Looking for income? Bonds are a true provider

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The fixed income experts

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1. Is BHP a good income stock?

In mid-2015 when I was presenting at a series of conferences, one of the other presenters was excited that he'd bought a new income stock – BHP Billiton for a bargain price of $25. The presenter was nearing retirement and was attracted by the 10% dividend.

Since then the share price has fallen to around $17 and this investor would have lost over 30% of the value of his capital.

Prior to BHP's recent results announcement, there was much speculation about a possible dividend cut. Commentators were questioning whether the dividend could be sustained and BHP CEO Jac Nasser said the company's balance sheet "must always come first", ahead of sustaining a progressive dividend.

Unfortunately, my fellow presenter who purchased BHP for its high income would have been devastated by its recent severe dividend cut of 75% from US62 cents to just US16 cents.

To my mind, BHP demonstrates the absolute necessity for investors to diversify into bonds, which are the true 'income provider'. No matter what happens in regards to profitability, bond income is a contractual liability and the company must make the payments or face serious consequences.

Capital is also preserved as the face value of the bonds is returned to investors at maturity.

Last year, BHP issued an equivalent USD6.5 billion multi-currency bond. The USD ten year fixed rate bond pays 7%* per annum fixed return or 3.5% per half year until first call in 2025. Investors in this bond have that certainty. I argue there is little doubt about BHP's 'survivability' and capacity to make the bond payments and return capital at maturity. However, share price and dividend 'growth' is in doubt resulting in significant uncertainty and price volatility.

Similarly, other strong commodity producers have reported losses and cut dividends. While a lower dividend is a negative result for shareholders, it is positive for bondholders, as the companies keep capital rather than distributing it and this supports ongoing interest and maturity payments. While growth may be in doubt for some of these companies, their capacity to pay interest remains strong. Below are some current bonds from BHP Billiton, BlueScope, Fortescue Metals Group and Glencore. To invest in these bonds, you need to be classified as a sophisticated or wholesale investor.

Company name	Currency	Rating	Maturity/ call date	Capital structure	Yield to maturity/call (pa)	Income (running yield)	Min face value parcel
BHP Billiton Finance USD Ltd	USD	BBB+	20/10/19	Subordinated debt	6.25%	6.25%	USD200,000
BHP Billiton Finance USD Ltd	USD	BBB+	25/10/19	Subordinated debt	7.02%	6.88%	USD200,000
BHP Billiton Finance USD Ltd	GBP	BBB+	22/10/22	Subordinated debt	6.96%	6.66%	GBP100,000
Bluescope Steel Finance Ltd	USD	BB	18/05/01	Senior debt	7.35%	7.16%	USD10,000
FMG Resources	USD	B+	19/11/01	Senior debt	11.04%	8.99%	USD10,000
FMG Resources	USD	B+	22/04/01	Senior debt	13.30%	9.32%	USD10,000
FMG Resources	USD	BB+	22/03/01	Senior debt	10.85%	10.24%	USD10,000
Glencore Australia Holdings Pty Ltd	AUD	BBB-	19/09/19	Senior debt	8.67%	5.14%	AUD10,000

Source: FIIG Securities

Note: the above rates are indicative only accurate as at 26 February 2016 and are subject to change. Bonds are available to wholesale investors only.

**Call date/yield to call*

2. SMSF concerns in 2016

Economic concerns:

1. *The state of the global economy, especially with Chinese GDP growth lower than expected.*
2. *Will interest rate rises in the US impact interest rates here?*
3. *As oil prices continue to decline, is deflation a possibility?*

Individual concerns:

4. *Income – low interest rates mean low deposit rates and low returns – SMSFs need to eke out as much income as they can but still be able to sleep at night.*
5. *Capital preservation.*
6. *Liquidity.*

How to use bonds to mitigate risk

In 2015, the domestic share market finished at much the same level as it started, delivering little to index investors. The start of 2016 has seen an 8% decline to the end of February, worrying SMSF investors, especially those planning on retiring in the next 12 months.

