SPECTRUM ASSET MANAGEMENT

Damien Wood, Principal

Spectrum Insights

JUNE 9, 2015

Corporate bonds – the new frontier for retail investors

Investing in corporate bonds, otherwise known as notes or debentures, can help Australian investors spread their risk and reduce volatility in their overall investment portfolio. In the past, investor access to this market was restricted to large investments or through fund managers. Nowadays, investors can access corporate bonds via a fund on the mFunds platform or, increasingly, via the Australian stock market. Spectrum Asset Management believes Australian investors will make corporate bonds a larger part of their portfolios as access improves and understanding increases. In this report, we describe corporate bonds and why it can be a relatively safe investment. We will publish future reports on valuation and diversification benefits.

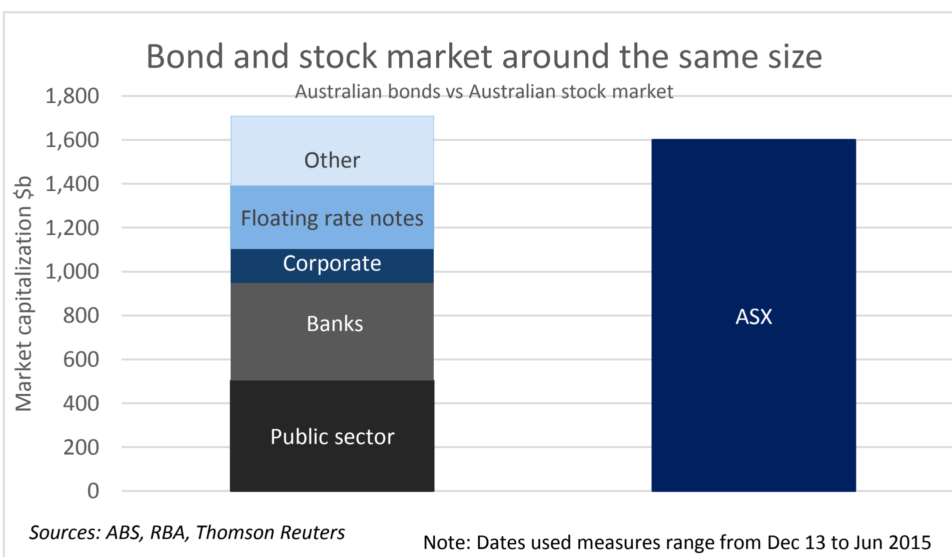
Corporate bonds often provides investors with an income stream that is above deposit rates, but less risky than dividends and capital gains from equities

Why invest in corporate bonds? – Safety

In sum, corporate bonds often provides investors with an income stream that is above deposit rates, but less risky than dividends and capital gains from equities. Unless the company defaults, the investor will get back all the money originally lent to the company.

The Australian corporate debt market

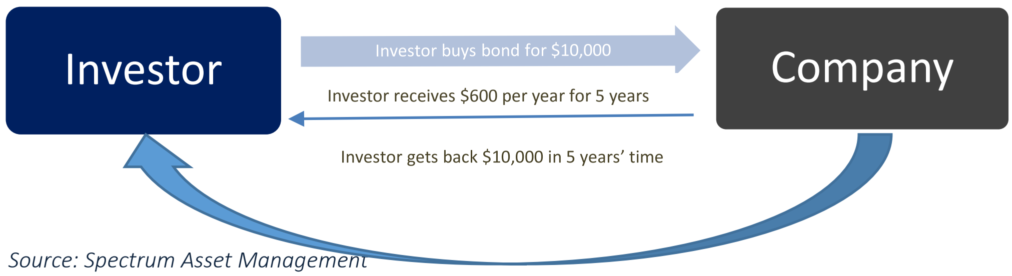
While it does not get the same media coverage as equities, the domestic bond market is arguably as important as the local stock market. For example, the Australian tradeable debt market is around $1.7 trillion in size. Taking out the government-linked debt, the size is around $1.2 trillion. The Australian stock market is comparable, at around $1.6 trillion.



