

EUREKA *report*



Slow but steady

By Elizabeth Moran

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PORTFOLIO POINT: Investors in fixed-income securities have generally achieved positive returns, but be aware of the risks.

One of the first questions that people new to fixed interest and investing in bonds ask is, “how much can I expect to earn?” The answer can be anywhere between 4% and 40% depending on how much risk you are prepared to take.

The table below sets out a sample of the returns available from fixed income. The table is by no means a complete list of securities available, rather a selection offered as a guide to investors thinking about starting their own fixed income portfolios.

You'll see that for each security a range is quoted. Like most goods, the quantity of merchandise you buy can have a measurable impact on the price.

Those investments that are near the top of the table are lower risk and provide lower returns. They are also easier to understand in that they have fewer conditions attached to them. But, as you scan the list and move down the table, you'll see returns start to increase, as does the risk involved, and generally, the securities become more complicated.

Returns are a function of:

- The credit risk involved
- Where the security sits in the capital structure
- Time to maturity
- Liquidity of the security (wider bid/offer spreads show less liquid markets)
- Compensation for expected inflation

Those securities with the lowest returns are of a very high credit quality and are usually very liquid.

Those towards the bottom of the table, some with very impressive returns, are much higher risk. Usually the market is uncertain about the underlying credit quality of the issuer and there can be a long time to final maturity, increasing uncertainty. A wide bid/offer spread usually means lower liquidity, and this is often reflected in a higher return.

For ease of comparison, the bonds listed below are all fixed rate.

Sample Returns on Fixed Income Securities					
	Type of Security	Sub-Class	Institution	Maturities	Returns*
Lowest Risk	Commonwealth Government Bond		Commonwealth Government	Jun-11	4.65% - 4.7%
				Apr-12	4.78% - 4.83%
				Apr-16	5.24% - 5.29%
	Term Deposit	Government Guaranteed (<\$1m) (guarantee in place until 11 October 2011)	Top 4 Australian Bank Regional Bank Credit Union	90 days	5.60%
				90 days	5.90%
				90 days	6.05%
	Semi-Government Bonds		QTC	Jun-11	4.77% - 4.82%
				April 2012	5.05% - 5.10%
				Apr-16	5.87% - 5.92%
	Term Deposit not explicitly government guaranteed		Top 4 Australian Bank Regional Bank	1 - 3 years	6.10% - 6.40%
1 - 5 years				6.50% - 7.93%	
Senior Bonds (Fixed Rate)	Top 4 Australian Bank	NAB	Jun-11	4.96% - 5.01%	
			April 2012	5.41% - 5.46%	
			WPC	6.70% - 6.75%	
	Corporate	Australia Post Sydney Airport Healthscope	Mar-12	5.40% - 5.50%	
			Jul-15	7.40% - 7.80%	
			Jun-16	11.27%	
Subordinated Bonds (Fixed Rate)	Top 4 Australian Bank	ANZ NAB	May-11	5.73% - 5.93%	
			Dec-12	6.25% - 6.45%	
Tier 1 Securities/ Hybrids	International Banks Insurance Companies	Rabobank Swiss Re	Call/Step/Reset**		
			Dec-14 25-May-17	7.9% - 8.5% 10% - 11%	
Highest Risk	Hybrid Securities#	Income Notes and Securities	Macquarie Group National Australia Bank	Call/Step/Reset**	
				Perpetual Perpetual	9.39% 8.26%
		Reset Preference Shares	IAG Reset Preference Shares 1 Suncorp Metway RPS	15-Jun-12	8%
				14-Sep-11	9.19%
		Convertible Preference Shares	ANZ Westpac	15-Dec-16	8.55%
				30-Sep-13	7.29%
		Step Up Preference Shares	Goodman Plus Woolworths Notes Paperlinx	Mar-13	22.50%
				Sep-11 Jun-12	8.19% 39.90%
Stepped Up Preference Shares	Australand Assets Trust Gunns Limited	Perpetual	11.36%		
		Perpetual	14.10%		

* Based on FIIG offers, annualised and current as at Friday 11 February 2011

#This is the yield to maturity of the security.

This amount includes both the income component and any capital gains calculated on the security being redeemed at its first call/maturity/redemption date. Please note that some securities are unlikely to be called at this time.

**The date the security is first available for call/redemption/step up. Please note that in most cases, the security is in fact perpetual.

