

EUREKA *report*



Blueprints for better returns

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PORTFOLIO POINT: These three model bond portfolios will provide a known return and diversify your risk at the same time.

Interest in fixed income is gaining momentum as more and more investors are seeking to define their returns and protect their capital. Those of you at or near retirement need the certainty of knowing that your capital base won't be eroded by volatile share markets or a downturn in property.

If you feel you haven't saved enough for retirement – and retirement is imminent – now is not the time to take risks with the bulk of your capital. The pension is only \$670.90 per fortnight for singles and \$505.70 each for couples and I don't think any of us want to rely on that for a comfortable retirement.

A little risk does improve overall returns but investors should also seek to protect what they have worked so hard to build. This is where fixed income comes into play. Fixed income offers investors certainty through:

- Capital repayment at maturity (in most cases)
- A defined income stream
- Diversification

Do it yourself

First you need to research the entity and seek independent research from as many sources as possible. The best brokers will offer research on companies that includes the benefits of the securities but also considers the risks involved. Don't rely on credit ratings alone, they provide an indication of the credit worthiness of the issuer but are often slow to react to changes in the market (and sometimes they are just wrong). If you're thinking about fixed income securities such as bonds and hybrids, make sure the research you are given is based on debt and not on equity (shares).

The drivers of the two asset classes are very different. When investors buy fixed income securities (often called debt securities), they are making an assessment of the entities ability to continue trading or survive. Equity investment on the other hand is an assessment of the companies' ability to grow. A growing company means a growing share price and the possibility of increased dividends and as we know, the rewards can be great.

But trying to predict growth is much harder than gauging an ability to continue trading. There is a great deal to consider when starting a portfolio and if you are a novice I suggest you read some of my earlier features first (***A fixed income primer***, July 11). The key in fixed income is the ability to diversify your existing portfolio. Try to avoid investing in the same companies where you already hold the equities.

Remember some companies with poor equity performance will be great opportunities for bond holders. Equity performance of Macquarie Bank (MQG), Downer EDI (DOW) and Leighton (LEI) haven't been great, but bonds in these companies offer all the things the shares can't: a known return, capital certainty with the capital being returned to the investor at maturity, greatly reduced volatility (and this won't matter to fixed income investors that can hold the bonds until maturity where they are assured of receiving \$100 face value, assuming the company continues to trade).

How much money do you need?

Government and semi-government bonds can be bought for as little as \$1,000. These are very high credit quality and

very low risk, so offer relatively low returns. If you are pessimistic about the chances of a global recession then these securities may suit you.

ASX listed bonds and hybrid securities don't have any minimum purchase amount, but the range of available securities is small, as is the range of risk and reward attributes. Again, make sure you understand the nature of what you are buying most hybrids have different characteristics. The recent ANZ CP3 issue is a point to note ([click here](#)).

Should a capital trigger be breached these hybrids convert to ordinary shares, which is fine but a breach of the trigger is likely to coincide with a decline in the share price, so that you would expect to lose capital. Not that I would expect this event to occur in the first place, but it does increase the risk associated with the security and investors would expect to be compensated for that risk by a higher spread over similar securities without the conversion clause.

Investors can start to build a fixed income portfolio with a relatively small initial investment. However the vast majority of bonds only trade in minimum face value parcels of \$500,000 (link to premium discount article). Some brokers have broken bonds into smaller parcels to provide direct access to more investors. FIIG has over 90 bonds available in smaller parcels of \$50,000 or \$100,000. But like anything in life, the more you spend, the cheaper it gets. In other words larger bond parcels or a higher number of trades will usually mean investors can earn better returns.

How many bonds do you need for a diversified portfolio?

I'm often asked how many bonds are needed for a diversified portfolio. I think you need between five and 10 as an optimum, but it depends to the total value of your portfolio and your overall aims for your investments. My preference is for seven securities, but five can work and if you can access bonds with lower face value parcels, that means investing approximately \$250,000. Below are three sample portfolios. I'm not recommending any portfolio over another and it's easy enough to blend investments from all three. But I thought it was worth showing you the types of investments we can offer and the sorts of returns that are available in the current market.

