

## Power to the utilities

4:00 AM Sunday Feb 14, 2010

Over the past 12 months, a number of corporates have issued bonds to the public. These include Fonterra, Contact Energy, Vector, NZ Post, TrustPower and Watercare.

Investors have fully supported these issues as they offered attractive yields in an environment when bank deposit rates were falling. During the economic crisis, when most other asset classes were declining, these issuers offered name recognition and stability.



Utilities companies' shares have the same defensive characteristics as bonds from other stable companies. Photo / NZ Herald

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The recent announcement by The Warehouse that it was looking to issue \$100 million of bonds to the public highlights the clear investment appetite for bonds of stable, defensive companies.

Investing in these bonds for yield is a reasonably sound investment strategy but investors could also consider investing in shares of the same companies.

By investing in these bonds, investors are implicitly saying this company will survive, at least until the maturity of the bond.

The attraction of utility companies such as Contact, Vector, TrustPower and Watercare is their defensive nature. Even during recessions, people will tend to pay their power or water bills. These companies are therefore well placed to withstand the inevitable economic shocks.

However, three issues could derail this investment strategy: liquidity, tax and inflation.

Most investors expect to hold the bonds until maturity but plans can change and, regardless of your intentions today, an investor may not be able to hold the bonds until maturity.

In these circumstances, the investor can sell the bonds in the secondary market, although they are at risk of the market price being below the face value of the bonds. This will occur if interest rates rise or there is some concern around the viability of the company.

The advertised rate on these bond issues is also before tax. Typically, these are around 8 per cent, so for investors on a 21 per cent tax rate the after-tax yield is below 6 per cent.

New Zealand shares pay imputation credits, so an investor (unless they are on a 38 per cent tax rate) is not required to pay tax on the dividend they receive. In addition, all capital gains on New Zealand shares are tax free.

Inflation is the silent assassin for investors. At maturity you will get back the original capital, but the

purchasing power of this capital would have declined because of inflation.

The Reserve Bank of New Zealand is currently mandated to keep inflation between 1 and 3 per cent a year. Since the establishment of the Reserve Bank target in 1989, inflation has tended to average towards the top end of this range.

The average maturity of the corporate bonds issued last year was six years. Over six years, inflation at 2.5 per cent would reduce the purchasing power of an investor's capital by 16 per cent.

So at maturity, instead of getting back your original capital, in inflation-adjusted terms you will only get back 84 cents in the dollar. Another strategy worth considering is supplementing a bond investment with investment in the shares of the same companies.

For risk-averse investors, utility companies' shares have the same defensive characteristics as their bonds.

This means their dividends, in particular, are reasonably stable, even during economic downturns. In most cases, the dividends will be similar or higher than the yield of their corporate bond.

Investing in shares exposes the investor to the risk of share price changes. But if the investor is mainly investing for yield, share price changes should be largely irrelevant as the shares are held for yield, not capital gain.

Should circumstances change, the investor may have to sell their shares.

In these circumstances, their overall return will depend on the prevailing share price. But over time, the share price of a well-managed company would be expected to rise.

Therefore there is a high probability in six years' time the share price will be above today's price.

An investor following this strategy will therefore receive a similar yield to the corporate bonds and this yield should grow each year.

Well-diversified investors may want to follow both strategies.

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