Corporate Bonds

REIGNITING THE BOND

Australia's corporate bond market has long been in the shadow of international heavyweights, but new opportunities are starting to emerge, even in the historically-grounded retail market, **Malavika Santhebennur** writes.

THE AUSTRALIAN CORPORATE bond market has been slow off the mark compared to its global counterparts, especially the United States.

But it is starting to gradually mature.

This has particularly been the case with domestic issuance by lower-rated entities, and has been spurred on by recent developments in market infrastructure.

Australian companies have customarily borrowed from financial intermediaries such as banks and finance companies, and the big companies have borrowed through market instruments since the Wallis Inquiry.

According to the Reserve Bank of Australia's (RBA) submission to the Financial System Inquiry in March this year, corporate gearing has stayed on the lower side since the early 2000s compared to other countries, although it did climb in the prelude to the global financial crisis (GFC) and immediately afterwards.

One reason the corporate bond market has not picked up in Australia is due to its dividend imputation tax system, which results in the lowering of cost of equity compared to debt.

Many Australian companies have accessed offshore funding markets, with around three-quarters of corporate bond issuance conducted offshore. Much of this has been denominated in US dollars, which is testament to the size and depth of the US bond market.

Through this Australian companies can match the currency of their revenues with their interest payments.

In a speech to the Economic Society of Australia in April, assistant governor (financial markets) Guy Debelle said Australian corporates had good access to bond markets in the domestic and offshore markets, raising $35.1 billion of new bonds since the start of 2013, but this was less than in 2012.

In 2012, this was mostly driven by the large Australian miners as they were able to access the market at as low a cost as banks.

Resource companies like to borrow directly from capital markets for their external financing requirements.

"As these companies have reduced capital expenditure, their need to tap the bond market for long-term funding has declined, leading to a drop-off in their bond issuance," Debelle said.

The corporate bond market is expected to hit $775 billion by June 2015.

Debelle noted the main change in the corporate market over the past year or so has been the increase in lower rated issuance into the domestic market, at longer maturities compared to the past.

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He said while domestic tenors still lag behind those tenors at which corporates raise bond funding in offshore markets like the US, this is a good thing as it illustrates the ongoing maturity of the domestic market.

BBB+ and BBB- rated Australian corporates preferred seven-year maturity for domestic issuance, with $2.2 billion raise by nine issuers across 10 bonds.

Many investors are looking for a way to achieve a safe income stream and preserve capital value over a long period of time.

This is especially the case among ageing investors, who, by weighting investment portfolios more heavily towards fixed income investments instead of equities, can decrease the risk of putting a major dent in their savings that cannot be undone before retirement.

The key characteristics of corporate bonds make it an important asset class to include for investors as part of their diversified portfolio. They offer a stream of coupon payments and return of principal on maturity.

The investor will collect future cash amounts of which they are aware at the time of the initial investment. While coupon interest amounts in individual bonds are tiny compared to the principal repayment at maturity, investors can design a relatively stable stream of payments by investing in a range of bonds with different maturities compared with shorter term cash holdings.

Of course, the risk with this is the company could fail and cannot fulfil the promises of providing the income stream.

KNOWLEDGE IS THE KEY

While the Australian corporate bond market is behind its overseas counterparts, especially the United States, one industry analyst said investors are showing keen interest to invest in them.

But what's stopping them? Knowledge.

Senior analyst at market research house Investment Trends Recep Peker referred to the Investor Product Needs report from November last year, which surveyed 10,421 Australian investors.

The analysts looked at the corporate and government bond market and, using the sample, modelling, and real life data, found that there are 24,000 current corporate or government bond investors, and an equal 24,000 investors who were looking to invest in 2014.

Out of the 24,000 who hold bonds, 78 per cent hold corporate bonds, and are the most commonly held form of bonds.

Of these, 59 per cent invested in corporate bonds for diversification, 52 per cent did it to get the fixed interest or

Continued on page 16

coupon rates with consistent returns, and 42 per cent said it is a good balance of risk and return.

Peker said that while some Australian are waiting for higher returns before investing in corporate bonds, the bigger issue is that people want adviser recommendation or education.

Among the 24,000 who were willing to foray into their first corporate bond investment in 2014, 60 per cent said they need recommendations from financial advisers.

"They're saying if I understood them better or if an adviser recommended it to me, then I would make my first investment to bonds," Peker said.

But as investor appetite for growth assets made a comeback in 2013, financial planners seem to be diverting their attention to advising on managed funds and listed investments.

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– Tim Murphy

HOW DOES IT LOOK ON PAPER?

AMP Capital corporate bond fund co-portfolio manager David Carruthers said the corporate balance sheets are in good shape at present.

He said previous earnings season cycles have suggested corporate fundamentals are very supportive.

But he noted that interest rates are likely to increase over time as the economy improves, which may put pressure on fixed rate corporate bonds.

"As a house, the way we manage corporate bonds at the moment is we're reducing our interest rate exposure," he said.

"We're shorter duration, which means that we're trying to protect from a rising interest rate environment."

He noted the RBA has been reluctant to prepare the market for a higher interest rate too early. But as a fixed income house, Carruthers said AMP expects an interest rate rise around mid-2015, with markets starting to price in higher yields by about 25 basis points or so.

"I guess corporate bonds are supported because the interest rate cycle is kind of telling you it's not too hot and it's not too cold to some extent."

Director of debt markets at National Australia Bank (NAB) Mark Todd does not think interest rates are going to move any time soon and noted that there is more downward pressure than upward pressure.

