EUREKA report

# Where to get 6.5% or better

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**PORTFOLIO POINT: The security of income from fixed interest offers an attractive alternative to sharemarket volatility.**

Lower interest rates have reduced investors' minimum required returns, with most now seeking 6.5% fixed. Demand for fixed rate bonds across the market has been high and some lines are becoming scarce. However, investors are still able to lock in solid returns through a number of fixed rate bonds from quality issuers. Wholesale investors have more options and it is still possible to build a diversified portfolio of high quality senior bonds with a yield above 7%.

When purchasing bonds, the credit quality of the issuer is key. Investors need to assess the ability of the issuer to continue to trade; while growth is mostly positive, it isn't the key focus of fixed income investors. If the credit quality of two or more bonds is similar as are the maturity profiles, you'd then need to assess their returns. There are two ways to compare returns of bonds; one is by running yield and the other, yield to maturity.

## Running yield

Running yield, also known as current yield, uses the current price of the bond instead of its face value and represents the return an investor would expect after purchasing a bond and holding it for a year. It is determined by dividing the coupon by the market price. Running yield can also be referred to as bond yield and is similar to dividend yield for equities. If a bond is trading at a discount to its original face value, then running yield will be higher than the coupon payment.

## Yield to maturity

The calculation for the running yield does not take into account the discount or premium paid on purchase of the bond. Yield to maturity (YTM) calculates how much a security will earn if it is held to its maturity date. The value includes any gain or loss if the purchase price was below or above the face value when purchased. For this reason, the yield to maturity is the more important variable of bond analysis as it provides a basis for comparison between different securities and other interest rate-based products.

Investors seeking an income, particularly those in retirement will be more interested in running yield. Bonds issued when interest rates were higher may now be trading at a premium; that is more than the $100 issue price. It's important for investors to realise that these bonds will move towards the original face value the closer they get to the maturity date. So, if you hold a bond trading at a premium, you'd start thinking about selling it at least a year before maturity.

Below are two tables, both showing fixed rate securities that offer either a running yield or a yield to maturity of over 6.5%. The first shows securities available to retail investors. The stand-out bond in terms of return is the Downer bond, offering a yield to maturity of 7.90% and a running yield of close to 9.5%. This bond only has around 21 months until maturity, so if you were purchasing it mainly for the running yield it provides, you'd consider selling it later this year.

The Praeco bond also offers good returns and is essentially supported by a federal government cash flow. Praeco was established as a special purpose vehicle to construct and operate the Department of Defence Headquarters Joint Operations Command (HQJOC) just outside Canberra.

The construction phase of the project was completed in July 2008 and delivered over 28,000 square metres of office and support plant space. With the construction phase now complete, the project has moved on to the low-risk operational phase. This phase entails the upkeep and maintenance of the site and the contract continues through to 2036 when the facilities will revert back to Commonwealth ownership.

**Fixed offers - Retail clients**

| Issuer | Maturity | Yield to maturity | Running yield | Capital price | Min investment |
|---|---|---|---|---|---|
| **Senior bonds** | | | | | |
| DBCT Finance Ltd (Dalrymple Bay) | 9/06/2016 | 6.65% | 6.35% | $ 98.49 | $ 50,000.00 |
| Downer Group Finance Pty Ltd | 29/10/2013 | 7.90% | 9.47% | $ 102.99 | $ 50,000.00 |
| JEM (Southbank) Pty Ltd | 28/06/2018 | 6.75% | 6.68% | $ 99.41 | $ 50,000.00 |
| Praeco Pty Ltd | 28/07/2020 | 7.05% | 7.09% | $ 100.51 | $ 50,000.00 |
| Telstra | 15/07/2020 | 6.08% | 6.99% | $ 110.92 | $ 50,000.00 |
| **Sub debt** | | | | | |
| Macquarie Bank Ltd | 31/05/2012 | 6.87% | 6.51% | $ 99.84 | $ 50,000.00 |
| National Wealth Management | 16/06/2016 | 6.60% | 6.71% | $ 100.56 | $ 50,000.00 |
| Suncorp | 23/09/2014 | 7.09% | 6.81% | $ 99.18 | $ 50,000.00 |

*Source: FIIG Securities*

*All prices and yields are a guide only and subject to market availability and are accurate as at 16 January 2012. FIIG does not make a market in these securities.*

The list of available wholesale securities is much longer and includes more traditional bonds that can only be traded in minimum $500,000 parcels.