The **reliability and thus attractiveness of bonds** really comes to the fore in a declining share market. Locking in returns and preserving capital are the main benefits of bonds which is why they should be held by all SMSFs. They are **defensive assets** that provide slightly more risk than deposits for slightly higher **returns of around 1 to 2% per annum throughout the economic cycle**, although there are high risk corporate bonds earning as much as 15% per annum.

Holding a portfolio of all three types of bonds – fixed, floating and inflation linked bonds - will help protect a portfolio against the risks listed above.

Fixed rate bonds will deliver a known income stream and protect a portfolio against further cash rate cuts and deflation.

The income paid by floating rate bonds is adjusted quarterly and moves up and down according to market expectations, thus protects when interest rates move higher.

Inflation linked bonds have unique properties and given inflation is a key risk in retirement; they should be an essential component in an SMSF.

All bonds help preserve capital, given they provide a known future date when you receive your investment back in cash.

For more information on how bonds mitigate risks in a portfolio please see other resources listed at the end of this paper.

3. Bonds come in many shapes and sizes

The global bond market is around twice the size of the global share market, making it crucial to understand even if you or your clients never invest in it.

Bonds are a form of debt, so you might sometimes hear the market referred to as the 'debt market'. Being debt, bonds are a contractual, **legal obligation** and the entities issuing them must pay interest and return capital when they say they are going to or they face serious consequences.

On the flip side those obligations offer investors a lot of certainty. They know when they are going to be paid their interest and get their capital back.

Globally, governments are big issuers of bonds and the rates of interest they pay on the bonds are often used as benchmarks for other bond issuers.

In Australia, the Commonwealth government has around $350 billion dollars outstanding in bonds. All the states and territories issue bonds, as do many companies. The beauty of Australian dollar denominated bonds is that big international companies also issue them such as Apple, General Electric and Intel as do some joint venture infrastructure companies not listed on the ASX, making them **ideal for investors looking to diversify** their portfolios.

Being a global market, bonds are issued in many currencies. USD, Euro and GBP are very large markets. Australian investors also have access to direct investment in these bonds.

The vast majority of bonds are traded in the over-the-counter (OTC) market. A broker or dealer works to match the buyer and seller to enable the transfer of ownership. There are a limited number of bonds available through the ASX.

4. Bonds are safer than shares in the same company

Property investors know and respect the mantra; location, location, location. In bond and fixed income markets, the equivalent of location is 'seniority' in the capital structure, which determines who gets paid out first in the event of a company wind-up.

The **seniority, or rank in the company's capital structure, is crucial in determining whether the return offered adequately compensates** the investor for the risk involved. Every bank and company has its own capital structure and it is legally binding.

In the event of wind-up or liquidation, funds are paid to the most senior investor in the capital structure (senior secured debt) first and these investors must be repaid in full before any funds are paid to investors on the next level down. In turn, each level must be repaid in full before funds are apportioned to the next level below. The higher your investment sits in the capital structure, the lower the risk.

