

# EUREKA *report*



## Safety in these numbers

By Elizabeth Moran

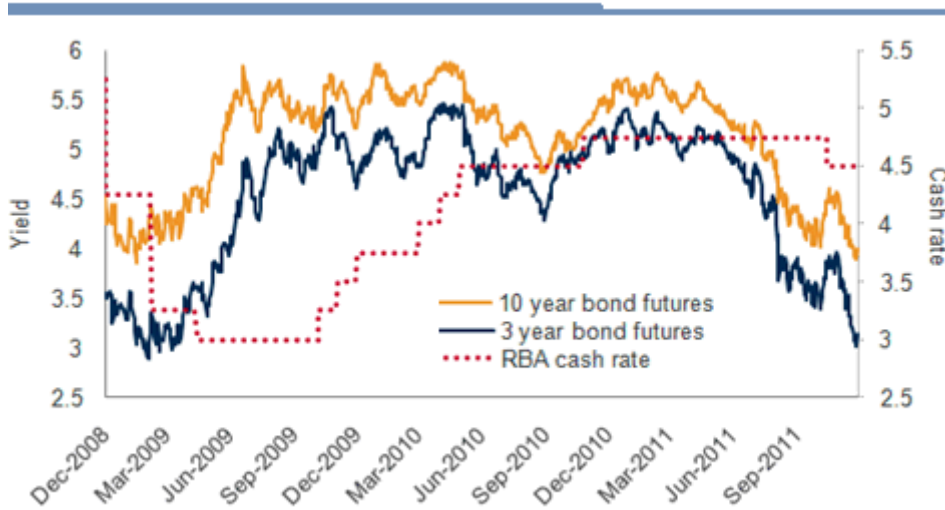
November 28, 2011

**PORTFOLIO POINT: Where to turn when the market is volatile and interest rates are falling? Here's a bond portfolio paying better than 6%.**

Australian Commonwealth government bond yields continue to contract as investors seek the safest investments with Europe yet to broker a deal to calm the market.

Below is a graph showing the cash rate and the three-year and 10-year Commonwealth government bond futures rates. You can see that both the three-year and 10-year bond future rates moved sharply lower this month and as at close of business on Friday, November 26, were 3.14% and 3.99% respectively. The cash rate, currently sitting at 4.50%, looks too high in comparison. The difference between the cash rate and three-year bond futures rate is extreme at 136 basis points and something has to give; essentially the market is pricing in lower growth expectations and a series of rate cuts.

**Government bond futures vs RBA cash rate**



Source: Bloomberg, FIIG Securities

I would usually write my “review your investment portfolio” article just before Christmas to remind investors to review their percentage allocations when they have some spare time over the festive season, but the rapidly declining

European situation will impact our banks (they still have wholesale funding requirements) and while much of their funding for 2012 has already commenced, I'd expect their costs to increase, and they will be passed on to us. Last week Germany, Europe's strongest economy, got a nasty surprise when it tried to sell €6 billion in 10-year bonds only to see poor demand for just €3.64 billion, signalling diminishing investor appetite for even the safest eurozone assets.

Further, the banking system is global, so what happens to one will affect them all. Current estimates of European bank shortfalls in capital vary widely, but they will need to raise additional capital and Australian banks will then be competing for limited investment dollars; there's only one way bank funding costs are going and that is up.

These costs will be felt right across our economy. Growth should be lower and limited. This is not an environment that is conducive to the stockmarket, which is predicated on growth. So, it's worth re-evaluating your portfolio allocations now and taking action to limit losses. See the article ***A fixed income primer*** about how to assess what you'll need.

Right now I'd be more conscious about protecting the capital I have as opposed to exposing my portfolio to undue risk to try and maximise return. Investors are shunning risk for safety, as demonstrated by the current yield to maturity of just 3.04% of the June 2016 Commonwealth government bond issued at a fixed coupon of 4.75% shown in the portfolio below. Demand has driven yields lower and prices higher.

A bond portfolio has a known income stream and investors will be repaid capital on maturity (assuming the issuer does not go into wind-up) providing certainty compared to higher-risk asset classes of equity and property, where repayment is subject to sale (and is therefore unknown), as is income where dividends can be cut and properties left vacant.

