

Buy bonds direct and beat bank term deposits

Smaller corporate bond parcels are now on offer

BEN POWER



IN equities, a debate has long raged over the benefits of direct holdings as against managed funds. Now there is better access to direct fixed income, such as corporate bonds, investors are also weighing up the benefits of buying bonds direct.

Australia's fixed-income market has been dominated by the wholesale market and managed funds, but now the likes of FIIG Securities and JBWere are offering clients smaller-sized bond parcels. FIIG offers bonds in \$50,000 lots, while JBWere offers \$100,000 parcels, both significantly lower than the wholesale cut-off of about \$500,000.

FIIG has a menu of government and semi-government bonds as well as 50 to 60 corporate bonds, including infrastructure bonds and hybrid-subordinated bonds, all available for direct purchase.

"Before, for people to get into the market they needed \$500,000," says Paul Banner, principal financial adviser at Provenance Advice. "For investors with \$800,000 to a couple of million,

\$500,000 is a high amount of exposure and doesn't provide diversification. Breaking those [bonds] into \$50,000 parcels has provided access to the market."

Managed funds and direct fixed income both have benefits. But some financial advisers, and particularly their self-managed super fund clients, are increasingly using direct fixed income to improve portfolio transparency.

To manage cashflow and generate a higher yield, many are also shifting out of term deposits, which are rolling over to lower rates, into direct fixed income such as corporate bonds.

Banner began using direct bond holdings during the global financial crisis in late 2008 and early 2009 when he started seeing an opportunity to buy quality corporate bonds trading at a substantial discount to their face value [which allowed his clients to lock in an attractive yield and healthy capital gain at maturity].

He says bonds are a fairly straightforward instrument. "If you buy a bond, you know who you are investing with; it is relatively simple to evaluate counterparty risk. You give them money, they pay you interest and you get your capital back in 2013, 2014 or whatever."

Banner says clients like the greater transparency of direct bond holdings, particularly after supposed income funds burned many investors badly during the GFC. "It's attractive in an environment where a lot of people are overwhelmingly disappointed with their investments," he says. "So many managed funds have proved to hold investments the client didn't understand and, to be fair, the investment professional didn't

understand."

Laurie Conheady, executive director fixed income strategy at JBWere, agrees transparency is a big benefit of direct bonds. "At least you know what you have got," he says.

"People like the fact they can pick up a monthly report or quarterly report that shows they hold Transurban bonds and Adelaide Airport bonds, rather than a report from a fund manager where they know what general exposure they have but they don't have as much granularity."

Banner says: "Through staggered bond maturities, augmented with dividends from shares, coupons payments and other income from the portfolio, we can ensure our clients can meet their stated cashflow objectives with greater certainty."

He plans cashflows on a rolling three-to-five year basis. "It is about providing our clients the peace of mind that they can fund their lifestyle or liabilities," he adds.

Banner uses term deposits for immediate cashflow needs [six to 12 months] but says bonds offer an attractive margin over prevailing term deposit rates with only a modest increase in risk.

"I try to run a two-to-five-year strategy on the bonds side so it is effectively covering the medium-term cashflow needs with an attractive return when compared to term deposits," he says.

"Also, term deposit rates are set based on the current interest rate outlook and there is a risk rates may change when you lock-in term deposits."

The ability to manage cashflow is a big



benefit of direct fixed income. "Distributions from managed funds are probably not as predictable," Conheady says, adding managed funds have multiple exposures and their distributions depend in part on whether they make capital gains or losses, or receive coupons during the period and, for offshore managers, what currency hedging they undertake.

Banner says when he meets a client he seeks to understand their risk profile and discusses different asset classes to get an understanding of what they're comfortable with. He also gets an idea of whether or not they have cashflow requirements.

If they do have cashflow needs, he constructs a bond portfolio with staggered maturity dates. The maturity and proceeds of maturity are matched against the client's cashflow requirements. If a client wants \$60,000 to \$70,000 pension income a year, then in 2012, for example, the portfolio might have a bond parcel of \$50,000 maturing.

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Assuming the bonds are held to maturity, a total return of close to the 7 per cent mark can be achieved, against 5.5 per cent to 6 per cent at best for term deposits.

But to achieve that return investors need to focus on buying corporate bonds. Ten-year government bonds are at present yielding a little more than 4 per cent.

"I can't see that's any real value unless you believe in a bit of an Armageddon outcome," says Jim Stening, managing director of FIGG Securities.

Banner says he avoids direct holdings of government bonds. "If you're going to buy commonwealth bonds you should probably just buy an index fund," he says, adding that he is looking at a more attractive risk-to-return trade off, which is available in corporate bonds.

He says the big bank bonds, for example, pay a margin over commonwealth bonds, but the risk increases only modestly.

Banner focuses on bonds issued by large companies, particularly financial services companies, that can demonstrate a long track record of running a profitable business and paying dividends. "It provides some degree of protection," he says. "Bond holders are further up the capital structure and investors can feel more confident they're protected and that their investment won't default."

