010

PORTFOLIO POINT: For a slight increase in risk, investors can enjoy much stronger performance with bonds.

Investors new to fixed income often ask: "Why invest in bonds when you can earn a good return from government-guaranteed term deposits?"

There are many reasons a bond portfolio is preferable to term deposits, but the main reason is the capacity to earn greater returns for a marginal increase in risk. Allow me to demonstrate.

By far the biggest investment allocation in my portfolio (click [here](#)), the \$500,000 face value Rabobank bond. Rabobank is Dutch and one of the few banks to maintain its AAA credit rating throughout the GFC.

Last month when I chose the portfolio, the tier-one Rabobank bonds had a yield to maturity of about 8.8% (assuming the bonds are called at first opportunity on December 31, 2014, which is our expectation). The coupon is fixed at 6.415%.

As the bonds are trading at a discount, the yield to maturity is made up of a running yield of about 7%, with the balance of the return or yield to maturity representing the expected capital gain when the bonds are redeemed for \$100 face value, expressed as an annual percentage.

Roughly speaking, the running yield is 7% and capital gain component is 1.8%. While the calculations below use the yield to maturity of 8.8%, investors must be aware that 1.8% of that return will not eventuate until the bonds are redeemed, most likely in December 2014. Alternatively, the bonds can be sold on market before redemption, at a capital gain (or loss) depending on the market price at that time.

To best compare term deposits with bonds, we need to match maturity dates. Therefore, we need to select a four-year term deposit rate. The highest four-year term deposit rate is 7.08% with a small ADI (see below) and 6.5% with a recognised bank. In our analysis, we have chosen the recognised bank, remembering that the Rabo bond we have chosen is one of the highest-rated global banks available. The difference in earnings is represented as:

Rabobank Bond

$\$500,000 \times 8.8\% \times 4 \text{ years} = \$176,000$

Term Deposit

$\$500,000 \times 6.5\% \times 4 \text{ years} = \$130,000$

Difference = \$46,000

By investing in the Rabobank bond, investors have the capacity to earn an additional \$46,000 over four years. Bond investors have the capacity to sell bonds where there is the capacity for a capital gain or loss but term deposit investors wanting access to funds prior to maturity will be penalised and must accept a lower return.

Some other points to note:

- The government guarantee expires in October 2011. We expect term deposits may no longer be government-guaranteed up to the \$1 million limit after that date.
- Bonds can be bought or sold at any time on market, subject to liquidity. Investing in term deposits, means agreeing to lock away your money for a set period. Usually investors can negotiate to have funds released but in most cases they pay a penalty, reducing the expected return.

- Some bonds are inflation-linked (see ***Inflation-friendly bonds***), meaning that if the Australian economy goes through a protracted hike in inflation, the bonds protect the underlying capital investment, a feature that no term deposit offers. My portfolio included two such bonds, Sydney Airport Finance and Queensland Treasury Corporation, to reduce damaging inflation rate risk.
- Bonds provide an avenue for investors to have access to a wide range of companies that often do not have listed equity or whose shares are not denominated in Australian dollars.
- The highest government-guaranteed one-year term deposit rate available is 6.31%. Break-even analysis can be used if the investor wants to invest in the one-year government guaranteed term deposit, and upon maturity invest in another three-year term deposit to match the expected call date of the Rabo bond.

