

FIXED INCOME WALK ON THE SAFE SIDE

Protect your investment and reap the profit

I **F YOU WANT TO GENERATE AN INCOME OF \$25,000** a year, you need to assess your appetite for risk. Typically, risk is not judged on an equivalent basis across asset classes. For example, a bank equity investment is seen as conservative in the equity market, yet it is deemed a higher-risk investment in a fixed-income portfolio.

However, a spread across different risk levels of fixed income can provide an income stream of \$25,000 in a relatively safe environment. To achieve this kind of return, on a weighted average running yield of 9.02%, you would need to have starting capital of around \$280,000.

So what do we mean by fixed income? Investment in fixed income is principally about conserving capital and providing income. A fixed-income security or bond is effectively a loan from you, the investor, to the issuer of the security. Fixed income generally refers to debt securities that pay a defined distribution for a given period of time and, unless the security is perpetual, repays the face value at maturity, thus conserving the capital.

Issuers of fixed-income securities in Australia include the federal government, state governments, banks and corporations. There are many products with varying risk and return characteristics for you to consider and a fixed-income portfolio can provide a high annual cash income stream, depending on your risk appetite, without the level of risk and volatility of the higher-risk asset classes such as equities or property.

Generally, fixed income performs well when equities perform poorly, as poor equity conditions are symptomatic of weak economic conditions, where interest rates fall and bond prices rise. For example, during the GFC, the annual return for the main fixed income index was higher than usual, at around 10%, when the annual return for equities was around -40%.

Fixed income versus equity

The key advantage to fixed income over equity is that it sits higher in a company's capital structure. An investor can invest in bank equity, and sit at the bottom of the creditor queue, or can purchase a bank senior debt bond, and sit towards the top. In other words, the fixed-income investor, holding a company's bond, is in a much more protected position, compared with an equity investor – a shareholder – in the company, should the company get into trouble.