He said it is hard to predict as it is dependent on what the US does with its interest rates.

Because it is difficult to guess where rates will ultimately settle, Todd tells his clients to buy a combination of fixed and floating rate bonds.

"If you are of the view that interest rates are going to go up, you might not want to buy a fixed rate bond. If interest rates go up tomorrow the valuation of that bond, the price at which you sell it should diminish because you have a higher interest rate setting," Todd said.

"If you bought a floating rate note and interest rates go up, that will increase in value because they're getting a higher return.

"What tends to make some sense to that portion of the portfolio that you're looking to build out the cash price, you should buy a combination of fixed and floating."

Because it is difficult to control the impact of inflation on a client, Todd also recommends inflation-linked bonds, so that it is linked to that inflation and can hedge some of those costs to the client.

Altius Asset Management senior portfolio manager Chris Dickman said corporate balance sheets are in a good position, and he does not think there is a huge amount of supply that is going to hit the market to push yields higher.

He believes yields in the US treasuries will probably push higher later this year.

"You've seen this huge grab for yield, carry trades and all these sorts of things," he said.

"The way I think of carry trades is they're a leveraged version of scrap yield. People borrow in a low yielding market and go and buy assets

in a high yielding market and take the high yield. Also, to some extent, as stocks move closer to maturity so too do they accrue capital gains by rolling down the yield curve."

He said swaps are at very tight levels with little buffer between those yields and that of Commonwealth government bonds.

Corporate bonds usually offer a higher expected return than government bonds but it must be noted that corporate bonds have a higher correlation to equities than government bonds.

Morningstar director of manager research Tim Murphy said the idea of having growth and defensive assets as part of a diversified portfolio is so that one is working when the other is not.

But if all of the defensive part of

Continued on page 17

the portfolio is allocated to credit, this part of the portfolio is unlikely to hold up as well in a big market downturn as if it were oriented more towards government bonds.

AN UNBRIDGED GAP

An area that is yet to take off is retail investors' access to corporate bonds. A NAB report on corporate bonds argued that because most bonds trade over the counter in the wholesale markets rather than on the Australian Securities Exchange (ASX), it has been a hurdle for retail investors to access it.

Murphy said individual investors are leaning towards the hybrid securities market, where they are hybrids of debt or equities, which varies depending on the structure.

Hybrid securities have offered healthy yields, especially from the major banks, and individual investors are chasing these yields, he said.

The benefits of issuers going into the retail market do not outweigh the burden of going through the process of issuing a product disclosure statement and the costs involved in that, he said.

"Particularly where credit spreads are now, the yields that the corporate issuer can offer to a retail investor to get them involved aren't what they were three or four years ago," Murphy said.

"A combination of lower yields as well as the cost of issuing that to issuers means you're probably unlikely to see a massive pick-up any time soon in the direct bond market for retail investors."

He said advisers typically use managed funds to expose clients to the retail market, and advisers invest in that on the client's behalf.

Funds have generated good returns in recent years because credit exposure has been a good place to be where clients have the income as well as some capital gains from investing in recent years.

Murphy added that credit spread, the yield that is earned on credit, has contracted in recent years since the global financial crisis, going back to levels that were in 2006 and 2007.

"The yields now available are lower and the question is are you getting paid for that additional risk? There's a bit of debate out there in the market about that," he said.

Todd is hoping the passing of the Corporations Amendment (Simple Corporate Bonds and Other Measures) Bill in August will result in investors having access to a more simplified prospectus, which means they will be able to buy corporate bonds on different exchanges.

Access to corporate bonds by retail investors will be aided by the use of the CHESS Depository Interests (CDI) mechanism, which is a beneficial interest in a simple corporate bond.

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>
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This is where issuers meet the criteria and the underlying bonds are held in ASX's wholesale debt securities platform Austraclear.

Todd said that with the advent of the superannuation system in the 90s, there is a bigger pool of money at present, and there is a need to find other assets to service the amount of money that is in the market.

"It's more a combination of investor need, issuer need, companies wanting to issue, investors wanting to buy, organisations like NAB wanting to facilitate, and the government creating legislative changes," Todd said.

But Aberdeen senior investment manager John Manning believes the legislation is not going to have an impact on the retail bond market in the immediate term because corporate Australia currently does not need a lot of funding.

"The last thing we want is corporate issuing debt for the sake of issuing a bond market. We want them to be issuing debt when they have good reasons for raising funding," he said.

Corporate Australia has extended its debt maturity profiles over recent years and they have taken the opportunity to lock in low interest rates, and they have shown restraint in pursuing aggressive growth strategies, Manning said.

He argued retail investors have not got their heads around the structural complexities of what is being sold as retail bonds over recent years.

"There's a high degree of subordination and the difference between one instrument and the next instrument is complex and it can't be ignored," he said.

"That's a challenge that all investors face when it comes to these hybrid investments because they are available to these institutional investors and I don't think that the retail bond market or the retail hybrid market have adequately understood those risks."

COMPANIES TO AVOID

Manning suggests retail investors should define their own risk parameters to understand where those risk parameters are reflected appropriately in the market.

If investors are looking at volatile or highly seasonal businesses, they should be aware the cash flows generated by that business and the risk profile will be volatile.

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Todd said investors generally favour ASX-listed companies because of the continuous disclosure rules, and because the bar is raised in terms of due diligence.

While he does not bar the purchase of bonds from ASX-listed companies, he does stress the need for greater clarification on how investors will be paid, what access to assets they have got, and what covenants and protections the bonds will have. MM