

EUREKA *report*



Time to think about 'floaters'?

By Elizabeth Moran

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PORTFOLIO POINT: For investors who think rates are close to the bottom, floating rate notes can capture any future increases.

Last week the RBA surprised the market and left the cash rate on hold at 4.25%, breaking the current easing cycle. The question for fixed income investors is: Does this signal the low point in the interest rate cycle?

If, as an investor you expect interest rates are close to or at the low point then you would change your preference from buying fixed rate bonds (preferred when the economy is contracting and interest rates are moving lower) to buying floating rate notes and inflation-linked bonds which capture future increases in interest rates, through the benchmarks (such as BBSW) to which coupon (interest) payments are tied.

The relationship between the cash rate, the bank bill swap rate (BBSW) and floating rate notes (FRNs) is often misunderstood. BBSW and the cash rate may well move in sync but this is not always the case. Seasoned fixed income investors will appreciate that BBSW is the more important of the two in predicting future returns on FRNs.

There are instances where the cash rate may move lower but BBSW may not follow, as I'll explain below.

What is BBSW?

One of the key terms for Australian fixed income investors is BBSW. It is the term used for interest rate swaps (from fixed in to floating rate) of 12 months or less and anything longer is simply referred to as the swap rate.

While BBSW has many uses, for fixed income investors its main relevance is as a benchmark upon which we can evaluate returns for floating rate bonds or investments.

BBSW is a compilation and average of market rates supplied by domestic banks in regard to the specific maturities of bank bills and is the rate at which

banks will lend to each other. It is calculated for various maturities, at 10am each business day, and compiled by Australian Financial Markets Association (AFMA), providing an independent and transparent reference rate for the pricing and revaluation of Australian dollar derivatives and securities.

The 90-day BBSW is often referred to as the reference rate for market interest rates and, in particular, is used as a benchmark interest rate for floating rate bonds and other floating rate financial instruments such as hybrids.

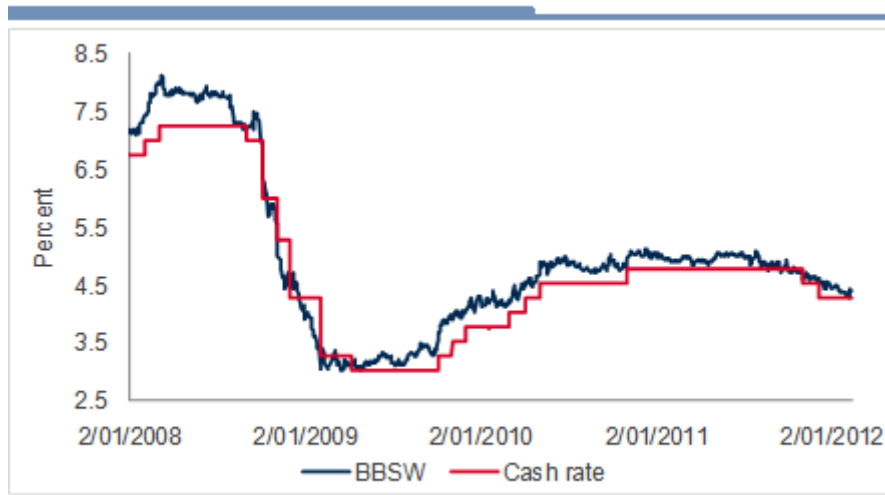
Importantly, while the RBA (through setting its cash rate) influences the short end of the yield curve, market expectations have the greatest impact on the longer end of the yield curve, which the swap curve would show.

The relationship between BBSW and the cash rate

Typically BBSW and the cash rate have been highly correlated. A change in BBSW has then been reflected in the cash rate and vice versa. However, during the GFC the two rates diverged, reflecting banks' increasing nervousness about lending to other banks and the lack of credit in the market.

At its widest, BBSW was approximately 90 basis points (bps) more than the cash rate in early 2008 (see below). The equivalent measure in the US in early 2009 saw a 400bps differential as the fear of a banking system collapse overtook the market.

Three-month BBSW versus cash rate



Source: FIG Securities, Bloomberg

Over the past few weeks, Australia's big four banks have started issuing **covered bonds**. These bonds are the lowest risk in their capital structure as they are secured by a pool of housing loans. Being very low risk, we would have expected them to issue at very low rates over BBSW. However, with tightening credit conditions, the rate at which they have issued is almost double what we would have anticipated when APRA approval came through for their issuance last year.

Even if the cash rate is cut in the coming months, it doesn't mean BBSW (especially given the rising cost of interbank funding) will follow. Nor does it mean that the returns investors earn on floating rate notes will be lower.

When you should consider buying floating rate notes

Investors choose to invest in floating rate notes so that coupon payments reflect changes to interest rates. They pay a coupon tied to an underlying variable or benchmark, such as the bank bill swap rate (BBSW). Picking the low point in the interest rate cycle will mean higher returns, if BBSW starts to climb.

Generally, in a rising cash rate environment, floating rate notes are preferred as the coupon will be reset quarterly and thus reflect a higher benchmark rate. In this environment, fixed rate bond prices usually decline, so attempting to judge the low point is advantageous to investors who like to trade their bonds, as opposed to those content to hold to maturity.

Equally, in a low growth environment, there is a point when the stimulus of lower interest rates begins to take hold and businesses and investors use the lower rate to borrow to develop projects and so the economy begins to grow again. It's at this point that floating rate notes can also become attractive.

Remember BBSW reflects the rate banks are prepared to lend to each and a tightening credit market may signal the low point for BBSW.