Table 1 shows a conservative portfolio with a 6% target return. This would be most suited to investors seeking to improve returns over the cash component of their portfolio but want better liquidity and still want a very low risk allocation. National Wealth Management is a National Australia Bank subsidiary and for the risk involved with this security we think the return is excellent. Note that it's running yield offers around 130bps (1.3%) more than the ANZ term deposit and while it is slightly higher risk, the additional return more than compensates for the additional risk involved.

Example 1: 6% target

Monday, 5 September 2011

CAPITAL STRUCTURE EXPOSURE

Cash / TD	19.33%
Senior Debt	61.83%
LT2 Sub Debt	18.84%
T1 Capital	0.00%

PORTFOLIO EXPOSURE STATISTICS

Weighted Average Yield to Maturity	5.96%
Weighted Average Running Yield	6.30%
Weighted Average Term to Maturity	4.57
Weighted Average Trading Margin	1.29%

ISSUER	MATURITY/ CALL DATE	COUPON	TRADING MARGIN	COUPON TYPE	% EXP	CAPITAL STRUCTURE	YTM**
Australia and New Zealand Banking Group Ltd	04/09/2012	5.70%	1.02%	Fixed	19.33%	TD	5.70%
New South Wales Treasury Corporation	01/04/2015	6.00%	-0.23%	Fixed	20.97%	Senior Debt	4.19%
Australia Pacific Airports (Melbourne) Pty Ltd	14/12/2015	6.00%	1.34%	Fixed	19.64%	Senior Debt	5.91%
National Wealth Management Holdings Ltd	16/06/2016	6.75%	3.10%	Fixed	18.84%	LT2 Sub Debt	7.74%
Telstra Corp. Ltd	15/07/2020	7.75%	1.40%	Fixed	21.22%	Senior Debt	6.43%
	RUNNING YIELD***	CAPITAL PRICE	FACE VALUE*	CAPITAL VALUE	ACCRUED INTEREST	TOTAL VALUE	
Australia and New Zealand Banking Group Ltd	5.70%	100.00	\$50,000	\$50,000		\$50,000	
New South Wales Treasury Corporation	5.66%	105.98	\$50,000	\$52,992	\$1,230	\$54,222	
Australia Pacific Airports (Melbourne) Pty Ltd	5.98%	100.34	\$50,000	\$50,170	\$623	\$50,793	
National Wealth Management Holdings Ltd	7.03%	96.07	\$50,000	\$48,035	\$682	\$48,717	
Telstra Corp. Ltd	7.12%	108.84	\$50,000	\$54,418	\$472	\$54,890	
			\$250,000	\$255,614	\$3,007	\$258,620	

*Current Face Value on Inflation Linked bonds represents the Inflation Adjusted FaceValue.

**Yield for Floating Rate Notes is the swap rate to Maturity/Call plus the trading margin.

***Yield for ILB equals Real Yield plus a current inflation assumption of 3%.

****ILB running yield quoted is a commencing value, given current indexation, but will accrete up with inflation.

Source: FIG Securities (price subject to change)

Table 2 shows a portfolio with a slightly higher 7% target return. Here I've included some higher risk securities but kept the NSW Treasury Corporation bonds for their liquidity. Praeco is an infrastructure company formed to build the Department of Defence headquarters outside of Canberra. The building is now complete and the project has moved onto the low risk operational phase where the owners must maintain the building for a period extending to 2036, when the ownership of the buildings reverts back to the Commonwealth. This bond is long dated with a maturity before the maintenance contract expires in 2020 but essentially relies on a Commonwealth Government cash flow. This security still offers a very attractive return for what we think is a low risk investment of over 7%.

