

EUREKA *report*



How about property bonds?

By Elizabeth Moran
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PORTFOLIO POINT: Investors tempted to buy property should consider property-related bonds.

There's something innately attractive about property. It's tangible, it can be beautiful or be of cultural or historical value and it can be emotive. Coupled with attractive negative gearing benefits for high income earners, the asset class has a lot going for it.

But none of these reasons mean you'll make money on a direct property investment. Do your numbers and try and make a critical assessment of any prospective deal – you might just find that there's better ways to invest in property for your SMSF.

Lower interest rates will help stimulate demand but I tend to agree with Michael Feller's sentiment in his article *Property pales before bond rivals*, rather than Monique Sasson Wakelin (see *Building a case for bricks and mortar*) who has a very different approach. The way I see it, residential property isn't going to return to those historic highs in a low-growth environment and investors would be better off considering bonds.

Direct property investment and its likely near-term lower-than-average returns will not compensate investors for the two main disadvantages of the asset class: lack of liquidity and diversification.

Most investors either own or are on their way to owning the residential property in which they reside. But how many properties do you need to hold to have a diversified property portfolio and are these properties spread nationwide to avoid volatility in any one market? Equally, if there is an emergency and you need to sell a property in your portfolio, how can you access your capital quickly?

There are opportunities in any market at any point in time but did you know that the fixed income asset class also offers exposure to residential and commercial property? For example, investors can acquire a senior bond in Stockland or Mirvac, offering a known return and a known maturity date.

There is no guesswork in trying to locate growth hotspots or uncertainty regarding returns as the return on these investments is known from the outset. Both the Mirvac and Stockland bonds are senior debt and both pay a running yield of more than 7.4%, a yield to maturity above 6.5% and are available to wholesale investors in parcels from just \$50,000. Investors at all times are beneficial owners of the bonds and can buy and sell at their discretion. Like other senior bonds, the returns offered are what the investor receives, there are no ongoing fees.

The table shows some other securities that are property-related.

ISSUER	MATURITY/ CALL DATE	COUPON	COUPON TYPE	CAPITAL STRUCTURE	YTM**	RUNNING YIELD***	CAPITAL PRICE	FACE VALUE*
AMP Capital Shopping Centre Fund	28/04/2015	7.50%	Fixed	Senior Debt	5.39%	7.05%	106.40	\$500,000
AMP Capital Wholesale Office Fund	05/10/2014	8.00%	Fixed	Senior Debt	5.19%	7.46%	107.24	\$500,000
CFS Retail Property Trust (formerly Gandel)	18/07/2014	5.75%	Fixed	LT2 Sub Debt	6.94%	5.91%	97.26	\$500,000
CFS Retail Property Trust (formerly Gandel)	22/12/2014	6.25%	Fixed	Senior Debt	5.00%	6.04%	103.45	\$500,000
Genworth Financial Mortgage Insurance	30/06/2016	4.75%	Floating	LT2 Sub Debt	8.97%	9.67%	100.01	\$50,000
General Property Trust	22/08/2013	6.50%	Fixed	Senior Debt	4.85%	6.33%	102.64	\$500,000
Minvac Group Funding Ltd	16/09/2016	8.00%	Fixed	Senior Debt	6.67%	7.60%	105.31	\$50,000
Stockland Trust	25/11/2020	8.25%	Fixed	Senior Debt	6.58%	7.42%	111.12	\$50,000
<i>All prices and yields are a guide only and subject to market availability. FIIG does not make a market in these securities.</i>								\$2,650,000

Another way to access property through fixed income is via Residential Mortgage Backed Securities (RMBS). These securities are issued by banks and used to help finance their balance sheets. RMBS are a type of debt security secured by a pool of home loans. Because RMBS is secured, they often achieve very high credit ratings and are considered a very low-risk investment.

By combining mortgages into a large and diversified pool via a trust and then breaking the combined pool into smaller, marketable classes, the RMBS become attractive to investors who would otherwise be unable to create a diversified exposure to the mortgage sector.

The concept of breaking the pool into varying classes of securities allows investors with specific risk appetites to target the appropriate class, and thus returns they are seeking. In this way, the classes act like a normal company capital structure, where investors with the lowest risk appetite target the senior bonds (or in the case of RMBS, the highest classes) and those with a higher risk appetite target the lower ranked capital, like hybrids or equity (or in the case of RMBS, the lowest ranking classes).

RMBS provides another source of funding for lenders in addition to customer deposits and corporate borrowings. Virtually all Australian Prudential Regulation Authority (APRA) regulated lenders (including the "big four" banks) use RMBS as a source of funding. Investors in RMBS include super funds, insurance companies, high net worth investors, and more recently, the commonwealth government. Prior to the financial crisis about 25% of housing credit in Australia was funded through RMBS, and while this level has decreased, RMBS still represents around 10% of housing credit funding in the Australian market.

RMBS offers investors exposure to the residential property market, but current pricing allows investors to achieve far stronger returns for their investment than investing directly in residential property. It also avoids all the extra costs of owning residential property directly like stamp duty, agent fees, insurance and maintenance.

Last month Suncorp issued and priced its APOLLO Series 2011-1 RMBS issue, which was upsized to \$1.25 billion from \$750 million in response to strong investor demand. Details of the tranches are found in the next table.

Suncorp APOLLO Series 2011-1 RMBS

Tranche	Credit Rating	Value (A\$m)	Pricing
A1	AAA	912.5	1m BBSW + 135bps
A2	AAA	250.0	1m BBSW + 150bps
AB	AAA	65.0	1m BBSW + 250bps
B	AA-	22.5	1m BBSW + 425bps

Source: Insto, FIIG Securities

The issue consisted of 3500 fully documented loans originated by Suncorp with a weighted average loan to valuation ratio of 64.2% (in other words, average equity in the properties was 35.7%). One interesting thing about the issue was that the Australian Office of Financial Management, which manages the debt of the Australian government, purchased all of the A2 notes and \$63 million of the AB notes, so that if you bought

the A1 notes, the Australian government sits lower in the note structure. Even stronger returns may be available in the secondary market.

RMBS are limited to wholesale investors with minimum face value parcels of \$500,000. They are often tightly held by institutions so don't often come onto the market. If you are interested you need to let your broker know, so you can be contacted when there is a new issue or an existing parcel is sold onto the market.

Conclusion

If you are a property investor, think about your contingencies. Do you have other assets that compensate for poor liquidity and enable easy access? Have you diversified sufficiently into fixed income or equities to protect yourself in case the Australian residential property market were to fall like the US?

If you are a diehard property investor, instead of investing in more direct property consider investing via fixed income. Buying bonds or other fixed income securities offers lower risk, known returns and better liquidity.

Note: This is a very basic explanation of an RMBS security. To find out more, please contact your broker.



*Elizabeth Moran is director of education and fixed income research at **FIG Securities**.*
