EUREKA report

Bonds for all mankind

By Elizabeth Moran
February 28, 2011

PORTFOLIO POINT: Both ends of the market are well served by these new fixed interest products.

In the past few weeks there have been a couple of new bond issues that are worth discussing that should appeal to investors of all kinds.

One has been issued by an Australian regional bank available to retail investors, while the other is a far more complex issue from an international bank only available to sophisticated or wholesale investors.

The first security has been issued by Bendigo and Adelaide Bank and could reasonably be described as 'vanilla'. The bank has signalled its intention to issue a series of retail bonds of which this is the first. Bendigo now own 100% of Rural Bank, which is part of **my portfolio**.

The second is from Rabobank Capital Securities, which has issued a new style Tier 1 security that meets the new Basel III regulations and has a "loss absorbing" clause. Australia's big four banks may issue securities similar to these in the not-too-distant future, which means they are worth examining in some detail.

But first, let's look at the issue that is likely to have the broadest appeal.

Bendigo and Adelaide Bank

Bendigo recently announced that it would enter the retail bond market by issuing a security paying 1.40% over the 90 day bank bill swap rate (BBSW) for a three-year term. The issue is an important step for the retail bond market and follows on from the Commonwealth Bank's decision to issue a similar security **late last year**. The key features are outlined below.

Bendigo and Adelaide Bank Limited Retail Bond Series 1

Issuer	Bendigo and Adelaide Bank Limited
Term	3 Years -- Maturity Date of 17 March 2014
Listing Date	15 March 2011
Offer Closing Date	8 March 2011
Size	Up to a maximum of A$250m
Listing	Bendigo and Adelaide Bank will apply for the retail bonds to be listed on the ASX.
Margin	The margin is 1.40% over 90day BBSW (90day BBSW to be set on issue date.
Par Value	$100 per bond
Coupons	- Coupons are senior unsecured - Coupons are paid quarterly in arrears with the first payment on 15 June 2011 - First coupon payment approx 6.30% (~ 4.90% + 1.40%)
Ranking	Senior Unsecured
Suitable For	Retail and wholesale investors
Reason for Issue	The offer is being made as part of the bank's ongoing funding strategy
Minimum Application Size	50 units being $5,000

The securities will be titled 'Retail Bonds Series 1' (Retail Bonds), and by accessing the retail sector the bank is

diversifying its funding base and opening up to a new class of investors.

The Retail Bonds are a low-risk security offering a competitive rate of 1.40% over the BBSW for a three-year term. They are suited for investors who are looking for a defensive asset and value the ability to liquidate the investment on short notice if required.

Rabobank Capital Securities

In late January 2011, Rabobank announced details of a new US$2 billion issue of Capital Securities, the first in the new breed of loss absorbing Tier 1 securities following finalisation of the new Basel III capital rules. The securities rank the same as existing Tier 1s but, in the event of the bank's equity capital ratio falling below 8%, are loss-absorbing.

The new structure is similar to existing Tier 1s, but obviously the crucial difference is the ability to write-down the principal amount if a trigger event occurs. This poses a number of questions that must be considered:

1. Does the additional coupon provide enough reward given the possibility of write-off at a time of distress? (Remember if the securities are converted the value of the equity buffer is likely to have dropped considerably from existing levels).
2. What is the likelihood of the bank becoming distressed?
3. What mechanisms does the bank have in place in order to protect itself and has there been any evidence of any stress in the past?

Key Features: Rabobank Capital Securities

Issuer	Rabobank
Term	Perpetual, with no fixed maturity date but will reset every five years – first reset date is 26 July 2016 - Rabobank has stated that if not already called by 2041 it will redeem the securities subject to various conditions, including regulatory approval and ability to re-finance with "qualifying securities" that will meet the appropriate capital requirements at that time - Callable at the issuer's option on 26 July 2016 and semi-annually thereafter on each interest payment date
Minimum Application Size	Minimum investment US$100,000
Suitable for	Sophisticated or wholesale investors
Credit Rating	Rated 'A-' by Fitch Rating
Par Value	$100 per bond
Size	US$2bn
Coupons	- Coupon 8.375% fixed until 26 July 2016 and re-set every five years at the prevailing 5 year US Treasury rate + 642.5bps - Coupons payable semi-annually in arrears - Non-cumulative
Ranking	Tier 1 - Constitute direct, unsecured and subordinated obligations of the issuer
Reason for Issue	To meet new Basel III capital requirements
Loss Absorption Clause	Investors may lose all or part of their investment upon the occurrence or, as appropriate, the continuation of one or more of the following events (each a "Loss Absorption Event"): (a) as a result of losses incurred by the Rabobank Group as reported in its relevant accounts, the Issuer's equity capital ratio falls or remains below 8%; or (b) there has been such a significant reduction in the retained earnings or similar reserves of the Issuer or the Rabobank Group causing a significant deterioration in the financial and regulatory solvency position of the Issuer and the Rabobank Group that the Issuer determines, or the Dutch Central Bank has the Issuer in writing that it believes, that the Issuer's Equity Capital Ratio will fall below 8% in the near term.