The Rabobank callable (Tier 1) bond, sits low in Rabo's capital structure and is considered higher risk than other Rabo debt but remains a great opportunity. Rabobank is a very low risk issuer and the additional premium for the possibility of non-call looks over-done here. Yield to maturity of 7.71% with less than three years till first call looks very attractive.

Societe Generale senior debt with a YTM of 9.69% for around 2.5 years also looks cheap. Global banks are all still building their capital bases under Basel III guidelines to protect senior debt, making senior debt investments safer. The shorter time frame until maturity means less risk and it's very hard to imagine that one of the big French banks could default in that period.

The other bonds I'd highlight are the CBA and Westpac senior bonds. While they are long dated, they still offer a running yield of 6.80%. Spreads on the Big Four banks' senior debt have increased in recent months, reflecting tightening credit conditions globally. Locking in high returns on senior debt, which is considered only marginally higher risk than term deposits, is a sound starting point for those new to fixed income.

**Fixed offers - Wholesale clients**

| Issuer | Maturity | Yield to maturity | Running yield | Capital price | Min investment |
|---|---|---|---|---|---|
| **Callable bonds** | | | | | |
| AXA SA | 26/10/2016 | 13.83% | 9.57% | $ 78.39 | $ 100,000.00 |
| Rabobank | 31/12/2014 | 7.71% | 6.64% | $ 96.64 | $ 100,000.00 |
| Swiss Re | 25/05/2017 | 11.64% | 9.05% | $ 84.35 | $ 100,000.00 |
| **Senior bonds** | | | | | |
| Adelaide Airport | 20/09/2016 | 6.74% | 6.37% | $ 98.05 | $ 500,000.00 |
| Bank of America Corporation | 9/09/2013 | 7.42% | 6.82% | $ 98.98 | $ 500,000.00 |
| Barclays Bank PLC | 17/08/2015 | 6.90% | 6.78% | $ 99.51 | $ 500,000.00 |
| BNP Paribas (Australia) | 21/01/2014 | 7.45% | 6.62% | $ 98.26 | $ 50,000.00 |
| Commonwealth Bank of Australia | 5/02/2020 | 6.20% | 6.80% | $ 106.57 | $ 500,000.00 |
| Goldman Sachs Group Inc. | 12/04/2016 | 7.35% | 6.59% | $ 96.40 | $ 500,000.00 |
| Lloyds TSB Bank PLC | 22/11/2013 | 7.10% | 7.23% | $ 100.25 | $ 500,000.00 |
| Merril Lynch & Co | 12/03/2014 | 7.15% | 6.80% | $ 99.21 | $ 500,000.00 |
| Mirvac | 16/09/2016 | 6.62% | 7.59% | $ 105.45 | $ 50,000.00 |
| Morgan Stanley | 26/05/2015 | 6.98% | 7.19% | $ 100.77 | $ 50,000.00 |
| RBS (Australia) | 10/03/2014 | 7.10% | 7.23% | $ 100.29 | $ 50,000.00 |
| Societe Generale | 20/10/2014 | 9.69% | 7.26% | $ 93.03 | $ 500,000.00 |
| Southern Cross Airports | 6/07/2015 | 6.16% | 7.57% | $ 105.66 | $ 500,000.00 |
| Stockland Trust | 25/11/2020 | 6.68% | 7.47% | $ 110.38 | $ 50,000.00 |
| Westpac | 11/02/2020 | 6.20% | 6.80% | $ 106.58 | $ 100,000.00 |
| **Sub debt** | | | | | |
| Bank of Queensland | 4/06/2013 | 6.48% | 10.19% | $ 105.51 | $ 50,000.00 |
| Suncorp | 6/10/2016 | 7.62% | 6.99% | $ 96.58 | $ 50,000.00 |

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With so much uncertainty in global markets, these fixed rate bonds offer known returns and in most cases a known maturity date.

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