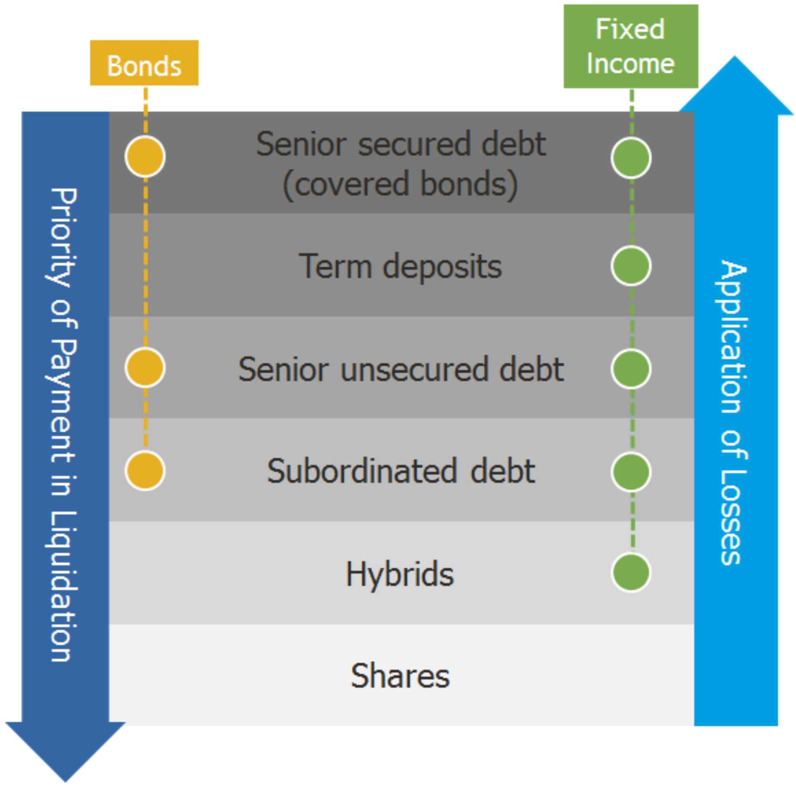
Investments at the top of the structure have known interest and maturity dates. Companies that miss paying interest or principal face serious consequences.

Moving down through the rungs, terms and conditions change and there is less certainty. Interest can be deferred or not paid at all, while maturity dates can be extended or become perpetual where there is no obligation to return principal to the investor.

Investments lower in the structure do not offer the same certainty and are thus higher risk, and should offer higher returns to investors. For example, there is no obligation for companies to pay dividends to shareholders. They can be cut without any serious consequences and there is no repayment date for shares. Shareholders must sell to recoup capital. This uncertainty needs to be adequately rewarded with higher returns.

In liquidation, losses are applied from the lowest level up, making shares the 'first loss' and highest risk investment in the capital structure. Each rung from the lowest up must be 'wiped out' before the next rung up on the ladder takes any loss.

However, new Basel III regulations mean bank hybrids can convert to shares on breach of a capital trigger and bank subordinated debt and hybrids can be deemed "non-viable" by APRA and also converted to shares. These conditions increase the risk of the new style investments and need to be compensated through higher returns. In essence, the regulations are to ensure the bank maintains sufficient capital for its operations and they protect investors sitting higher in the capital structure (see the simplified diagram below).



Source: FIIG Securities

Bonds are issued at three different levels in the capital structure: senior secured, senior unsecured and subordinated debt, whereas the fixed income asset class also includes deposits and hybrids.

Risk has a direct relationship with reward. The higher the risk of a security the greater the expected reward. Investing a high proportion of your capital in the highest risk category, which is shares, can expose your portfolio to loss in a cyclical downturn. Investors need to diversify investments to protect their income and capital. Bonds generally lower the risk of your overall portfolio and help to preserve capital.

5. Three types of bonds for every economic climate

There are three different bonds that work best under different economic conditions:

1. *Fixed rate*
2. *Floating rate*
3. *Inflation linked*

It is important to hold an allocation to all three bonds for protection and diversification. However, the weighting may vary depending on the investor's view of interest rates.

5.1 Fixed rate bonds

A fixed rate bond is a security that pays a **fixed pre-determined rate of interest** (known as a coupon). A fixed rate bond's interest rate will be set at the time of issue and will not change during the life of the bond.

Fixed rate bonds add interest rate 'risk' to your portfolio in that the only way these bonds can reflect changes in market expectations of interest rates is through a change in the price of the bond. If interest rates fall, fixed rate bond prices will rise. The opposite is also true, if interest rates rise, fixed rate bond prices will fall.

5.2 Floating rate bonds

A floating rate bond or more commonly termed a floating rate note (FRN) is a security that pays **interest linked to a variable benchmark**. In Australia, the benchmark is usually the bank bill swap rate (BBSW) which moves up and down (or 'floats') with movements and expectations of the RBA cash rate.

Interest on FRNs is set as a fixed margin over the benchmark. For example, the interest rate on the Rabobank senior floating rate bond with expected maturity of 11 February 2020 is quoted as 3 month BBSW + 1.05%.