Example 2: 7% target Monday, 5 September 2011

CAPITAL STRUCTURE EXPOSURE

Cash / TD	0.00%
Senior Debt	60.91%
LT2 Sub Debt	39.09%
T1 Capital	0.00%

PORTFOLIO EXPOSURE STATISTICS

Weighted Average Yield to Maturity	7.19%
Weighted Average Running Yield	7.30%
Weighted Average Term to Maturity	4.96
Weighted Average Trading Margin	2.59%

ISSUER	MATURITY/ CALL DATE	COUPON	TRADING MARGIN	COUPON TYPE	% EXP	CAPITAL STRUCTURE	YTM**
New South Wales Treasury Corporation	01/04/2015	6.00%	-0.23%	Fixed	21.41%	Senior Debt	4.19%
Morgan Stanley	26/05/2015	7.25%	2.33%	Fixed	20.41%	Senior Debt	6.79%
Vero Insurance Ltd	07/09/2015	6.15%	3.80%	Fixed	18.88%	LT2 Sub Debt	8.33%
Genworth Financial Mortgage Insurance Pty Limited	30/06/2016	4.75%	4.55%	Floating	20.22%	LT2 Sub Debt	9.17%
Praeco Pty Ltd	28/07/2020	7.13%	2.75%	Fixed	19.08%	Senior Debt	7.75%
		RUNNING YIELD***	CAPITAL PRICE	FACE VALUE*	CAPITAL VALUE	ACCRUED INTEREST	TOTAL VALUE
New South Wales Treasury Corporation		5.66%	105.98	\$50,000	\$52,992	\$1,230	\$54,222
Morgan Stanley		7.14%	101.49	\$50,000	\$50,745	\$936	\$51,681
Vero Insurance Ltd		6.64%	92.68	\$50,000	\$46,338	\$1,463	\$47,800
Genworth Financial Mortgage Insurance Pty Limited		9.71%	100.78	\$50,000	\$50,389	\$804	\$51,193
Praeco Pty Ltd		7.42%	96.03	\$50,000	\$48,016	\$310	\$48,326
				\$250,000	\$248,479	\$4,742	\$253,221

*Current Face Value on Inflation Linked bonds represents the Inflation Adjusted FaceValue.

**Yield for Floating Rate Notes is the swap rate to Maturity/Call plus the trading margin.

***Yield for ILB equals Real Yield plus a current inflation assumption of 3%.

****ILB running yield quoted is a commencing value, given current indexation, but will accrete up with inflation.

Source: FIIG Securities (pricing subject to change)

Table 3 shows a higher yielding portfolio with an 8.5% target return. With the exception of Suncorp Metway, none of these issuers are listed on the ASX, so the securities offer a great chance to diversify your portfolio. This portfolio includes two inflation linked bonds and while I wouldn't usually recommend both of these in a starters portfolio, I wanted to show you the quite high returns on offer on securities that will protect capital particularly for those investors in the pension phase. Southern Cross Airports is Sydney Airport, while Envestra is another infrastructure asset with monopoly rights over gas pipelines.

Example 3: 8.5% target Monday, 5 September, 2011

CAPITAL STRUCTURE EXPOSURE		PORTFOLIO EXPOSURE STATISTICS	
Cash / TD	0.00%	Weighted Average Yield to Maturity	8.50%
Senior Debt	60.29%	Weighted Average Running Yield	6.47%
LT2 Sub Debt	39.71%	Weighted Average Term to Maturity	7.95
T1 Capital	0.00%	Weighted Average Trading Margin	2.38%

ISSUER	MATURITY/ CALL DATE	COUPON	TRADING MARGIN	COUPON TYPE	% EXP	CAPITAL STRUCTURE	YTM**
Genworth Financial Mortgage Insurance Pty Limited	30/06/2016	4.75%	4.55%	Floating	20.77%	LT2 Sub Debt	9.17%
Suncorp Metway Insurance Ltd	06/10/2016	6.75%	4.39%	Fixed	18.93%	LT2 Sub Debt	9.07%
JEM (Southbank) Pty Ltd	28/06/2018	6.64%	2.86%	Fixed	19.33%	Senior Debt	7.75%
Southern Cross Airports Corporation Pty Ltd	20/11/2020	3.76%	0.08%	ILB	22.40%	Senior Debt	8.10%
Ervestra Ltd	20/08/2025	3.04%	0.16%	ILB	18.56%	Senior Debt	8.40%
	RUNNING YIELD***	CAPITAL PRICE	FACE VALUE*	CAPITAL VALUE	ACCRUED INTEREST	TOTAL VALUE	
Genworth Financial Mortgage Insurance Pty Limited	9.71%	100.78	\$50,000	\$50,389	\$804	\$51,193	
Suncorp Metway Insurance Ltd	7.45%	90.66	\$50,000	\$45,330	\$1,337	\$46,667	
JEM (Southbank) Pty Ltd	7.05%	94.17	\$50,000	\$47,084	\$562	\$47,646	
Southern Cross Airports Corporation Pty Ltd	4.22%	110.31	\$61,840	\$55,157	\$57	\$55,214	
Ervestra Ltd	3.99%	91.39	\$60,050	\$45,696	\$44	\$45,741	
			\$271,890	\$243,655	\$2,805	\$246,459	

