



Income investing without high anxiety

Higher-yielding assets need not keep you awake at night

JAMES DUNN
BONDS

THOSE who rely on their investments for an income, mostly retirees, are in a dilemma.

They need safety, but they also need a decent yield and the higher the yield, the less safe the investment, generally speaking.

The 10-year Australian government bond trades at a yield of 5.5 per cent. That's safe, but it might not be a high enough yield on which to live in retirement.

It's an ever-present conundrum for income-oriented investors: where exactly on the yield curve (the range of returns of various assets) does safety end?

Stiven Laszlo, managing director of specialist fixed-interest broker Secure Investments FIB, says Australian investors at the moment enjoy a relatively high risk-free investment rate.

"What I would call 'sleep at night' money, the risk-free rate, should be around the cash rate at 5.5-5.6 per cent, but is at least 1 per cent higher than it should be" as banks compete for deposits, Laszlo says.

"With banks very wary of what will happen when the commonwealth government's deposit guarantee ends on October 12, there are still highly attractive rates on offer. Rabo Direct Online Savings, for instance, offers 6.6 per cent for a one-year term deposit.

"That's quite amazing, given that the parent bank, Rabobank of The Netherlands, is the only bank in the world that is still rated AAA, and yet it offers not only a higher rate than the AA/A2-rated big four Australian banks, it offers the highest one-year rate in the market," Laszlo says.

"If you're getting 6.6 per cent with a AAA credit rating, that's not only 'sleep-at-night' money, it's

'good-dreams' money as well."

With risk-free money, or as good as risk-free, higher than where it normally could be expected to be, "high-yield" is also slightly higher than many investors realise, says Brad Newcombe, director of listed income securities and fixed-income research at fixed-interest broking firm FIIG Securities.

"When you use the term 'high yield', technically and traditionally you're talking about going out past investment-grade rated bond issues," Newcombe says.

"As long as that is understood, we would say that a client can at the moment put together a portfolio that quite easily generates a portfolio yield of 10-12 per cent. That can actually be done quite conservatively at present: you're not talking super-high-risk plays that are geared to the hilt."

Newcombe says not many investors realise the most accessible market for interest-bearing securities is those listed on the Australian Securities Exchange.

He says the listed interest-bearing sector contains a variety of "hybrid" securities, so named because they have characteristics of both equities (shares) and debt (bonds), issued by companies ranging from the nation's highest-rated (AA/A2) banks to industrial companies without a credit rating.

Using this range of issuers, and the consequent range in yields, investors can put together portfolios that match the yield they are seeking with the risk they are prepared to bear.

"The great thing about the listed interest-bearing securities market is that you can invest any amount, you pay normal brokerage, and you get a good variety of issues to choose from," he says.

"If safety is your prime concern, you would stay in the major bank hybrids, but we would argue that taking on lower-rated and unrated issues (but still securities that are names that people know and have a bit of research coverage, and have good liquidity) you can move into high-yield territory, double-digit returns, without undue risk."

Newcombe says putting an interest-bearing portfolio together is all about combining risk and return to come up with a portfolio yield with which the investor is comfortable. "You can afford a bit of higher-risk stuff if you have the lower-risk core," he says.

Steven Wright, head of fixed interest at RBS Morgans in Brisbane, says the listed hybrids generate a cash yield from the distributions, plus franking credits, which is the "running yield": it is usually based on a margin over the bank billswap rate at any time (that is, the rate is "floating", as opposed to fixed).

But there can be another component to the yield, the movement in the security price to its issue price, or par value.

Wright says many of the ASX-listed hybrid securities are "step-up" perpetuals, where they will either be redeemed at a certain date at par, or the yield "steps up" (increases). If the security is redeemed, holders receive the par, or issue, value.

"You effectively have two yields: the running yield on a portfolio is the cash yield plus the franking credits; and the expected yield to maturity is the total of the cash, the franking credits and the assumption of the security's price returning to par by maturity or call date. With some of them, the market price implies a pretty hefty return if the security is redeemed," he says.

Wright provided two sample portfolios from the listed interest-bearing market, the first a conservative portfolio laden with banks and rounded out by insurer Suncorp Metway and retail giant Woolworths. This portfolio gives a running yield of 7 per cent and an expected yield to maturity of 8.8 per cent. Taking on more risk, his second portfolio of lower-rated



corporate bonds and hybrids generates a running yield of 9.5 per cent and an expected portfolio yield to maturity of 23.1 per cent. He says the listed interest-bearing sector allows investors and their advisers to put together a portfolio that matches desired yield with the investors' "risk budget", the risk they are prepared to bear.

Wright says the listed interest-bearing market is "more transparent" for retail investors than using a specialist unlisted high-yield fund, but many investors "do not know that the market is there". What makes the listed market bet-

ter suited to the retail investor, he says, is that they can put together a portfolio where they have a good idea of what return to expect.

"We can say, 'here is a group of listed securities, here are the market prices and, based on what we expect the cashflows from that security to be and the expected capital moves (that is, back to par value), here's the expected return,'" Wright says.

While that expected return cannot be predicted to the cent, the investor generally has a "fairly good idea", he says. "In contrast, a high-yield fund will say, 'here's the re-

turn we generated last year', with the usual disclaimer that past returns can't be taken as a guide to future performance."

The transparency angle is also important, he says. "In a portfolio of listed names, yes, the investor bears the risk of price fluctuations in the listed market, but the flipside of that is liquidity. If they start to be concerned about a name, they can sell it and replace it in the portfolio.

"In a high-yield fund, the investor might not even know that they hold that stock."



A CONSERVATIVE, HIGHER YIELD PORTFOLIO

Stock	ASX code	Credit rating	Price (\$)	Step-up/ maturity date	Cash yield (%)	Yield to maturity (%)
Suncorp Metway CPS	SUNPB	BBB+	99.5	14-Jun-13	5.69	14.5
IAG RES	IANG	A-	104	15-Dec-19	6.25	8.56
Westpac TPS	WCTPA	A+	92.9	30-Jun-16	4.15	7.91
Woolworths Notes	WOWHB	BBB	99.95	15-Sep-11	6.02	7.62
ANZ CPS2	ANZPA	A+	105	15-Dec-16	5.62	7.92
Bendigo Bank SPS2	BENPC	n/a	95.1	10-Oct-14	4.67	9.87
CBA PERLS IV	CBAPB	A+	197.45	31-Oct-12	4.18	7.35
CBA Bonds I	CBAHA	n/a	100.4	24-Dec-15	5.97	6.69
Portfolio yield to maturity						8.8

Source: RBS Morgans