What is corporate debt?

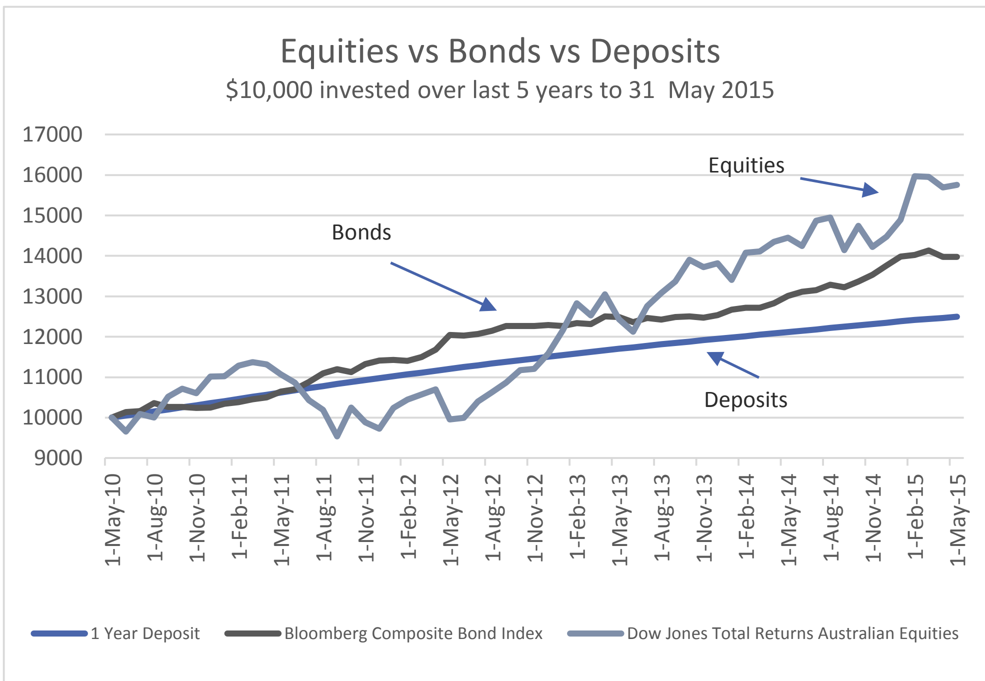
When a company wants to borrow money from investors rather than borrow from a bank, it issues these investors IOUs or corporate debt. Likewise, a bank issues debt rather than collect more deposits. For corporate debt, there is an agreed interest payment and a set time to repay the IOU, much like a typical loan from a bank.