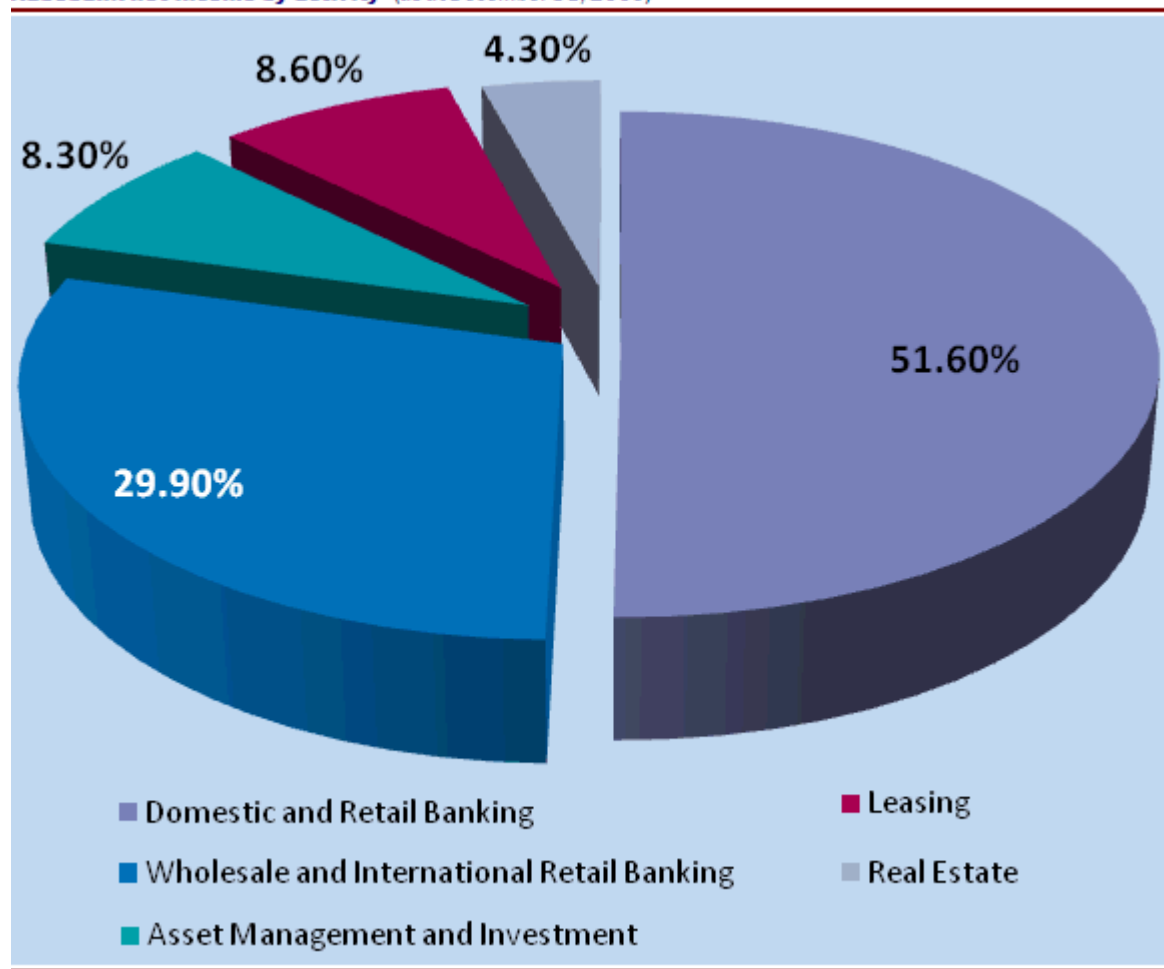
When investors start to analyse the difference in returns over a slightly longer period, the capacity to earn higher returns becomes apparent. The credit quality of the issuer is the key. If investors are confident that the issuer will continue to operate, moving down the capital structure and taking some additional risk can offer substantial rewards. Term deposits are at the top of a bank's capital structure and bonds rank lower, so they typically pay a higher return for the small additional risk.

Please note, the above calculations are simplified and have considerable rounding error contained. In particular, the Rabo bond matures in four years and three months but I have assumed a four-year maturity for easy of comparison.

Focus on Rabobank

Coöperatieve Centrale Raiffeisen-Boerenleenbank B.A. (Rabobank) is one of the largest banking organisations in the Netherlands with market leading mortgage lending and savings operations. It also has a large international presence with operations in 46 countries, €675bn in assets, €40bn in equity and more than 60,000 employees.

Rabobank offers retail banking, wholesale banking, asset management, leasing and real estate services. It is a full service bank in its home market of the Netherlands but is known internationally for its specialisation in the food and agricultural sectors, particularly in the US, Australia, Ireland and other parts of Europe. It is also characterised by a very strong capital base and low-risk lending practices.

Rabobank net income by activity (as at December 31, 2009)

Source: Rabobank

Rabobank has been rated the highest possible level by Moody's (Aaa) since 1986 and Standard & Poor's (AAA) since 1984 and is consistently ranked as one of the world's safest banks.

