Investment Insight

CORPORATE BONDS

NZFUNDS

"Gentlemen prefer bonds"
– Andrew W Mellon, US financier and philanthropist (1855-1937)

"Much bad advice is given free"
– Benjamin Graham, investment manager and lecturer in finance at Columbia University (1894-1976)

Periods of structural change in the global economy can change more than corporate fortunes; they can also change history's perception of individuals. The Great Depression, for example, fundamentally altered the way we view the contributions of two exceptional individuals – Andrew Mellon and Benjamin Graham.

Andrew Mellon rose to prominence as a wealthy industrialist, who ultimately became United States Secretary of the Treasury. His early policies were popular and saw him achieve the seemingly incongruous goal of reducing American tax rates while increasing the government's revenue. (This was accomplished by lowering the high level of tax avoidance associated with a 70% tax rate.) His popularity, however, waned with the onset of the Great Depression.

In response to the reckless lending standards of the time, Mellon advocated a 'liquidationist' thesis which aimed to weed out weak banks by refusing them additional funds. He also advocated spending cuts to keep the Federal budget balanced and opposed the mass printing of money. Sadly, his strong financial ethic proved as unpopular then as it would now.

In contrast, Benjamin Graham's star was on the rise. Having weathered the Great Depression, he – together with colleague David Dodd – published Securities Analysis which (along with a later book Intelligent Investor) became a cornerstone text for the investment industry. Reflecting on the public's behaviour during the Great Depression and, in particular, its propensity to buy corporate bonds, Graham wrote:

"It appears to be a financial axiom that whenever there is money to invest, it is invested; and if the owner cannot find a good security yielding a fair return, he will invariably buy a poor one. A prudent and intelligent investor should be able to avoid this temptation, and reconcile himself to accepting an unattractive yield from the best bonds, in preference to risking his principal in second-grade issues for the sake of a larger coupon return."

That axiom is the subject matter of this paper.

CORPORATE BOND PRIMER: WHAT IS A CORPORATE BOND?

A corporate bond is a form of debt issued by a corporation. When an investor purchases a corporate bond they are providing a loan to that corporation. In exchange for the loan, the corporation promises to pay interest (ie a 'coupon') to the investor (ie 'bondholder') over the life of the bond – usually a fixed period of one to 30 years (or more).

When a bond is issued, the corporation will offer to pay either a fixed interest rate (for example, Contact Energy's current offer of 7.75%) or a variable interest rate, which is usually pegged to cash rates. In the case of a variable rate bond, if interest rates rise the corporation will pay a higher rate of interest and vice versa if they fall (a recent example being Westpac's government-guaranteed floating rate bond, which yields 0.6% over cash rates). Fixed coupon bonds are more popular with retail investors because they create the illusion of security of income (more on this later).

WHY THE SUDDEN RUSH TO ISSUE BONDS?

In simple terms, corporations issue bonds when they do not have enough cash and want to borrow. As both an investment manager and a lecturer in finance, Benjamin Graham was able to appreciate both the financial theory and economic reality behind these issuances.

In theory, a good business should finance a portion of its assets at a low fixed rate (through a bond) and thereby enable shareholders to earn a higher rate of return on the remainder of the assets. In practice, Graham observed, businesses and bankers issued bonds when it was difficult to raise money in other ways. The public, lulled into a sense of security by the promise of a fixed rate of return from 'old, established enterprises', were willing purchasers.

Some 80 years later, little – if anything – has changed. During the economic boom between 2003 and 2007, higher-quality corporations (ie those with less debt to start with) tended not to issue bonds in New Zealand. Instead, they were able to borrow money either directly from the bank (at a lower rate than a public offering of bonds) or through offshore financing. Since the advent of the credit crisis in September 2007, it has become increasingly difficult for New Zealand corporations to borrow offshore. The international market no longer wants to lend to small companies on the other side of the world (even if we are nuclear free!).

Why not borrow from our local banks instead? Anyone who has approached their bank for a home loan knows the answer: where banks formerly required a 5% deposit, they now require 20%. A similar principle applies to corporate borrowers. "Bank lending is contracting and banks are beginning to ration loans with the most worthy borrowers receiving priority." ("Debt falls out of fashion in hard times", Brian Gaynor, NZ Herald.) As a result, a wide range of corporations have begun pitching their borrowing at the retail market – and New Zealand's retail investors are proving all too obliging.

NEW ISSUANCES IN THE NEW ZEALAND RETAIL MARKET

Issuer	Govt guarantee	Size NZ$m	Rate %	Previous retail issuance
Auckland Airport	No	$50	7.25%	Nov-08
Fonterra	No	$800	7.75%	2001 - Capital note
Auckland City Council	No	$150	6.00%	Jun-05
Wellington Airport	No	$100	7.50%	No
Genesis Energy*	No	$120	7.25%	No
Genesis Energy*	No	$105	7.65%	No
NZ Post*	No	$200	tba	No
Tower	No	$100	8.50%	No
Fletcher Building Finance	No	$131	9.00%	Mar 09 - Capital note
South Canterbury Finance	Yes	$100	8.00%	Jun-08
Contact Energy	No	$550	8.00%	No
AMP	No	A$300	8.84%	No

Source: BNZ, Westpac. *State-owned enterprise.