The latter clause effectively gives the Dutch regulator the power to require a writedown, even before the 8% trigger is breached. Importantly, the new Basel III capital rules will provide all regulators with the power to require writedowns or conversion to equity of all new, but not existing, Tier 1 and Tier 2 regulatory capital securities.

Our analysis of the new securities for a very low-risk institution like Rabobank was relatively easy given we think there is a very low risk that Rabobank would breach the 8% equity capital ratio. But, as other financial institutions of a lower credit quality issue these types of securities to meet new Basel III requirements, careful analysis will need to be made of the terms and conditions as we expect them to vary greatly.

Mid-February, Credit Suisse also issued a new bond to meet Basel III requirements. Instead of there being a write-off clause, there was a conversion to equity clause, including a share price floor for conversion. We're not sure the path that Australian banks will take to meet Basel III capital requirements (APRA should provide their interpretation soon), but we suspect the conversion to equity clauses will be more palatable to Australian investors.

Banks that are first to the market with new products, such as the Rabobank Capital Securities, often offer attractive returns to ensure the capital raising is successful. The market liked these Rabobank securities, so that the yield has declined to 7.02% and they are trading at a premium of $106 per $100 face value. Investors that acquired the securities in the primary market could sell for a very attractive profit for an investment of only a month.

Subsequent issues by other global banks may offer lower returns.

Why do Bond Prices Increase when the Yield Declines?

Bonds may contain an element of capital gain or loss if sold prior to maturity. Bonds are traded on secondary markets and their prices are constantly changing. The Rabobank Capital Securities, as detailed above, are now trading at a premium as the market viewed the fixed rate coupon as cheap (a good relative value investment which did not reflect the credit quality of the issuer).

Another major factor influencing bond prices is interest rates. However, floating rate notes are priced quarterly and linked to an underlying benchmark, so changes in interest rates do not have as much impact as they do to fixed rate bonds. Also, there are always opportunities in any cycle to find good relative value fixed income securities.

When interest rates rise, nominal fixed rate bond prices fall, and the reverse is also true; when interest rates fall, nominal fixed rate bond prices rise. Put simply, think of a see-saw in perfect balance.

If you buy a bond with a face value of $100 with 10 years to maturity which pays a 5% coupon delivering a required yield of 5% and this is the starting point, a rise in rates to 6% means that for the bond to have the same initial return of 5%, the price must reduce proportionally to $92.561 so that the see-saw remains balanced. The reverse is also true. If interest rates fall to 4%, then the bond price must increase to $108.176 to maintain the initial 5% return (*see Figures 1, 2 and 3 below*).