Source: FIIG Securities Limited

Portfolio Assessment

In the very first article I wrote, I outlined the portfolio in terms of the face value of the bonds that I acquired (**Your \$1 million bond portfolio**, Sep 6). A quick glance at our bond portfolio shows a holding period return of 3.465% – which annualised becomes 8.213% – I'm very happy with that outcome given the low risk involved.

In the table below, I show the actual purchase prices, coupon payments and current value. I've assumed a mid-pricing point when calculating the current value and that there are no liquidity issues however if investors find themselves forced sellers of these instruments so soon after purchasing them, they may find themselves doing so at a loss.

Fixed Income Portfolio Performance - Revaluation as at 4 February 2011					
	Initial Investment	Coupon Payments	Current Value	Holding period	Annual Return
Rabobank	\$464,264	\$16,037.50	\$471,288		11.773%
GE CAP Australia Funding	\$99,146	\$3,000,000	\$94,768.22		-3.294%
AXA SA	\$85,653	\$3,750,000	\$88,537.57		18.359%
Macquarie Bank Lyd	\$48,441	\$674.16	\$49,281		7.409%
Rural Bank Ltd Australia	\$105,999	Due 12/2/11	\$108,559.03		5.724%
Sydney Airport Finance	\$51,368	\$561,744	\$51,649.50		3.891%
Queensland Treasury Corp	\$52,436	\$392,838	\$50,729		-5.940%
Credit Union Term Deposit	\$50,000	\$702.74	\$50,702.74		5.700%
CBA Retail Bonds*	\$50,000	\$0	\$50,000		7.051%
At Call Account Interest			\$149.65		
Totals	\$957,307	\$25,118.98	\$965,664.71		

* CBA retail bonds acquired with the matured term deposit funds on 22 December 2010

Source: FIG Securities Limited

Unlike equities, fixed income investment is focused on a much longer time horizon and while you can trade over shorter time frames, you are more inclined to find yourself on the wrong side of the buy/sell spread.

With this in mind, it's interesting to note that two investments are currently showing a loss for the period.

The two bonds in question are GE and QTC. Yields on these bonds have increased, resulting in lower bond prices (this is an important point and one I'll explain in my next article) and although I'm showing a loss, that's only assuming I sell them prior to maturity.

If I hold them to maturity I'll receive the \$100 face value back per bond and as I acquired them at a discount, means I'll make a small profit. The GE bond enables me to explain a little bit more about the pricing. I acquired this bond about 10 days before the coupon of \$3,000 was due.

Accrued interest generally builds between coupon payments and when you buy bonds, they're usually sold at a "dirty price". This means they include accrued interest. The purchase price of the GE bond included almost \$3,000 in coupon interest, which I received soon after purchase.

The star performers of the portfolio have been Rabobank and AXA SA. Having 50% of the portfolio in Rabobank has offset small losses elsewhere. Cash in my at call account has been building and now sits at approximately \$24,970. I could buy some small parcels of hybrid securities with the cash to boost my return, but as this portfolio is meant to compliment a higher risk equity portfolio, I'll let the cash build for the time being.

Some of the securities in my portfolio are still available at reasonable returns but others have moved with the markets and spreads have contracted, meaning they are not as attractive as when I purchased them on 3 September 2010.

Definitions

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Bond

A security that pays a defined distribution (the coupon) for a given period of time (the term) and repays the face value of the security at maturity. A bond is a loan from an investor to the issuer of the security. There are many types of bonds including; floating, fixed, consumer price index (CPI) bonds, inflation-linked, nominal and Eurobonds.

Clean price

Is the price of a coupon bond that does not include any accrued interest.

$$\text{Clean price} = \text{dirty price} - \text{accrued interest}$$

Clean price is also known as capital price, meaning 'clean of, or excluding the coupon'.

Dirty price

Is the price of a bond that includes interest accruing and is due for payment on the next coupon payment. Dirty price is also known as gross price.

Holding Period Return

The mark to market gain plus any cash flows over the period, divided by the price you originally paid.

Liquidity

The liquidity or marketability of an asset is a function of the difference between the bid (the price at which the market is willing to buy the security) and the offer (the price at which the market is willing to sell the security), more commonly known as the bid-offer spread. If a market is liquid it will have many participants at any given time

competing to buy or sell the assets, resulting in a narrow spread. If it is not liquid it will be very difficult to buy or sell the asset without adjusting the capital price paid or received for the asset significantly, creating a wide bid-offer spread.

Perpetual security

A security with regular periodic payments for an infinite number of periods with no maturity date.