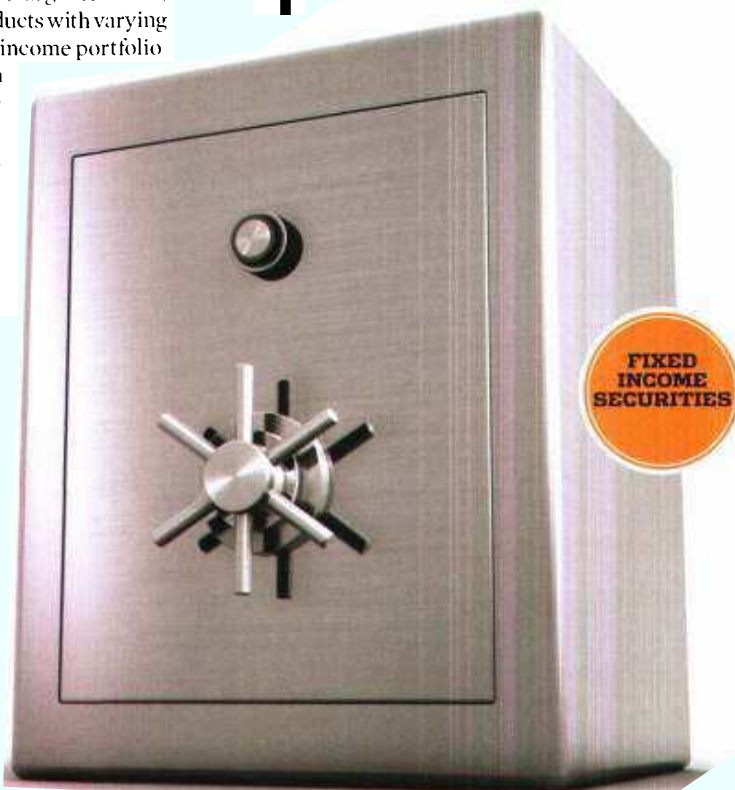
Types of fixed income

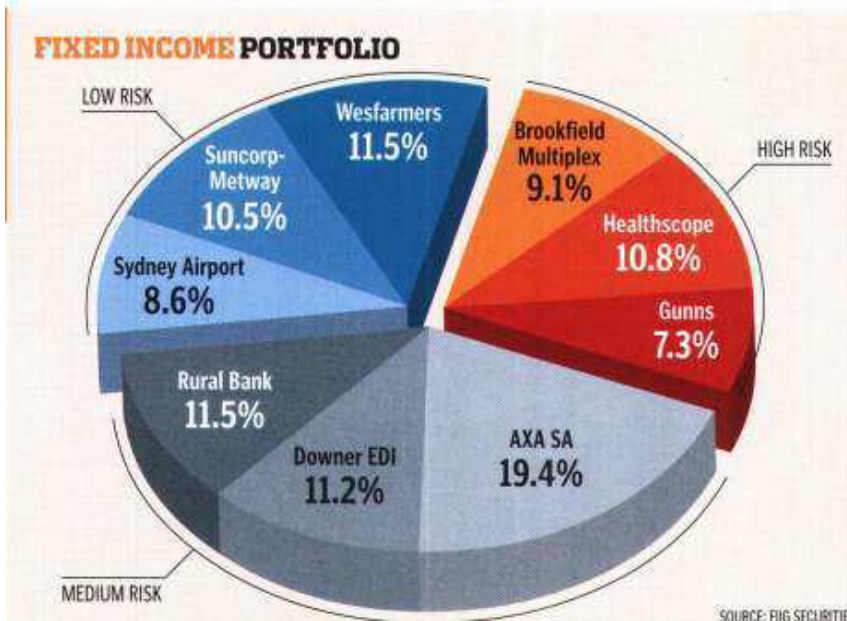
There are three main types of fixed income. It is worth noting that the return from fixed income is typically higher than the annual volatility of its returns, unlike equities, whose annual return over the past 10 years of 10% has been much less than its annual volatility of around 19%. In other words, fixed

income gives you more return than risk; the opposite of equities.

Fixed-rate bonds (nominal bonds): These bonds have fixed coupons and maturity payments. Over the past 10 years, the most widely used index recorded an average annual return of 6.25% with an annual volatility of around 3%.

Inflation-linked bonds (ILBs): These bonds have coupons and maturity payments that are linked to inflation; as inflation rises, the coupon also increases. Over the past 10 years the most widely used index recorded an average annual return of around 6.5% with an annual volatility of around 3.6%.





The fixed-income investor is much more protected

risks associated with fixed income, principally credit risk and interest rate risk.

Credit risk is the possibility that the bond issuer is unable to fulfil its financial obligations. From an investor's perspective the bond issuer has two principal obligations: to make interest payments when they fall due and to repay the adjusted capital price of the ILB at maturity, and the face value of the bond in the case of an FRN or nominal bond.

While one should always seek advice on the evaluation of credit risk, and while ratios vary with the industry, some ratios to look for are: the leverage ratio – debt to equity; and the earnings before interest, tax, depreciation, and amortisation (EBITDA) to gross interest ratio.

With interest rate risk, variability is the focus point. As interest rates decrease, the price of a fixed-rate bond will rise, and vice versa. This creates the likelihood of a capital gain or loss in the event the holder needs to sell the fixed-rate bond prior to maturity. Usually, bond prices move in the opposite direction to equity prices, making them a great way to reduce portfolio risk.

Your \$25,000 portfolio

In order to generate an income of \$25,000 a year, we have picked a range of bonds and spread them across high-, medium and low-risk investments.

In the low-risk category we have invested in two highly rated companies familiar to most retail investors – Wesfarmers and Suncorp Metway. In our medium-risk category we have sought companies whose bonds offer superior returns for their investment-

grade levels of risk, thus offering the best of both worlds. In our high-risk category we have focused on moving down the capital structure to supercharge our returns.

This portfolio would achieve a weighted average running yield of 9.02%, although rates have fallen of late, and an investor would need to have around \$280,000 to invest in order to achieve a \$25,000 return.

The portfolio was designed to achieve exactly \$25,000 a year. Due to restrictions on bond parcel sizes that can be bought, an actual portfolio would have fewer individual bonds; however a return of \$25,000 would be achievable for a similar outlay.

Bonds, with an investment timeframe of three to 20 years, can be sourced through your regular broker or a specialised fixed-income securities broker.

Floating-rate notes (FRNs): These bonds have a fixed maturity payment, yet the coupon varies with a short-term interest rate, like the quarterly bank bill rate (BBSW). While credit risk applies, as these are typically not issued by governments, there is virtually no interest-rate risk in these securities. Over the past 10 years the most widely used index recorded an average annual return of around 5.6% with an annual volatility of around 1.2%.

The upside

There are some key advantages of fixed-income bonds. The first is that you always know what your cash flow will be. Usually, a

bond issuer can only change the terms of the bond, or coupon payment, if a restructuring occurs. This differs to equity dividends, which can change at any time, for any reason.

Bond markets are also usually more liquid than equity markets as they are much larger. Another plus is diversity.

The bond market provides a choice of many issuers and much diversity for investors.

Finally, a bond investor will generally be repaid capital in full at a known maturity date, typically ensuring capital stability.

The down

As with any investment strategy, there are

DR STEPHEN J. NASH

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