Figure 1

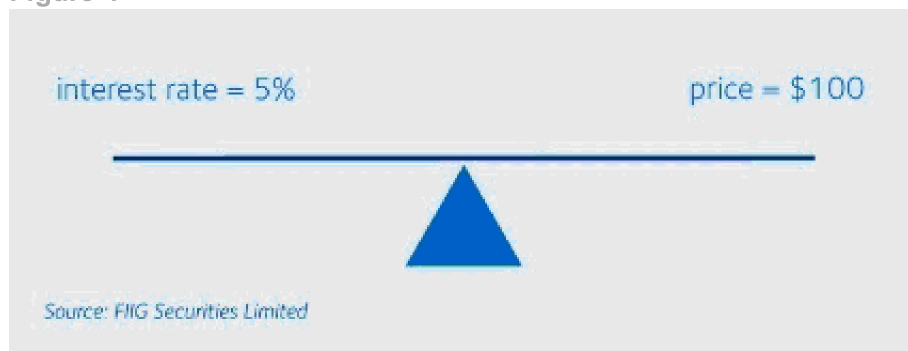


Figure 2

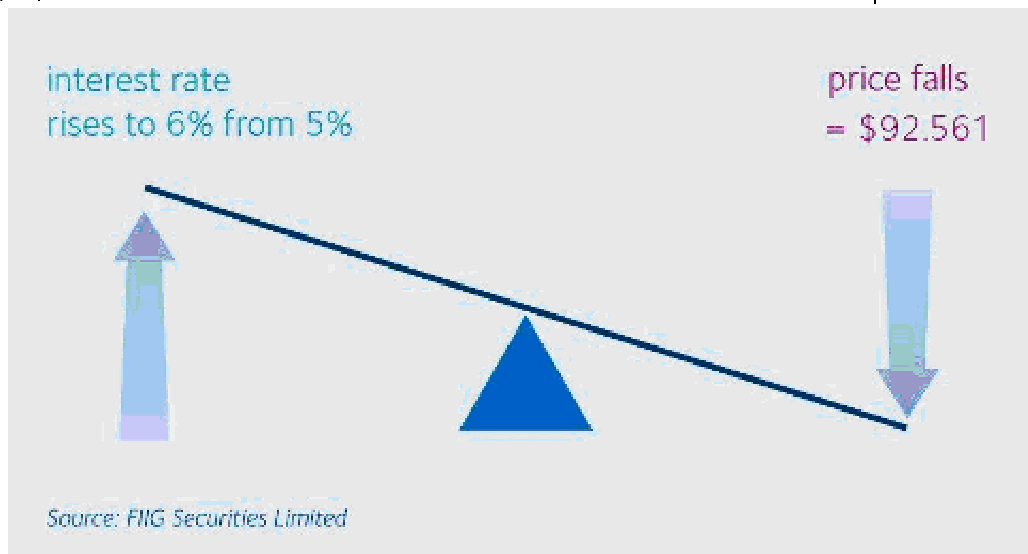
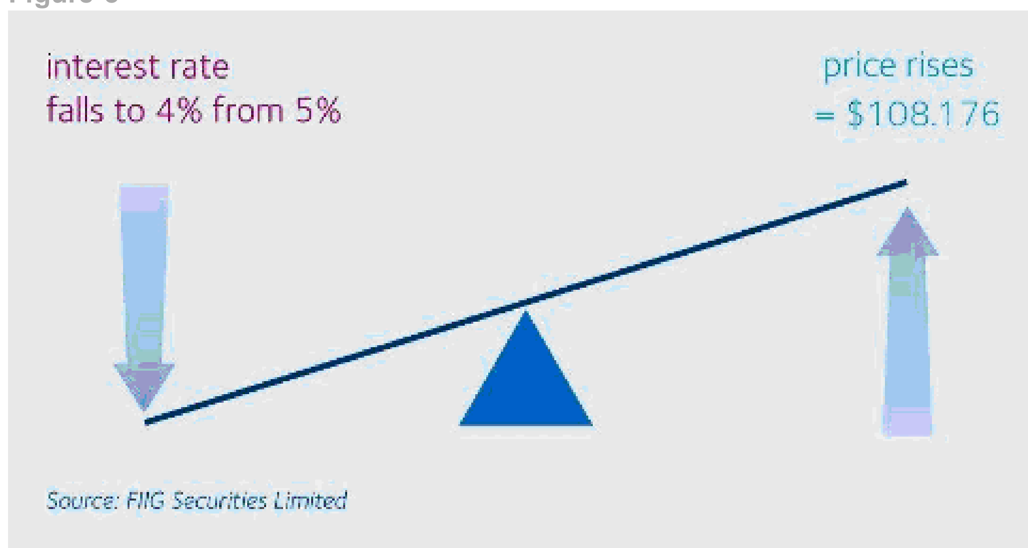


Figure 3



It is essential to understand that bonds have these two characteristics; i.e. both income and capital gain or loss, since most people tend to only concentrate on any potential income. Importantly, it is the capital gain or loss that performs an insulation function for your portfolio. For this reason, bonds are an essential part of a balanced portfolio as they help to reduce the volatility of returns in divergent growth scenarios. While the idea is not new it stems from the fact that, in most cases, the total returns from bonds and equities move in opposite directions.

FIIG Securities is distributing the Bendigo and Adelaide Bank Retail Bonds.