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Philip is a columnist for *Smart Investor* and former bond trader who identifies opportunities and threats for investors every month.

YIELD

New bonds on the block vie for attention

The number one wish of investors is to find a decent-yielding security at a reasonable price. Two new issues at the smaller end of the market aim to fill that gap, writes **Philip Baker**.

Similar to governments around the world, big companies issue bonds to finance their spending. But it's been unusual for small Australian investors to be given the chance to invest directly in a company's bonds.

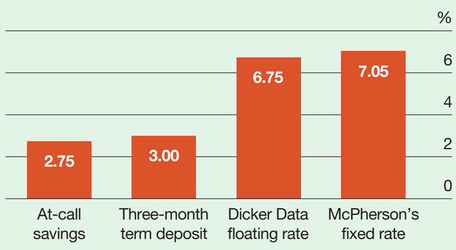
That is slowly changing and over the past month FIIG Securities, a fixed-income specialist, has helped companies such as Dicker Data and McPherson's issue $100 million worth of bonds.

If you're in a bond fund you're probably already exposed to a range of corporate bonds. Most larger companies will have bonds in the professional market, such as Telstra Corp and BHP Billiton, but it's a different story for smaller companies. In the past they may have got their funding from a bank, perhaps through a syndicated loan or by a line of credit. But new capital rules mean that can be expensive, so more and more companies are issuing direct to the market.

Dicker Data, via its launch of a $40 million five-year floating rate wholesale bond, and McPherson's, with a $60 million issue, are making corporate bonds available to retail investors – and they pay a decent interest rate.

Some corporate bonds are rated by a credit ratings agency but not all, and these are two examples of ones that don't get a rating. That doesn't mean they are risky; sometimes a company doesn't want to pay the fee to get rated. What it might mean is it's harder for retail investors to get a handle on the risks they are taking. But they do get a decent yield. Dicker Data bond investors will get a margin of 440 basis points over the benchmark borrowing index, which will deliver a first coupon payment of 6.725 per cent and an estimated yield to maturity of 6.9 per cent.

RISK-FREE RATE v SMALL BOND ISSUES



Source: FIIG, Canstar, InfoChoice

This is a floating rate note and will mature in five years. Such notes are a good idea when rates are rising, but not when they are falling. If the Reserve Bank keeps cutting the official cash rate, investors might end up with a lower yield than when they bought them.

McPherson's is doing a mixture of fixed and floating rate notes. Investors will receive a quarterly coupon of 7.05 per cent on the fixed rate note which matures in six years, and on the floating rate note investors will get 430 basis points over the benchmark borrowing index rate for four years.

Both McPherson's and Dicker Data bonds have a minimum initial investment of $50,000 and are only suitable for sophisticated or professional investors.

The return from a corporate bond depends on the creditworthiness of the issuer and the duration of the bond. Most issuers are rated by agencies such as Moody's or Standard & Poor's and the rating reflects the company's financial strength. Westpac, for example, rated AA by S&P, is considered financially stronger than Qantas at BB+, so bonds from Qantas would pay a higher return than those from Westpac to reflect the additional risk.

The return from bonds, or the yield, is also affected by external factors such as rising interest rates. A raft of bonds have done well over the past year as yields have collapsed but this has almost been by accident, as central banks have bought all sorts of bonds to keep yields, and borrowing costs, at record lows.

It's important to understand that a higher potential yield also comes with a higher risk. Investors need to be clear on what they're taking on before investing in flashy new funds or structures. But with interest rates so low and investors around the world chasing any sort of yield, bond investors have two choices: either accept lower and lower yields, and therefore returns, or take on more risk.

Overseas investors are piling into emerging markets, while energy companies have issued record amounts of bonds despite the fall in the oil price. But with yields at close to 30-year lows investors should concentrate on the higher-quality segments of the market.

Bond-buying by central banks can, for a time, mask any drop in the credit fundamentals of some sectors. Companies that at other times would not be able to tap capital markets find that they can.

Fund managers such as Kapstream Capital, which looks after $6 billion in bonds, favour higher-quality positions for its portfolio. It prefers companies with "robust and visible cash flow, underlying collateral, monopoly positions and solid ownership structures". The fund says it would be happy with returns of about 4.5 per cent to 5 per cent in future. sm