

Investing in bonds: what to look for

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Investing in a nicely yielding debt security sounds good, particularly to retail investors looking for easy ways to diversify portfolios to avoid unexpected capital loss. But debt securities – be they bonds or floating-rate notes – are not shares. Their market behaviour and risk are different and it requires different skills to assess them than it does to analyse a stock.

Retail investors have in the past not had to bother much about this difference, preferring to use cash management accounts when they want to diversify into fixed income.

But things are changing fast. Late last year the federal government announced it would permit its securities to be listed on the Australian Securities Exchange, and Commonwealth Bank launched a \$500 million retail floating rate note issue.

In addition, the Australian Securities and Investment Commission recently loosened the rules for bond issues by established companies so that the company only has to give basic details of the issue, including size, returns and time to maturity, rather than issue a full prospectus.

Debt securities could well become a bigger part of average portfolios as a consequence of all this change. So what should investors look for when evaluating a bond issue?

Chris Dalton, chief executive of retail bond ratings agency Australian Ratings, says a prime consideration is the ranking of the debt.

As a rule, a debt issue should be safer than equity in a company. If the company fails then debt will be paid out before shareholders see any money. But, unlike shares, debt issues may be paid out in sequence, depending on the terminology used, terminology that would be opaque to the retail investor.

For example, an issue of “senior” debt ranks over “subordinated” bonds if the company has to be wound up.

Dalton says retail bonds should be senior debt and mature in three to five years.

As for assessing the bonds, Australian Ratings has a system similar to that used for commercial bonds. Issues with high creditworthiness get the AAA (the highest) through to AA and A classifications. The next level down in creditworthiness are the BB and B classifications, while the low but still investment-grade ratings are B, CCC, CC and C.

Australian Ratings is the only game in town for retail bonds, as the major ratings agencies for wholesale bonds – Standard & Poor’s, Moody’s and Fitch – have elected not to meet the regulatory requirements to be permitted to rate retail bonds.

Australian Ratings was set up by experienced executives from the ratings agencies to take advantage of the resulting gap in the market, but business has been slow.

There were some issues last year and Dalton believes the market will be better this year.

In lieu of a proper rating for bond issues, there are various rules of thumb to follow.

Stephen Nash, an analyst at debt issue specialist FIIG Securities based in Brisbane, says investors should look first at their own needs – what sort of return are they seeking? – then check what sort of return the bond will give and how that return will be calculated. Will yield be at a fixed rate, or floating, or will it be inflation linked? In addition, investors should assess overall risk by checking how much debt the company has to begin with, and how cash flow is to cover interest rate payments, he says.

Debt ratios can be established by examining the company’s balance sheet but acceptable ratios can vary widely, depending on the industry the company is in. Working out the ratio of cash flow, which is earnings before interest payments and tax (EBIT) or the broader measure of earnings before interest, tax, depreciation and amortisation (EBITDA) is more difficult, as investors would have to hunt through the profit and loss account for the statutory separate section on cash flow.

A guide produced by ASIC entitled *Investing in corporate bonds?* notes that the EBIT and EBITDA figure should be “comfortably larger” than the interest payment.

As well as crunching the numbers, the guide notes, investors should also check whether the company has defaulted on any current or previous debt or has breached any conditions on its loans. In addition, the guide says, investors should check whether the company has a significant amount of debt which will reach maturity at once, and so have

to be refinanced at once, which banks may not be willing to do. This is known as the company's loan or maturity profile.

This profile can be established from a note to the company accounts, but it remains to be seen how many investors will be able to find the right note, or interpret it correctly when they do.

In a recent paper on retail bond issues, Kevin Davis, a professor of finance at the University of Melbourne, and research director for the Australian Centre for Financial Studies, also points to the problems investors will have in valuing debt issues.

He says the proposal is to treat bond issues much like an issue of shares by the existing company, but the company shares are already on the market and so have a price.

With little else to go on, investors will be "significantly influenced" by the issuing procedures, including any advice given as part of the procedures, but the regulations give little guidance on what advice to give, the paper says.

Another problem is that once issued, the market price of the bonds can still vary, but will move more in line with interest rates rather than the market itself, and move counter-intuitively. An increase in interest rates will cause bond prices to fall, and a cut will cause bond prices to increase – depending on what type of bonds you hold in the first place.

The ASIC corporate bond investment guide also notes that a credit rating agency may lower the credit rating for a company's bonds, perhaps because the issuing company is performing poorly.

"If this happens, the market price of the bond might fall.

"On the other hand, the credit rating might increase, leading to a higher market price," the guide says.

While retail investors try to come to grips with bond issues, and the market infrastructure develops, the market itself continues to grow, albeit slowly.

Last year, a \$150 million floating rate note issue by Primary Health Care that was aimed at the retail market mostly ended up with institutional investors, but its price has remained steady.

Issued at \$100 each, in mid-February the notes were at about \$100.50.

Philip Bayley, a debt market analyst with ADCM, also notes that the \$100 Commonwealth Bank bonds have risen to \$100.90 since listing (in mid-February, they were about \$100.70).

Vivek Prabhu, portfolio manager, fixed income, at Perpetual Investments, says retail investors will find it difficult to value bonds, unless there is a ratings system, but they can invest in fixed-interest funds which will do the assessment work for them.

Investors also have to remember that there is an "asymmetry of risk" in this form of investing. That is, the return is known and fixed at a certain interest rate, but if the company collapses then all of the investment may be lost.

For that reason, Perpetual always recommends that the investment portfolio be diversified but this is a problem in fixed interest as there is not a great deal of choice on the ASX, Prabhu says.

The Australian Financial Review

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