

EUREKA *report*



Higher rewards, lower risk

By Elizabeth Moran
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PORTFOLIO POINT: Investors kept awake by volatility can lock in returns of close to 10% and rest easy.

I met a client recently who was new to investing in fixed income and was very happy with the fresh direction of his portfolio. He relayed this delightful story of his 90 year-old mother calling him early one morning in a panic. Had he heard that the US sharemarket had fallen 4% overnight? What would it mean for Australian shares? By this stage the storyteller had a big smile on his face. His diversity into fixed income meant the loss on the US market didn't bother him at all.

To me the story pretty well sums up the major benefits of fixed income: capital protection; diversity away from the most volatile asset classes of shares; a known return; protection of your wealth; and, most of all, the ability to sleep well at night.

Global volatility is likely to continue. In particular US debt, possible (in my opinion probable) debt default by EU countries, economies recovering or experiencing natural disasters (Japan, New Zealand, Australia, Somalia) and the carbon tax will all contribute to a period – perhaps extending to years – of sharemarket volatility.

Take the time to jot down your portfolio allocation. What assets do you hold that will protect your wealth?

I know many Eureka Report readers are great fans of Australian shares and with good reason. Resource stocks have performed well, but consider what percentage they make up in your share portfolio and total portfolio.

BHP Billiton, the largest company on the ASX and worth about \$238 billion, is rated by Standard & Poor's (or equivalent) as A+, four notches lower than the highest AAA rating (attributed to the Commonwealth Government in Australia).

That means its debt is considered to have a low probability of default; BHP's shares, which are lower in the company's capital structure, would be higher risk. Part of the reason BHP's debt is only rated A+ is that the company largely trades in commodities. Commodities are cyclical so we know that their prices will go up and down and will impact earnings.

Go another step: imagine holding a large proportion of your wealth in a resource company that only produces one commodity; it is going to be considered very high risk.

So, how do you diversify and protect your wealth?

You do it with bonds, and if you already hold some you could buy some more. Global uncertainty will still affect debt markets – but to a lesser extent. In the majority of cases, investors know they will receive their capital back on a known date.

To demonstrate current opportunities, we have put together a portfolio including household names such as NAB and AXA that can achieve close to a 10% return while providing a weighted average rating of A+ (the same risk attributed to BHP Billiton). In rating agency terms, that represents a 0.60% chance of default over a five-year time horizon.

However, before we move on, it is important to point out the shortcomings:

- The first portfolio is only available to sophisticated investors because several of the bonds can only be sold in minimum face value parcels of \$500,000. In fact, replicating the portfolio would require \$1.75 million – not exactly small change. However, a similar portfolio based on an investment of \$350,000 but still returning more than 9% could be structured by substituting a few names, albeit with a slightly lower weighted average rating of A- (see below).

- Diversity is only moderate having just four bonds, two of which are insurers, plus a small allocation to a Rabobank "At Call" account. Also, three of the four bonds are Tier-1 hybrid securities. Typically we would recommend a more diversified portfolio with at least five bonds from a mix of industries.
- The portfolio is better suited to hold-to-maturity investors as Tier-1 securities could see some liquidity issues if the market is stressed at a time when these securities need to be sold quickly.
- Finally, it is important to point out that three of the securities are Tier-1 callable securities and the expected yield is based on the assumption all are called at first opportunity (which we do expect to occur). If not called, these securities are technically perpetual. The current market yield/swap curve and inflation expectations are also used to estimate the yield to (expected) maturity for the floating rate and inflation linked bonds in the portfolio.

The 9.9% portfolio (sophisticated investors only)

Despite the above-mentioned shortcomings, the ability to achieve close to a 10% expected return from a high-quality portfolio is worthy of assessment. All four of the bonds are among our top selections from a relative value point of view and also represent very solid credits. Due to ASIC restrictions, we are not able to publish individual ratings, but sophisticated investors can be provided with the full details by a FIIG dealer. A small allocation to a Rabobank "at call" account is also included for added flexibility.

Bond Portfolio Monday, 25 July 2011	CAPITAL STRUCTURE EXPOSURE		PORTFOLIO EXPOSURE STATISTICS	
	Cash / TD	3.47%	Weighted Average Yield to Maturity	9.94%
Senior Debt	25.07%	Weighted Average Running Yield	6.67%	
LT2 Sub Debt	0.00%	Weighted Average Term to Maturity	7.40	
T1 Capital	71.46%	Weighted Average Trading Margin	4.57%	
		Weighted Average Rating	A+	

ISSUER	MATURITY/ CALL DATE	ISSUE MARGIN	TRADING MARGIN	COUPON TYPE	% EXP	CAPITAL STRUCTURE	YTM
National Capital Instruments	30/09/2016	0.95%	3.61%	Floating	25.56%	T1 Capital	8.70%
Elm Bv (Swiss Re)	25/05/2017	1.17%	6.50%	Floating	22.60%	T1 Capital	11.85%
AXA SA	26/10/2016	1.40%	6.11%	Floating	23.30%	T1 Capital	11.19%
Envestra Ltd	20/08/2025	3.04%	2.77%	ILB	25.07%	Senior Debt	8.80%
RaboDirect At-Call Account	26/07/2011	6.50%	1.75%	Fixed	3.47%	Cash	6.50%