*Current Face Value on Inflation Linked bonds represents the Inflation Adjusted FaceValue.

**Yield for Floating Rate Notes is the swap rate to Maturity/Call plus the trading margin.

***Yield for ILB equals Real Yield plus a current inflation assumption of 3%.

****ILB running yield quoted is a commencing value, given current indexation, but will accrete up with inflation.

Source: FIGG Securities (pricing subject to change)

A couple of things to note:

- There is no obligation to buy a whole portfolio when you start investing. You can just buy one or two bonds to start, then add to your portfolio over time.
- You can buy and sell bonds for the minimum purchase amounts. For example if you buy \$300,000 of a minimum purchase \$50,000 bond, you can opt to sell down that parcel in \$50,000 lots. There is no obligation to buy and sell the whole parcel at any one time.
- If you are unsure of how markets are going to perform but you think a bond looks good value, you can buy the minimum amount, then keep buying minimum amounts over time to lock in the return now and capture any future downside. Much the same as you would if you were trading equities.
- Generally the lower risk the security the more liquid it will be, that is you'll be able to sell it quickly without influencing the price you will receive for the security.

How to transact

1. Most bonds are traded over the counter (OTC) that is there is no exchange used for the majority of bonds, which means you'll need to find a fixed income broker who matches buyers and sellers in the market. Otherwise, you can use your stockbroker to buy ASX listed securities.
2. Settlement for OTC traded bonds usually takes place three business days (T + 3) after the day the contract is issued for the transaction.
3. Investors are issued with a contract note when the trade is agreed which includes the full details of the security involved.

4. No fees are paid on the trade. Brokers take a small margin between the seller offering the security for sale and the buyer purchasing the security. But, no transaction would occur unless both were happy with the transaction, which means the margin is typically small. The actual transaction is the only way the broker makes any money. Unlike managed funds, there are no ongoing fees.
5. In most cases investors do not receive a certificate for their holdings. The holdings are held in an electronic register called Exigo (formerly Austraclear). If investors don't have an Exigo account, the securities are held in a custodian account, much like shares are held with a HIN.
6. If you want to sell bonds, you would need to contact your broker who would then find a buyer through their networks.



Waratah Bonds: Last week the NSW Treasury Corporation, otherwise known as TCorp issued a new series of bonds called "Waratah bonds" aimed at retail investors with a minimum investment of \$10,000. The bonds are fixed rate with the coupon paid semi-annually and a fixed maturity date. They are also guaranteed by the NSW Government with the funds being used for infrastructure projects. On face value, the bonds sound attractive, that is until you drill down to the return which shows that the security with 3 year maturity due September 1 2014 has a 4.25% p.a. fixed rate of return and the security with a 10 year maturity due September 2021 has a 5.10% p.a. fixed rate of return.

While these rates are in line with others offered by TCorp, they look more like the emperor's new clothes. That is they offer nothing over and above securities already issued by TCorp, so what's the big deal? Not much really, I guess the name Waratah might invoke some patriotic sentiment from rugby union followers, but does little to excite those of us from other states. Other semi-government issuers offer bonds in similar sized parcels and in some cases offer better returns. The returns offered are low but attractive if you think interest rates are coming down in future years. However, you can still earn 5.85% for a three year AMP term deposit which although not necessarily government guaranteed offers 160bps more than the Waratah bonds, more than compensating for the additional risk involved.

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