Young investors that have time to rebuild their portfolios can afford to take risks that those in or near retirement cannot, especially if you no longer have the capacity to earn an income. Below is a portfolio of low-risk bonds and for comparison I've included a major bank term deposit and the Australian commonwealth government (AGL) bond.

Both of these securities are very low risk and thus offer lower returns. The other bonds listed are all rated as a minimum "A" credit rating and most are senior debt, ranking high in the issuer's capital structure. The exceptions to these are National Capital Instruments, essentially National Australia Bank risk and Vero Insurance, a subsidiary of Suncorp-Metway, where we are confident in the credit assessment of the underlying issuer. The portfolio has a weighted average yield to maturity of 6.08%, but if the AGL bonds and the term deposit are excluded, this increases to 6.90% – 1.60% or 160 basis points more than the 12-month Commonwealth Bank term deposit rate of 5.30%.

The majority of the portfolio is fixed with expectations of lower growth, protecting your capital as well as your income.

### Low-risk Eureka Report portfolio, as at Monday, November 28, 2011

SECTOR EXPOSURE		CAPITAL STRUCTURE EXPOSURE		PORTFOLIO EXPOSURE STATISTICS	
Federal Government	15.51%	Cash / TD	14.18%	Weighted Average Yield to Maturity	6.08%
State Government	0.00%	Senior Debt	59.88%	Weighted Average Running Yield	6.08%
Corporate	84.49%	LT2 Sub Debt	12.87%	Weighted Average Term to Maturity	4.88
		T1 Capital	13.06%	Weighted Average Trading Margin	1.76%

ISSUER	MATURITY/ CALL DATE	COUPON	TRADING MARGIN	COUPON TYPE	% EXP	CAPITAL STRUCTURE
Australian Commonwealth Government Bonds	15/06/2016	4.75%	-1.18%	Fixed	15.51%	Senior Debt
GE Capital Australia Funding Pty Ltd	15/03/2019	6.00%	1.57%	Fixed	14.24%	Senior Debt
Morgan Stanley	26/05/2015	7.25%	3.35%	Fixed	14.15%	Senior Debt
Telstra Corp. Ltd	15/07/2020	7.75%	1.60%	Fixed	15.98%	Senior Debt
National Capital Instruments	30/09/2018	0.95%	3.15%	Floating	13.06%	T1 Capital
Vero Insurance Ltd	07/09/2015	0.70%	3.50%	Floating	12.87%	LT2 Sub Debt
CommInvest	27/11/2012	5.30%	0.89%	Fixed	14.18%	TD

	YTM*	RUNNING YIELD***	CAPITAL PRICE	FACE VALUE*	CAPITAL VALUE	ACCRUED INTEREST	TOTAL VALUE
Australian Commonwealth Government Bonds	3.04%	4.43%	107.20	\$50,000	\$53,599	\$1,097	\$54,695
GE Capital Australia Funding Pty Ltd	6.14%	6.05%	99.19	\$50,000	\$49,594	\$635	\$50,228
Morgan Stanley	7.35%	7.27%	99.71	\$50,000	\$49,855	\$50	\$49,905
Telstra Corp. Ltd	6.28%	7.06%	109.80	\$50,000	\$54,900	\$1,464	\$56,364
National Capital Instruments	7.40%	6.44%	91.15	\$50,000	\$45,575	\$499	\$46,073
Vero Insurance Ltd	7.56%	6.09%	90.90	\$50,000	\$45,450	-\$45	\$45,404
CommInvest	5.30%	5.30%	100.00	\$50,000	\$50,000		\$50,000
				\$350,000	\$348,971	\$3,698	\$352,668

\*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 Moodys ratings are converted into long term S&P Ratings

## An update on Origin Energy hybrids

Last week ASIC questioned the Origin Energy \$500 million hybrid offer, which includes a stipulation that interest payments on the hybrid instrument would be mandatorily deferred if Origin's credit rating falls below investment grade.

Because the Origin hybrid is intended for ASX listing it cannot be credit-rated by any of the three wholesale rating agencies because they do not have retail licenses. It is worth noting that the reference to the rating relates to the company's senior debt. The hybrid, if rated, would already likely be sub-investment grade due to its subordinated nature. Regardless, no reference to Origin's corporate rating may be made under the terms of the retail listing,

making the reference in the prospectus in contravention with ASIC guidelines.

At this stage the prospectus has been extended for a week until November 29, 2011.

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