In recent years the cost of borrowing for corporates has widened. "For investors that's a good thing and you can achieve a higher yield," Stening says.

"Those bonds have weakened so there are opportunities to lock in returns. The five-year or 10-year investor can target returns of around 6 per cent to 8 per cent for top quality offers. Within the corporate bond area you could usually lock that in."

Banner says the biggest disadvantage of corporate bonds is they can exhibit greater volatility in capital returns rela-

tive to other defensive alternatives such as sovereign bonds and term deposits.

"The other disadvantage of direct fixed income is the fact it is not as easy to transact as a managed fund or term deposit," he says.

"Naturally, the hybrids are easily tradable through the ASX, but small parcel bonds still have substantial minimums [\$50,000] and there is limited depth in the market.

"I manage both these disadvantages by always investing with the intent to hold until maturity; that way, we have confidence of getting back the face value and we also do not have to worry about market depth or transacting."

Banner says corporate bond analysis is relatively simple: is the company going to be able to make interest payments on the bond and will it pay the capital back? "We're not trying to guesstimate the share price or that type of thing," he says. "We're asking the question: is the corporate going to be able to follow through on their bond commitment to pay their coupon and repay capital upon maturity?"

But when it comes to buying specific bonds, Banner does recommend seeking advice and research generated by a broker or research house. "Having a source of research is really important for those things," he says. "Even as a person who knows a fair bit about individual securities, I see the value of research. On the question of whether or not to buy a CBA security, ANZ security or any other, in terms of direct bond parcels or hybrids

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Model portfolio	SECTOR EXPOSURE		CAPITAL STRUCTURE EXPOSURE		PORTFOLIO EXPOSURE STATISTICS			
Federal government	0.00%		Cash / TD	0.00%	Weighted average yield to maturity	7.44%		
State government	0.00%		Senior Debt	41.06%	Weighted average running yield	6.97%		
Corporate	100%		LT2 Sub Debt	58.94%	Weighted average term to maturity	4.67%		
			T1 Capital	0.00%	Weighted average trading margin	3%		



*Current face value on Inflation linked bonds represents the Inflation adjusted face value. **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.
 #For weighted average rating calculation, short term ratings and long term Moody's ratings are converted into long term S&P ratings

ISSUER	MATURITY/ CALL DATE	COUPON	TRADING MARGIN	COUPON TYPE	% EXP	CAPITAL STRUCTURE	YTM**	RUNNING YIELD***	CAPITAL PRICE	FACE VALUE*	CAPITAL VALUE	ACCRUED INTEREST	TOTAL VALUE
Bank of Queensland Ltd	04/06/2013	10.75%	2.80%	Fixed	21.04%	LT2 Sub Debt	6.88%	10.16%	105.85	\$50,000	\$52,927	\$1,983	\$54,909
Morgan Stanley	26/05/2015	7.25%	3.76%	Fixed	19.21%	Senior Debt	8.07%	7.44%	97.46	\$50,000	\$48,728	\$1,419	\$50,146
Vero Insurance Ltd	07/09/2015	6.15%	3.10%	Fixed	18.43%	LT2 Sub Debt	7.49%	6.44%	95.54	\$50,000	\$47,769	\$338	\$48,107
National Wealth Management Holdings Ltd	16/06/2016	6.75%	2.40%	Fixed	19.47%	LT2 Sub Debt	6.91%	6.79%	99.36	\$50,000	\$49,678	\$1,134	\$50,812
Southern Cross Airports Corporation Pty Ltd (Sydney Airport)	20/11/2020	3.76%	2.98%	ILB	21.85%	Senior Debt	7.85%	4.10%	113.30	\$61,840	\$56,650	\$369	\$57,019
										\$261,840	\$255,750	\$5,242	\$260,992

Source: FIGG Securities



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I outsource security selection decisions to a broker.”

That advice particularly relates to hybrid securities, which are exchange traded and therefore available in smaller parcels. “They sit lower on the capital structure than bonds,” Banner says. “If the company goes bang, the bond

holders will get money back before the hybrid owners, who will get money back before equity holders. Where you sit on the conga line frames the amount of risk you’re taking.”

Banner says hybrids, which are more volatile than bonds, are probably only just on the defensive side but he includes hybrids in most client portfolios. “The way to play this game and make the most of it is not actively trading, but buying and holding to maturity and realising a potential capital gain if you have bought well.”

But double-digit yields are on offer among hybrids. Stening cites the AXA hybrid, which is yielding low to mid

teens. “That’s a higher risk proposition,” he says. “That sits just above equity and offers an equity-like return.”

One area Banner doesn’t recommend direct holdings in is international bonds. “The moment I flip into international bond exposure, I exclusively use fund managers,” he says. “The market’s a lot deeper, a lot more layers or risk: sovereign risk, counter-party security risk, currency risk. That’s the perfect place for a fund manager.”

JBWere’s Conheady agrees: “You’re better holding offshore exposures through managed funds . . . A SMSF probably wouldn’t have the capacity to do it.”