A typical bond - 5 years length at 6% p.a



Source: Spectrum Asset Management

Returns compared

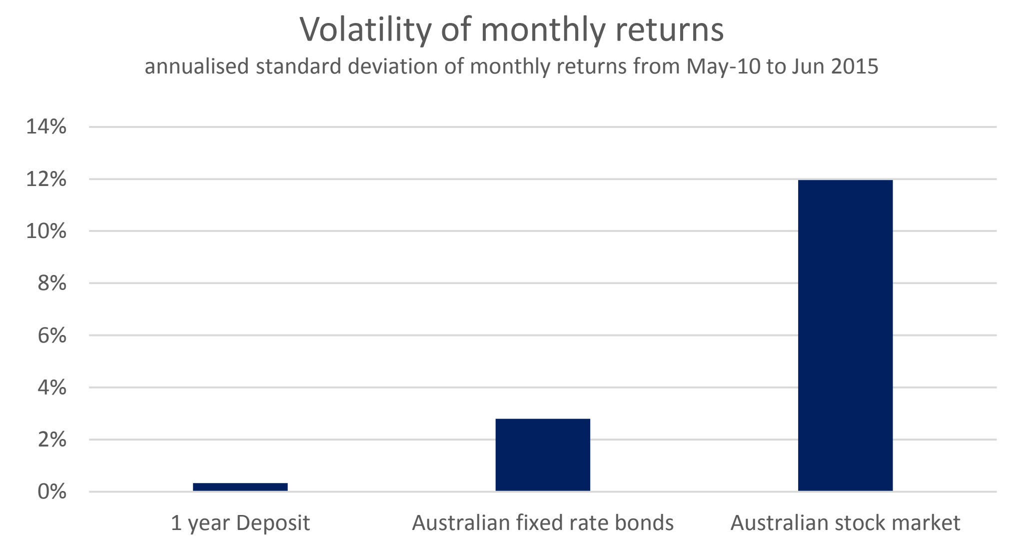


The graph above outlines the returns of $10,000 invested five years ago. We compare the overall Australian stock market returns with the composite fixed rate bond index and one year deposits. As shown in the graph, equities have outperformed bonds which, in turn, have outperformed deposits. This outperformance, however, was accompanied by greater volatility.

Risks compared

Return volatility and risk are two sides of the same coin. One way to look at how risky an investment may be is to look at how volatile its returns have been in the past. Below, we graph the annualized standard deviation of the monthly returns of the different asset classes since May 2010.

As to be expected, the variability in returns is low for deposits. Investors may note that the returns are also reasonably steady for bonds as opposed to equities.

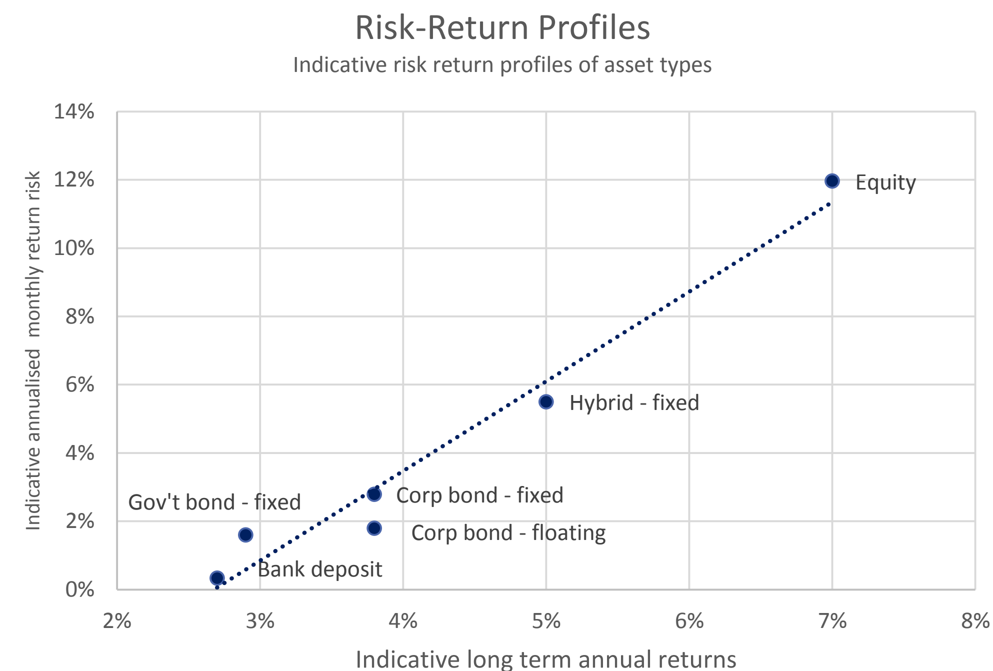


Sources: Spectrum Asset Managemement, Thomson Reuters, RBA

The risk-return trade off

As with many things in life, there is a trade-off between risk and return. For example, you can get steady returns from deposits, but the long term returns tend to be below those of equities.

Below, we plot some of the volatility results from the previous graph against plausible *(1)* return outlooks for different asset classes. This is indicative only and actual returns will be different.



Source: Spectrum Asset Management

---

(1) The returns take into consideration current yields for bonds, FRNs, deposits and the long term returns for equities.