Picking the low point will be profitable. Floating rate note prices are likely to be lower than fixed rate bonds issued at the same time by the same issuer. So, investors are buying floating rate notes at a discount to equivalent fixed rate prices and will capture any increases in rate expectations through BBSW. Investors would gain through anticipated higher future demand for floating rate notes and higher coupons with higher BBSW expectations if they correctly call the low point in the cycle.

Time to buy floating rate notes?

Trying to determine if it's a good time to buy floating rate notes or to switch some of your fixed rate bonds into FRNs very much depends on your view of the perception of interest rates, the relative value between fixed and floating rates notes offered by the same issuer with the same maturity date and the certainty you need in terms of your returns, because while FRN returns can move higher they can also move lower.

It's good to remember that a balanced portfolio will hold an allocation to fixed rate bonds, FRNs and usually have an exposure to inflation linked bonds

(bonds whose underlying benchmark is the consumer price index).

The tables below show current floating rate notes on offer that have a yield to maturity or a running yield of **over 6.5%**.

Floating rate note offers - Retail clients

Issuer	Maturity/ Call date	Coupon margin	Yield to maturity	Running yield	Capital price	Minimum investment
Senior bonds						
Morgan Stanley	22/02/2017	0.47%	7.29%	5.66%	\$ 90.08	\$ 50,000.00
Wesfarmers Ltd	11/09/2014	2.60%	5.22%	6.91%	\$103.60	\$100,000.00
Southern Cross Airports (ILB)*	20/11/2030	3.12%	8.50%	4.32%	\$ 84.44	\$ 50,000.00
Sub debt						
National Wealth Management	16/06/2016	0.63%	6.88%	5.43%	\$ 93.05	\$ 50,000.00
Suncorp Metaway Insurance	41905.00	1.00%	7.08%	5.80%	\$ 95.42	\$ 50,000.00

*Assuming 3% inflation

Source: FIIG Securities

Note: Yield to maturity is calculated based on swap rate expectations

The Suncorp-Metway Insurance subordinated debt is my preferred security here. It has a short time until first call when you'll be assured of a capital gain (assuming the company calls at the first opportunity and does not go into wind-up).

It is also interesting to note that the Morgan Stanley senior bond has a yield to maturity of 7.29%, more than 2% higher than for the Wesfarmers bond, highlighting the demand for Australian corporate debt as opposed to a risk differential between the two.

Floating rate note offers - Wholesale clients

Issuer	Maturity/ Call date	Coupon margin	Yield to maturity	Running yield	Capital price	Minimum investment
Senior bonds						
Bank of America Corporation	9/09/2013	2.10%	6.88%	6.70%	\$ 99.01	\$ 500,000.00
BNP Paribas (Australia)	18/03/2015	1.10%	7.37%	5.86%	\$ 94.25	\$ 50,000.00
Envestra (ILB)*	20/08/2025	3.14%	8.05%	3.78%	\$ 97.26	\$ 50,000.00
Lloyds TSB Bank PLC	22/11/2013	1.90%	6.70%	6.61%	\$ 98.85	\$ 500,000.00
Morgan Stanley	26/05/2015	1.80%	6.80%	6.58%	\$ 97.67	\$ 50,000.00
RBS (Australia)	10/03/2014	1.95%	7.09%	6.64%	\$ 98.00	\$ 50,000.00
Societe Generale	20/10/2014	1.50%	7.83%	6.21%	\$ 94.73	\$ 50,000.00
Westralia Airports Corp. Pty Ltd	10/05/2016	0.22%	7.41%	4.84%	\$ 95.00	\$ 500,000.00
Sub debt						
Bank of Queensland	10/05/2016	3.75%	7.67%	8.00%	\$ 101.61	\$ 100,000.00
Genworth Financial Mortgage Insurance	30/06/2016	4.75%	8.28%	8.95%	\$ 103.09	\$ 50,000.00
Tier 1 securities						
AXA SA	26/10/2016	1.40%	13.56%	7.85%	\$ 73.41	\$ 100,000.00
Rabobank	31/12/2014	0.67%	7.99%	5.60%	\$ 91.93	\$ 100,000.00
Swiss Re	25/05/2017	1.17%	10.90%	6.93%	\$ 79.38	\$ 100,000.00
National Capital Instruments	30/09/2016	0.95%	7.66%	5.89%	\$ 91.12	\$ 50,000.00

*Assuming 3% inflation

Source: FIIG Securities

Note: Yield to maturity is calculated based on swap rate expectations

Wholesale investors have a much greater range of securities available to them. Anything French seems to have investors concerned, yet the French government credit rating of AA+ is the same as the US and we think investor nervousness overstates the risks involved.

The AXA SA bond is showing a very attractive yield to maturity of 13.56%, reflecting this company's exposure to French government bonds, among other things. However, AXA SA was profitable throughout the GFC and has a very strong underlying business giving us confidence in their Tier 1 bonds. While there is risk involved, I believe the return offered outweighs the risk involved.

Societe Generale (SocGen), which I've mentioned in past Eureka Report articles, is offering a high yield to maturity of 7.83% (down by about 1% in a matter of weeks, meaning the bond prices have risen) for senior debt. BNP Paribas, perhaps the strongest of the French banks, is still showing a yield to maturity of over 7% for a senior bond with a March 2015 maturity date.

A diversified portfolio should contain an allocation to fixed, floating and inflation-linked bonds. If your portfolio is dominated by fixed rate bonds, now may be the time to consider shifting the balance if you think BBSW has hit its low point in the cycle.

Note: All prices and yields are a guide only and subject to market availability. FIIG does not make a market in these securities.



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