	RUNNING YIELD	CAPITAL PRICE	FACE VALUE	CAPITAL VALUE	ACCRUED INTEREST	TOTAL VALUE
National Capital Instruments	6.79%	89.00	\$500,000	\$445,000	\$2,295	\$447,295
Elm Bv (Swiss Re)	8.10%	78.00	\$500,000	\$390,000	\$5,565	\$395,565
AXA SA	7.96%	81.50	\$500,000	\$407,500	\$175	\$407,675
Envestra Ltd	4.10%	87.08	\$587,400	\$435,410	\$3,380	\$438,790
RaboDirect At-Call Account	6.50%	100.00	\$60,675	\$60,675		\$60,675
			\$2,148,075	\$1,738,585	\$11,415	\$1,750,000

Source: FIIG Securities Limited (pricing subject to change)

Notes:

1. The quoted running yield for Envestra is 4.10%, which is earned currently, given indexation to date. Going forward, it will accrete higher each quarter, in line with inflation releases. By May 2025, at a 3% inflation assumption, it will be paying a 7.27% running yield, giving a weighted average running yield of 5.68% throughout its life. The balance of return is delivered by indexation of the capital.

2. Floating rate note returns are subject to change. Expected fixed equivalent returns for floating rate notes are

based upon trade margin (credit spread to swap) plus the swap rate.

The 9.2% portfolio (direct bonds)

The National Capital Instruments and Envestra inflation linked bonds (ILBs) are available only in minimum parcels of \$500,000 face value. However, by replacing them with National Wealth subordinated debt (a wholly owned subsidiary of NAB) and Sydney Airport ILBs, a similar portfolio with a return of 9.22% and a weighted average rating of A- can be achieved (A- represents a 0.75% probability of default over five years). Total outlay for this portfolio is \$350,000. National Wealth and Sydney Airport ILBs are also among our top relative value picks, although Sydney Airport is relatively highly geared. Once again a small allocation to a Rabobank "at call" account is included.

Bond Portfolio		CAPITAL STRUCTURE EXPOSURE			PORTFOLIO EXPOSURE STATISTICS		
Monday, 25 July 2011		Cash / TD	9.96%	Weighted Average Yield to Maturity	9.22%		
		Senior Debt	23.01%	Weighted Average Running Yield	6.54%		
		LT2 Sub Debt	20.28%	Weighted Average Term to Maturity	5.73		
		T1 Capital	48.76%	Weighted Average Trading Margin	3.99%		
				Weighted Average Rating	A-		

ISSUER	MATURITY/ CALL DATE	ISSUE MARGIN	TRADING MARGIN	COUPON TYPE	% EXP	CAPITAL STRUCTURE
AXA SA	26/10/2016	1.40%	5.68%	Floating	23.72%	T1 Capital
Elm Bv (Swiss Re)	25/05/2017	1.17%	6.06%	Floating	23.03%	T1 Capital
National Wealth Management Holdings	16/06/2016	0.63%	2.10%	Floating	20.28%	LT2 Sub Debt
Southern Cross Airports Corporation	20/11/2020	3.76%	2.80%	ILB	23.01%	Senior Debt
RaboDirect At-Call Account	26/07/2011	6.50%	1.75%	Fixed	9.96%	Cash

	YTM	RUNNING YIELD	CAPITAL PRICE	FACE VALUE	CAPITAL VALUE	ACCRUED INTEREST	TOTAL VALUE
AXA SA	10.77%	7.82%	83.00	\$100,000	\$83,000	\$35	\$83,035
Elm Bv (Swiss Re)	11.24%	7.99%	79.50	\$100,000	\$79,500	\$1,113	\$80,613
National Wealth Management Holdings	7.29%	6.00%	94.00	\$75,000	\$70,500	\$484	\$70,984
Southern Cross Airports Corporation	8.50%	4.27%	106.50	\$90,735	\$79,872	\$646	\$80,518
RaboDirect At-Call Account	6.50%	6.50%	100.00	\$34,850	\$34,850		\$34,850
				\$400,585	\$347,722	\$2,278	\$350,000

Source: FIIG Securities Limited (pricing subject to change)

Notes:

1. The quoted running yield for Southern Cross Airports is 4.27%, which is earned currently, given indexation to date. Going forward, it will accrete higher each quarter, in line with inflation releases. By November 2020, at a 3% inflation assumption, it will be paying a 6.81% running yield, giving a weighted average running yield of 5.54% throughout its life. The balance of return is delivered by indexation of the capital.

2. Floating rate note returns are subject to change. Expected fixed equivalent returns for floating rate notes are based upon trade margin (credit spread to swap) plus the swap rate.

In conclusion, it's worth taking the time to assess the risks within your portfolio. Is your asset allocation diversified enough to withstand an extended period of share market volatility? Bond portfolios can offer high, known returns that are close to equity returns yet are significantly lower risk and generally less volatile in uncertain markets.



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