Why corporate debt is less risky than equity

For any company, its debt is less risky *(2)* than its equity or shares. The reasons are as follows:

- **Set interest payments:** for debt, investors get an agreed amount of coupons. The payment will either be a fixed amount or a fixed amount above a floating rate benchmark. Share dividends are made at the discretion of the company and can be cancelled, cut or raised from year to year.
- **Set repayments**: for debt, a set amount will be paid back and, in most instances, at a set time *(3)*. A company's share is perpetual. Hence, there is no need for the company to pay back the investment *(4)*.
- **Priority in liquidation:** if a company faces financial stress, it may go into receivership or liquidation. In either case, senior creditors have preferential rights over shareholders. In liquidation, an investor in senior debt of a company will often get back in the region of $0.30 to $0.60 for every dollar invested. In contrast, an equity investor would get back nothing or close to nothing in liquidation.

---

(2) In Australia, this is always the case. In most other countries, it is almost always the case. Some countries with less developed legal creditor protection may not offer lenders the same preference as they do in Australia. Spectrum only invests in Australian dollar securities.

(3) Most debt has a set time period. Sometimes the company has the ability to repay back earlier than the final maturity. For some bonds, under certain circumstances, the investor has the ability to put or redeem the bond earlier than the final maturity.

(4) For both debt and equity, these can be sold in secondary markets.

Risks of corporate debt

As noted above, corporate debt is usually a less risky investment when compared to equity. Corporate debt is, however, riskier than, say, government-guaranteed bank deposits. The key risks stem from the following:

- **Default risk:** if an investor buys corporate debt a major risk can be default of the issuing entity. The issuer may miss coupon or principal repayments and be wound up, leaving investors with far less than they originally invested.
- **Price risk:** corporate debt prices can move up and down. This volatility is usually much less than the share price of the same company. Factors that can cause price volatility are:
    - Government bond yield changes: As corporate bonds are benchmarked off the government bond yield, their prices will often move in similar proportions to the government bond market. Please note that floating rate note prices are far less sensitive to changes in government bond yields and, therefore, have less price risk.
    - Changes in credit spreads: the credit spread is the yield premium above the government bond yield. If the credit spread changes, the price of the note changes. The credit spread may change due to:
        - changing perception of the credit standing of the issuing company;
        - changing perception towards a certain industry or country that the corporate debt came from;
        - general market changes in appetite towards risk assets; and,
        - other factors driving change in supply or demand for corporate debt.
- **Liquidity:** an investor may not be able to buy or sell his or her bonds at the indicative price due to poor liquidity. Factors that generally drive liquidity are as follow:
    - Size: in general, the larger the bond issue, the more liquid it is.
    - Term: in general, a bond in Australia maturing in 3 to 7 years is more liquid than bonds outside this range.
    - Time from launch: bonds tend to be more liquid the nearer they trade to the launch date.
    - Frequency of issuer: the more times an issuer comes to the market, in general, the more liquid the notes become. This is because investors tend to trade along the issuer's "yield curve" and the market has a greater sense of what is "fair value" for the bond. Australian government bonds are an example of this.
    - Interbank or listed: investors who buy or sell a relatively large amount, say, $2m, may have trouble in trading the entire size in the listed market at around the indicative price. The interbank market typically provides superior liquidity for larger investment sizes.

How to judge the risks?

- **Creditworthiness:** as noted above, a key risk in investing in corporate debt is default or changes in perception of default by the issuing company. Creditworthiness is the term used to assess default risk. To help assess this risk, rating agencies such as Moodys, Standard & Poors and Fitch give opinions on the credit risk of a debt issue. These opinions are known as credit ratings. These ratings range from the highest Aaa/AAA, which is the current rating of the Australian government, down to D for default. The lower the rating, the greater the extra interest yield over the government bonds an investor is likely to get. Key drivers of ratings include the size and stability of earnings, the amount of debt the company has and the relative subordination of the debt.