The interest for the quarter is determined at the start of the period by applying the margin to the underlying benchmark on the first day of the interest period. In the case of the Rabobank FRN, the benchmark BBSW was 2.385% on the day of first issue so the interest for the first quarter was 2.385% +1.05% = 3.435% per annum equivalent.

At the start of the second quarter, the benchmark BBSW rate is reset and the same 1.05% margin added to calculate the interest payment for that quarter, and this process continues on a quarterly basis until maturity.

5.3 Inflation linked bonds

There are two major types of inflation linked bonds:

1. Capital indexed bonds (CIBs)

2. Index annuity bonds (IABs)

An inflation linked bond is the only security (fixed income or otherwise) that provides **a direct hedge against inflation** and therefore should feature in most investment portfolios. Major issuance in Australia is through the Commonwealth government and state government programs as well as a number of banks and corporations. The majority of these are structured using the CIB model; however, there are a small number of government and particularly infrastructure private public partnership IABs in the market.

Capital indexed bonds

The indexing of this CIB bond occurs quarterly on the capital or principal amount of the bond, which is repaid at maturity. The indexation factor is usually based on the rate of inflation represented by the Australian Bureau of Statistics' Consumer Price Index (CPI).

Interest is payable, generally quarterly, on the then current indexed capital amount at a fixed coupon rate. As indexation increases the principal value of the security over time, the amount due at maturity becomes greater.

During periods of negative inflation the coupon will be paid on a decreasing principal. However, under the terms of bonds issued by the government to date, the minimum return of the original capital value is guaranteed.

Indexed annuity bonds

Index annuity bonds are a stream of principal and interest payments, so that principal is paid off gradually over the life of the bond. This can be contrasted to CIBs that pay an indexed capital amount at maturity.

The ability to access the capital invested to increase your income over the life of the bond is especially beneficial in a low interest rate environment and an alternative to increasing risk for greater income.

Infrastructure companies are common issuers.

6. How to access the market

There are a number of ways investors can access the market:

Direct

1. *Direct bonds - over-the-counter (OTC) market*
2. *Managed Income Portfolios – OTC*
3. *ASX listed – Government bonds and three corporate bonds*

Indirect

4. *XTBs - units in a trust (similar to managed funds and ETFs) with each class reflecting individual bonds held in a sub-class, and listed on the ASX.*
5. *Managed bond funds - units*
6. *Exchange traded funds that invest in bonds – units*

While Australian investors have lower allocations to bonds than their global counterparts, there is a growing appreciation of the asset class and the benefits of investing direct.

Direct investment provides control over decisions like the desired overall income, return, cashflow and the maturity dates of the bonds, not to mention choice of companies.

Importantly, by investing direct the client receives all of the income when it's paid either quarterly or half yearly rather than waiting for the fund manager to make a distribution. Investors also have the benefit of being repaid when bonds mature as opposed to having to make a decision to sell and accepting the unit price at the time of sale.

The vast majority of the global bond market is traded over-the-counter (OTC) which means that trades do not take place on an exchange but are negotiated directly between buyers and sellers through a fixed income dealer or broker. An investor will contact a dealer or broker who will source the bonds, then relate yields and prices to the investor. An investor can select a particular bond based on their preference for issuer, coupon (interest), maturity and yield and request an offer yield or offer price for that bond, which is the yield at which the dealer will sell that bond to the investor.

Similar to buying and selling shares, investors contact their dealer or broker and place a buy or sell request. Depending on the bond and the number of buyers and sellers in the market, the fixed income dealer or broker will process your transaction. Dealers generally act in principal, that is, they sell the bond to, or buy it from, you.

No commission is paid on buying or selling bonds when using a dealer, rather dealers make a margin by buying and selling at different prices and acting as principal. In most cases, there is no stamp duty on bonds but generally tax is payable.

To learn more, go to http://www.fiig.com.au

Have a look at the bond news website http://thewire.fiig.com.au/

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