The Rabobank Group has a unique structure. It is not listed but rather is a cooperative or mutual entity that acts as the central clearer for all the branches/local banks, which in turn are members and sole owners of Rabobank. This structure served it well during the global financial crisis and has provided a very stable and consistent platform for over 100 years. Rabobank Group is comprised of 152 independent local Rabobanks plus Rabobank Nederland, their central organisation, and a number of subsidiaries.

Importantly, Rabobank entities are linked through a "cross-guarantee system". This provides for intra-group credit support among Rabobank Nederland, all local Rabobanks and certain subsidiaries. Under the system, funds are made available by each participating institution if another participant suffers a shortfall in its funds. If a participating institution is liquidated and has insufficient assets to cover its liabilities, the other participating institutions are liable to cover its shortfall.

Historically, Rabobank started over 110 years ago, engaged primarily in lending to the agricultural and horticultural sectors in the Dutch market. Since the 1990s, it has expanded domestically and internationally, offering a wider variety of commercial banking and other financial services to diversify from a traditional savings and mortgage-based business to be a provider of a full range of financial products and services, both in the Netherlands and internationally.

Rabobank Australia Limited commenced in 1990 with the acquisition of the Primary Industry Bank of Australia and is now a leading rural lender with approximately 20% market share. Generally speaking, all Australian-dollar debt issues fall under the cross-guarantee system.

Key points to note:

Throughout the global financial crisis, Rabobank remained profitable and did not require any government support. Its cooperative (unlisted) structure performed significantly better than its listed global peers. In fact profitability levels

have remained largely consistent, albeit on a growing asset base, since 2006 illustrating Rabobank's resilience.

The first-half results released on August 25 should allay any rating agency concerns, with bad debts down almost 50% and NPAT of €1.66 billion, up 26% compared to a year earlier. These figures, together with an improving outlook for the Dutch economy, suggest that profitability is getting closer to pre-GFC levels.

By peer comparison, Rabobank has among the best capitalisation, asset quality, liquidity and hence credit rating in the banking world. Whilst diversification is not at a world best level, its core operations in its home market of the Netherlands and its renowned global food and agriculture specialisation are key strengths.

Definitions

ADI: Authorised Deposit-taking Institution. APRA defines ADIs as: "corporations authorised under the Banking Act 1959. ADIs include banks, building societies and credit unions. All ADIs are subject to the same prudential standards but the use of the names 'bank', 'building society' and 'credit union' is subject to corporations meeting certain criteria."

Call Date: The date prior to maturity on which a callable bond may be redeemed by the issuer. If the issuer determines there is a benefit to refinancing the issue, the bond may be redeemed on the call date, at par, or at a small premium to par depending on the terms of the call option.

Face Value: The initial capital value of the bond and the amount repaid to the bondholder on its maturity, usually \$100.

Issue: The term often used to describe a particular bond issued by an entity or issuer. Its relevance is to the specific terms and point in the capital structure of the particular issuer.

Issuer: The borrower that issues the bond to raise money from investors. Issuers in the Australian bond market include the federal government, state governments, large international banks and companies plus domestic banks and companies.

Yield: This is a measure of the return that a bondholder makes on a bond, expressed as an annual percentage. The most common yield measure is "yield to maturity", which measures the yield on the bond, assuming that the bond is held to maturity and incorporates both the running yield or income component and the expected capital gain. It is a very useful indicator of value because it allows for direct comparison between different types of securities with various maturities and credit risk. For subordinated bonds and hybrid/tier-one securities, the market convention is to assume the security will be called and redeemed at first call date and hence the yield to maturity is calculated to the first call date. For fixed rate bonds, the yield to maturity is certain, however for floating rate bonds it is an estimate based on the current market expectations for interest rates/swap curves and will move with changes in those expectations.

Yield to Maturity: The return an investor will receive if they buy a bond and hold the bond to maturity. It refers to the interest or dividends received from a security and are usually expressed annually or semi-annually as a percentage based on the investment's cost, its current market value or its face value. Bond yields may be quoted either as an absolute rate or as a margin to the interest rate swap rate for the same maturity.

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Note that the yield and coupon are different.



*Elizabeth Moran is director of fixed income research at **FIIG Securities**.*