The rating scale and examples

AAA/Aaa	- Australian government
AA/Aa	- ANZ, CBA, NAB, Westpac senior debt
A/A	- Coca Cola Amatil
BBB/Baa2	- Lend Lease
BB/Ba2	- Fortescue Metals Group
CCC	- Boart Longyear, Atlas Iron
D	

Source: Thomson Reuters, Spectrum Asset Management

- **Length of bond:** in general, the longer the time the company has to repay the bond, the greater the risk to the investor. This stems from two factors:
  - The greater the period until the bond has to be repaid, the greater the chance the company will encounter financial problems.
  - The other reason is duration. The longer the time period, the more sensitive the bond price is to a change in government bond yields or changes in credit spreads.

Different types of corporate debt

There are many different types of corporate bonds. Below, we outline the key types found in Australia at present.

- **Fixed:** These provide a fixed interest payment over the life of the bond. These are described in the annualised return, such as 6%. An investor typically receives half yearly coupon payments, which would be 3% of the face value of the bond in this case.
- **Floating**: corporate bonds with moving coupons are often called floating rate note or FRNs. Floating rate bonds make interest payments that are linked to a measure of interest rates. In Australia, this is usually the 90 day bank bill swap rate or BBSW. The investor in a corporate bond will also earn extra interest over this to compensate for the credit risk of the company. Coupon payments are typically made four times a year.
- **Senior unsecured:** this is the most common type of issue in Australia. The coupons can be either fixed or floating rate. In general, these notes repay the principal at a set time. In liquidation, senior notes have priority over subordinated creditors in claiming the general proceeds from the sale of the defaulted company's assets.
- **Kangaroos:** these are Australian dollar corporate bonds that are issued by non-Australian groups.
- **Hybrid:** these instruments share characteristics of both debt and equity. That is, they may have a debt-like commitment contingent on certain conditions being met. If those conditions are not met, the notes may change in their terms to become more like equity in their risk profiles. They can be either fixed or floating rate notes. Because of the partial equity nature, they tend to have higher credit spreads than the senior debt from the same company.

Examples

Below is a table with examples of some of the different types of corporate debt available in Australia. These are not investment recommendations.

Company	Coupon type	Seniority	Coupon	Type	Listed/Over the counter	Call date/Maturity	Indicative Yield to Maturity/Call	Moodys Rating	S&P Rating
Woolworths	Fixed rate	Senior unsecured	6.0%	Domestic	OTC	Mar-19	3.3%	A3	A-
John Deere	Fixed rate	Senior unsecured	3.5%	Kangaroo	OTC	Dec-19	3.3%	A2	A
ANZ	Floating rate	Subordinated	5.0%	Domestic	Listed	June 2017/22	3.8%	A2	A-
National Australia Bank (NBAPA)	Floating rate	Preference share/Hybrid	3.8*%	Domestic	Listed	2019/Perp	4.7%	N/A	N/A

Source: Thomson Reuters, NAB   * Does not include any franking credits.

How does one invest in corporate bonds?

Investor can buy corporate bonds either at the bond's launch or in the secondary market. This is similar to when an investor buys shares either in the initial public offering or via the stock market at a later date.

An increasing number of corporate debt is available either on the Australian Stock Exchange or via exchange traded bond units (XTBs). Most corporate debt in Australia, however, is currently traded in the institutional dealer market. This market typically trades in parcel sizes of $500,000 or larger. This size prevents many retail investors from directly participating in most issues in the market.

Like stocks, investors in debt may prefer to let a fund manager invest in the asset class. A key benefit to investors is the ability to diversify exposure and avoid having too much exposure in a small amount of companies. The ASX mFund platform has a range of corporate debt funds investors can access.

If an investor seeks to buy individual corporate bonds, they should consider seeking financial advice, including tax advice. There may be nuances in the bond documentation or credit standing of the company not covered in the discussion above which could impact on the bond's performance.

Spectrum Asset Management manages the EQT Spectrum Credit Opportunities Fund. This fund invests in AUD corporate securities of which the majority are floating rate notes. The intention is to make this portfolio relatively immune from the bond yield volatility which can, in turn, hit equity and fixed income markets. The fund is also designed to deliver an income stream while generating capital gains from time to time. For more information please go to our website http://spectruminvest.com.au

DISCLAIMER