

News

Finding stability with bonds

By Stephen Hart on 1 June 2011



Relatively attractive performances throughout the global financial crisis have revived interest in bonds and other fixed income assets, writes Stephen Hart.

Bonds are mostly traded through fixed income brokers regulated by Australian Securities and Investments Commission (ASIC) on an over-the-counter (OTC) basis. However, there are also bonds that trade on the Australian Securities Exchange. In order to buy or sell unlisted bonds you will need to contact a fixed income broker, ideally one that specialises in fixed income. Depending on the bond and the number of buyers and sellers in the market at the time, the fixed income broker should be able to process your transaction promptly.

OTC means that bond trades do not take place on an exchange but are negotiated directly between buyers and sellers. Evidence of ownership is by way of a register maintained by Austraclear (also known as Exigo), or by other registry providers. However, Austraclear remains the sole Central Securities Depository of Debt Securities in Australia.

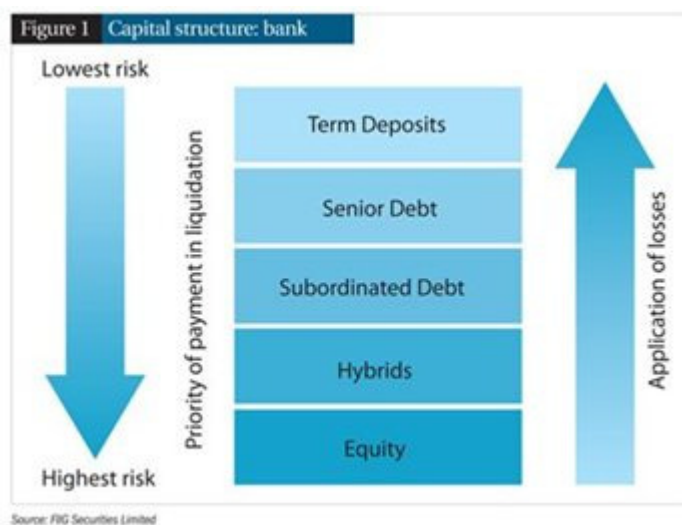
Retail investors are able to buy and sell government- and semi-government bonds as the issuers are exempt from the disclosure provisions of the 2001 Corporations Act. Because of the disclosure provisions of the Act, non-government bonds issued by banks and corporations are usually only issued to, and traded between, wholesale investors. The definition of wholesale investors includes individuals and entities that meet certain requirements under the Corporations Act.

Until recently, financial planners looking to add unlisted bank or unlisted corporate bond exposure to their clients' portfolios were limited to bond funds unless their clients had \$500,000 to invest in the purchase of a single bond parcel, due to the regulatory system. However, fixed income brokers who are licensed to provide custodial services are able to provide clients with direct investment in bonds, in parcels down to \$50,000.

Getting access

The relatively attractive performance of bank and corporate bonds throughout the global financial crisis (GFC) has revived interest in bonds and other fixed income assets, as well as the topic of how to access bank and corporate bonds directly without using a managed fund. The minimum \$500,000 parcel size referred to above had placed direct ownership of bonds and the associated benefits to investors – including the absence of management fees, asset transparency and the ability to match future liabilities closely with coupon payments and maturity dates – out of the reach of most clients.

Parties lobbying ASIC to reduce the disclosure requirements for listed bonds (and thus the associated costs of issue) to make the listed bonds channel a more attractive option for issuers have enjoyed only a small measure of success, as the issue requirements, despite some relaxation last year, remain onerous.



This is an anomaly in risk-terms as the effect is to restrict access to clients looking to invest in specific banks and corporates at a low-risk level in the corporate structure. Clients looking to invest in these specific entities will often have little option but to invest in the higher risk equities, as Figure 1 demonstrating the capital structure of an Australian bank shows.

Where the bond sits in the capital structure will determine its risk and reward.

One broker has moved to offer direct access to investment-grade bank and corporate bonds to clients in amounts from \$50,000, along with custody facilities. This is proving to be an attractive option for trustees of self-managed super funds, high-networth and non-high-net-worth investors. Investors not wishing to use managed funds as a means of gaining exposure to fixed income assets and being unable, for reasons of prudent diversification, to allocate \$500,000 to any one specific investment, are keenly seeking to create their own direct bond portfolio.

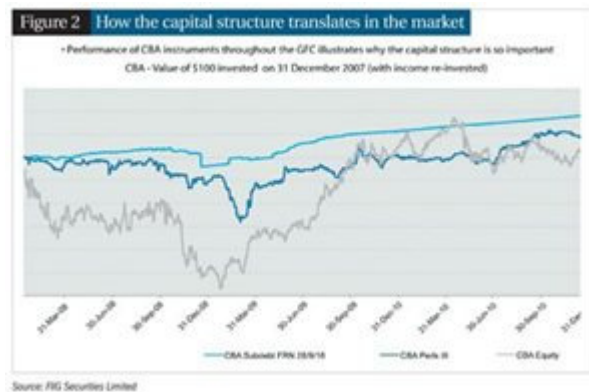
Australian dollar bond parcels available in amounts of down to \$50,000 include nominal and floating rate note issues by major Australian telcos, Australian major and regional banks, international banks, Australian and international insurance groups and several well-known Australian and international industrial groups. Non-government inflation-linked bonds are also available in parcels from around \$40,000 investment value.

Portfolio construction

A financial planner when constructing a fixed income portfolio will normally be driven by the following criteria.

Diversification

Review of the capital structure diagram above confirms that bond investors are repaid before hybrid and equity investors and it follows that diversification in a bond portfolio is of less importance than diversification in an equity portfolio.



Source: FIG Securities Limited

Figure 2 demonstrates the volatility of Commonwealth Bank shares, versus the Bank's hybrid issue Perls III, versus the Bank's subordinated debt from December 2007.

Nevertheless, unless the bond portfolio is made up entirely of government bonds, issuer – and particularly sector diversification – is always prudent.

Liquidity

Listed bonds offer access to retail investors and are generally well sought-after. The AMP April 2019 and Tabcorp May 2014s trade at a substantial premium. Generally, OTC bonds trade at a lower premium but liquidity is strong, particularly for the highly rated issues. Listing is no guarantee of liquidity, as the vast bulk of transactions are made on an OTC basis.

Yield

The bond market in Australia offers coupons in the range of 5.5 per cent (average) for government bonds through to more than 11 per cent for some unrated issues. Current returns from portfolios purchased in the secondary market using a mix of bonds from A-rated through to BBB-rated will yield around 8.5 per cent. A portfolio limited to A-rated or above issues will yield closer to 7 per cent.

With the high level of predictability associated with bond coupons and repayment (noting that non-payment of either is a default event, unlike payment of a dividend or hybrid distribution which are determined by the issuer's board) a bond portfolio is superior for asset and future liability matching.

Conclusion

Between 1 January 2011 and 27 April 2011 more than \$39 billion of Australian dollar bonds were issued by Australian governments, banks and corporates. With the fourth-largest savings pool in the world it seems regrettable that the majority of Australians are not investing directly in these quality assets. The high level of predictability of

bond cash flows coupled with the security highlighted by the capital structure above readily confirm that bonds should be present in all portfolios.

Stephen Hart is the head of planner services at FIIG Securities.