

## BANFIELD ON BONDS

Are you having sleepless nights worrying about how your share portfolio is performing? Are you looking for increased regular income from your investment? Are you nearing retirement and wary about capital retention? Do you have money in term deposits or debentures and enjoy the security these investments offer but would like to capitalise on movements in interest rates?

An investment in the debt market could be the solution you're looking for.

Many of you will be aware of the risks and benefits of investing in equity (shares) but you may not be aware of the same when it comes to investing in debt. Some of you may have a debt investment in the form of a term deposit or savings account at the bank without even realising it!

Here on the Direct Broking wholesale desk, we often see a lack of awareness surrounding the role debt investments can, and should, play in your investment portfolio. The buying and selling of fixed interest investments - such as bonds, capital notes and hybrid securities on the secondary market - is commonly overlooked.

### *Lost Already?*

Well fear not! Coming up are a series of articles that will explain what debt is and how it can work for you.

- Part I** This will discuss the basic distinction between debt and equity, and look at various investments available in the market.
  
- Part II** This will cover the importance of due diligence and the risks involved in investing in debt.
  
- Part III** This will walk you through the basics of valuation, including the concept of 'swap rates' and the role these play in determining the market value of your investment.
  
- Part IV** The final instalment will put all the above together and show you how to create a fixed interest portfolio. This will include showing you how you can capitalise on movements in interest rates by maximising or minimising the interest rate sensitivity of your portfolio.



**BANFIELD ON BONDS**

**PART I – DEBT SECURITIES EXPLAINED**

As an investor you may be asking... 'Well what is debt?' Or, 'what is equity for that matter?' And thirdly, 'is debt right for me?'

Let's look at the definitions of debt and equity. Even if you aren't aware of debt as an investment, you will most likely have some familiarity with debt as a borrower e.g. personal overdraft, credit cards, or a home loan.

Those with home loans probably acquired funding through a bank, or similar, and are now required to make regular repayments to cover interest as well as the actual amount borrowed.

How does this relate? Well this funding from a bank, or otherwise, used to purchase your property, is **debt**.

Because the bank will generally not lend the total value of the property you, as the investor, need to put up some money yourself. This amount forms the **equity** in your property purchase.

Although this example places the bank as the lender (investor) and individual as borrower (issuer), the principles of debt remain.

*We define an investment in debt as a loan for which the lender (investor) requires regular payments from the issuer (borrower), to compensate for the use of money.*

**What's the difference?**

Why do my returns differ depending on whether I am an equity or debt holder?

Well, to look at the property example again, we all know the bank (as a debt investor) requires regular payments whereas the equity investment (your investment in that property) does not.

As compensation the equity holding comes with ownership rights and will benefit from any increase in the price of the property – something the debt holder (bank) does not benefit from.

However, if the property decreases in value the bank – as a holder in debt – will still require the same regular payments to service the loan while the equity portion will become worth less.

These fundamentals also apply to an investment in a company. Holding **shares** equates to holding a portion of ownership that entitles the investor to a proportionate vote in company decisions and a share in any future profits.

A holding of **debt** in a company does not share in the profits of a company but, in the same way the bank's investment in your property will continue to require regular repayments; your debt investment will continue to generate regular cash flows. This will occur regardless of the company's performance, unless that issuer is unable to meet its financial obligations.

What we have just established is that there is a different level of risk in each of these classes of investment. It is for this reason that an investment in debt does not achieve the level of returns potentially available to an investment in equity.

Is debt right for you? At Direct Broking we believe it is financially prudent for all investors to hold a mixture of all asset classes, including both equity and debt, to help diversify risk.

While share ownership can reward holders with significant gains, these equity investments can be impacted significantly on the downside.



**What's the difference continued...**

Because the characteristics of debt often begin to align with the needs of a retiring investor – capital preservation, regular income and low risk appetite - a gradual transition from equities into debt as investors move closer to retirement is prudent.

However, debt can also play a role for the investor with a specific short term period of investment who does not want to risk the volatility of the share market. This is a particularly important point as many investors do not realise the alternatives available to a term deposit at the bank.

*Debt can help reassure investors with a greater certainty of returns which shares cannot provide.*

**The Issuers of Debt -**

Ever since trade and industry have occurred there has been a flow of capital between various market participants. Traditionally, banks have primarily been the intermediary facilitating the flow between those participants.

This flow occurs because in the same manner that individuals need money – as we discussed earlier in our property example - a company needs money to expand its business and the government needs money for everything from infrastructure to social programmes.

