Investment Insight

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INVESTING FOR YIELD

Over the past 12 months corporates including Fonterra, Contact Energy, Vector, NZ Post, TrustPower and Watercare have issued bonds to the public. Investors fully supported these issues as they offered attractive yields in an environment where bank deposits rates were falling. But while investing in bonds for yield is a reasonably sound investment strategy, investors could now significantly enhance their returns by switching some of their bonds into the shares of the same companies.

By investing in the recent wave of bonds on offer, investors have been confident that the companies would not default on any payments or reschedule these payments, and that they would receive their original investment back at the time of maturity.

The attraction of utility companies such as Contact Energy, Vector, TrustPower and Watercare for bondholders is their defensive nature. These issuers have offered both name recognition and stability during the economic crisis when most other asset classes were declining. Even during recessions consumers will still tend to pay their power or water bills. These companies are therefore well placed to withstand economic shocks. However, there are three issues which could derail this strategy: rising interest rates; tax; and inflation.

While most investors expect to hold the bonds until maturity, plans often change and this may require some investors to sell earlier. In these circumstances the investor can sell the bonds in the secondary market, although they are at risk of the market price dropping below the original price paid for the bonds.

For example, if interest rates rise then the market value of many bonds will fall. This may result in the investor making a loss on their investment. And while the advertised yields on many bonds were around 8%, this is before tax. For investors on a 21% tax rate, the after-tax yield is below 6%. By contrast, New Zealand shares pay imputation credits, so most investors are not required to pay tax on the dividend. In addition, all capital gains on New Zealand shares are, in most cases, tax free.

Inflation is a silent assassin for investors. At maturity, an investor should always get their original capital back, but what that capital can purchase may be significantly reduced due to inflation. The Reserve Bank of New Zealand is currently mandated to keep inflation between 1% and 3% per annum. Since the establishment of the Reserve Bank's target in 1989, inflation has tended to average towards the top end of its mandated range. Therefore, it is fair to assume that inflation will at least average 2.5% per annum over the next five to ten years. The average maturity of the corporate bonds issued last year was six years. Over six years, inflation at 2.5% would reduce the purchasing power of an investor's capital by 16%. So at maturity, instead of getting your original capital back, in real terms (ie inflation-adjusted terms) you would only get 84 cents in the dollar back.

AN ALTERNATIVE STRATEGY

Another strategy worth considering is supplementing a bond investment with an investment in the shares of the same company. For risk-averse investors, utility company shares have similar defensive characteristics to bonds. In particular, their dividends are reasonably stable, even during economic downturns. In most cases the dividends received from utility shares are higher than the yield of a corporate bond issued by the same company.

The following table looks at the yields of three bonds issued by utility companies last year and the dividend yield of the company when it issued the bond.

Company	Issue date	Yield on corporate bonds	Dividend yield (gross)
Contact Energy	Mar 2009	8.0%	4.7%*
TrustPower	Dec 2009	8.0%	8.1%
Vector	May 2009	7.8%	9.7%

Source: Bloomberg. *Contact Energy does not pay a dividend but instead issues bonus shares.

Not only was the dividend yield higher than the bond return in two of the three examples shown, but over time the dividends are likely grow. For example, Vector's dividend has grown by 5% per annum over the past three years, while TrustPower's has grown by 15% per annum.

Investing in shares does expose investors to the risk of share price changes. But if the investor is predominantly investing for yield, share price changes should be largely irrelevant as the shares are held for yield and not for capital gain. Should circumstances change, then the investor may have to sell their shares. In these circumstances their overall return will be dependent on

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the prevailing share price, but over time the share price of a well-managed company is expected to rise. There is therefore a high probability that in six years time the share price will be above today's price.

An investor following this strategy would therefore not only receive a similar yield to the corporate bonds, but would enjoy a yield that is likely to grow each year. In six years time, rather than just receiving their original capital back, investors should receive a premium on their original capital reflecting the appreciation in the share price. Unlike with a bond, this appreciation should more than offset the erosive power of inflation over the period. Highlighting the value of this alternative strategy over the past six years, TrustPower shares have appreciated by 14% per annum while Contact Energy's shares have appreciated by 2.7% per annum. Vector has not yet been listed for six years, so it is not possible to do a comparison.

A well-diversified investor may want to follow both strategies, investing in some corporate bonds and in some high-yielding shares.

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