With the advent of a Debt Facility on the New Zealand Stock Exchange in May of 1993, a new debt market was created. This enabled retail investors to buy and sell debt securities in a secondary market.

This facility provides financial markets with liquidity and gives investors the ability to invest in more than just government bonds and bank term deposits. From the perspective of borrowers, it also provides access to a pool of funds provided by the retail investor.

The New Zealand Government, local authorities (such as local and regional councils) and corporates all offer a range of debt investment opportunities that are accessible to a retail investor.

The debt instruments, issued by the above to raise capital, often share a number of basic characteristics. These include a **principal**, (amount being lent/borrowed), an **interest rate** - commonly referred to as the coupon rate - (payments to be made periodically) and a stated term till **maturity** at which point the principal will be due for repayment.

In its simplest form, the bond described above is commonly referred to as "Vanilla" in structure.

This means the principal is invested (usually in parcel sizes of \$1000), interest is then paid to the investor (usually quarterly or semi-annually) and

then, at a pre-determined point in the future, the principal is repaid to the investor.

Before we move too far from here, we should note a shorter term bond instrument often issued by banks (including the Reserve Bank). Known as a **zero coupon bond**, this is an instrument which many of you may have invested in without being aware of it.

Bank bills, treasury bills and bank term deposits are the most common forms of zero coupon bonds. Commonly referred to as a discount instrument, this bond does not pay a coupon but rather, on maturity, the principal (including the cost of borrowing) is repaid. This instrument generally has a term of up to one year. (Confused? Not to worry, we will look at this further in Part III).

Although issuers often issue different instruments for various reasons, the instruments all share the same basic characteristics covered above. The structure of these various instruments is outlined below:

Bonds issued by the New Zealand Government, referred to as **Government bonds**, are the most actively traded bonds in the bond market. They are 'vanilla' in structure.

**Local authorities** also generally issue bonds that are 'vanilla' in structure and often attract a rating from one or a number of rating agencies (more about this in Part II). This is because if a local authority was to meet financial strife, there is an ability to raise rates to meet these financial obligations.

**Corporates** commonly issue the largest variety of instruments in the market. The more common instruments include:

- o **Corporate Bonds** - As described earlier these are often 'vanilla' in structure and are usually the highest level (seniority) of debt issued.



**The Issuers of Debt continued...**

- o **Capital Notes** - This instrument deviates from our 'vanilla' structure with regard to its maturity date, more correctly referred to as its election date.

This is because on this date a holder can be offered new terms for reinvestment which they can either agree to **or** elect to have the notes converted into an equivalent value of ordinary shares of the issuer.

If the investor chooses the latter, the issuer will then have the option to purchase the notes for cash at face value (repayment of loan) plus accrued interest.

Although in theory the issuer could never need to redeem the instrument for cash (by continually offering new terms or converting to shares (equity)) in practice, for a number of reasons, it would be rare for this to happen. So the most common outcome is for the investor to roll-over the investment or the issuer repurchases the securities from the holder for cash i.e. the investor receives their money back.

Capital notes are generally unsecured subordinated debt which rank below senior debt, but ahead of ordinary shareholders (equity).

- o **Debentures** - Debentures are an instrument most commonly used by finance companies acting as quasi-banks. The companies borrow from the public at a fixed rate for a fixed term, usually one to five years. Investors are usually protected by a debenture trust deed which imposes constraints on the behaviour of the borrower by securing the loan over the company's assets.

These assets are made up of loans issued by a company to its borrowing clients. For this reason, it is important to remember that the security is only as good as the value of these loans.

- o **Floating Rate Notes** - This instrument has all the normal features including principal, maturity and coupon rate. However, instead of fixing the coupon over the life of the investment it is periodically re-set.

This means that, depending on the frequency of resets, the return on the investment will always reflect current market interest rates.

This sort of instrument often creates a lot of confusion. However, many investors will have more knowledge of this instrument than they realise. Those with a savings account at the bank have a floating rate instrument in the sense that the rate paid maybe re-set every day or month.

***All the above instruments may vary from issuer to issuer so it is important to consult your broker and read the investment statement to ensure you are aware of the individual characteristics of a fixed interest investment.***

Over the next few issues we will look at some of the pros and cons of these various instruments and for what investment strategy they are best suited.

Coming up in Part II we will discuss the concept of risk versus return and the due diligence process that should be undertaken by any potential investor.

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