Much like the theorists in Graham's day, investment bankers will no doubt argue publicly issued bonds help to provide 'flexibility and diversification benefits not always available from banks'. Whatever that means, we take it with a pinch of salt as it's the investment bankers who earn the big bucks when a corporate bond issue is successful. Unfortunately, these otherwise-talented organisations have seen a dramatic decline in merger-and-acquisition activity and must look elsewhere to maintain their modest standard of living.

OUR INVESTMENT THESIS

"Bonds should be bought on a depression basis"
– Benjamin Graham

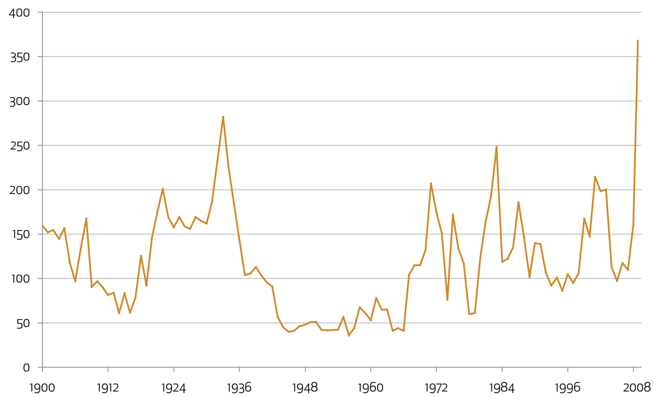
One might 'second guess' an investment manager who advocates hedging equities and buying bonds in the middle of a credit crisis. Nevertheless, this is largely what we have done. As with any good story, however, there's a twist.

Emerging from the Great Depression, Graham pronounced that corporate bonds should only be purchased when they offer equity like returns. For much of the century, the notion appeared preposterous – a security that ranked at the top of the capital structure (should anything go wrong), paying equity like returns?

Nevertheless, in today's market, corporate bonds the world over are trading with yields of 8%-9% or more, which is comparable with equity markets' long-term average return. In fact, corporate bond spreads have widened globally to levels last seen during the Great Depression.

'Spread' is best defined as the additional return an investor is rewarded with for taking on the risk of the corporation, as opposed to having all one's money in a risk-free government bond. For example, if a Fonterra bond yields 7.75% and government bonds yield 4.4%, the spread is 3.35% or 335 basis points.

CORPORATE BOND SPREADS



Source: Deutsche Bank, Bloomberg, Moody's, NBER, Irrational Exuberance (second edition) (Robert Shiller).

Unlike many of the pre-eminent economists and investment bankers who could not contemplate a US recession let alone a global credit crisis (and who are now telling us that the economy will recover in late 2009), we remain cautious. However, we are not too cautious to acknowledge that, at current prices, specific global corporate bonds represent a once-in-a-generation buying opportunity.

Corporate bonds are cheap for two reasons. First, there is a very real (and rising) risk that many will default. Default risk explains why bonds are as cheap as they were during the 1930s. However, as the spread graph above demonstrates, prices are even cheaper than during the Great Depression.

This brings us to the second reason why bonds have become mispriced. Unlike during the 1930s, today's investment community has been purchasing corporate bonds with borrowed money instead of cash. It has become fashionable to 'structure credit' by borrowing money to buy corporate bonds (using debt to buy debt!).

As the credit crisis developed through late 2007 and 2008, banks began asking for their money back and the value of corporate bonds began to fall. Investment banks and hedge funds scrambled to sell their bond holdings and repay their debts, further driving down the price of bonds – to levels below those of the Great Depression.

At this point in the cycle, we are comfortable with our decision to begin prudently purchasing well-priced, high-quality bonds. No doubt we will be early, but the rigorous investment approach and flexibility of the goals-based advice process give us the confidence to lock in the 'equity like' returns now on offer.

GRAHAM AND DODD'S APPROACH TO CORPORATE BOND INVESTING

Graham and Dodd advocated a number of principles in fixed value (bond) investing, which the passage of time has only served to reinforce. Here are four that, for obvious reasons, are as topical today as they were during the Great Depression.

1) SAFETY IS MEASURED NOT BY A SPECIFIC LIEN OR OTHER CONTRACTUAL RIGHTS, BUT BY THE ABILITY OF THE ISSUER TO MEET ALL OF ITS OBLIGATIONS.

Safety is not the stamp of approval from an investment bank or rating agency. Those investors who have not acquired a healthy dose of scepticism, by viewing AAA-rated structured credit at cents in the dollar, would do well to pause when considering the merits of an 'investment rated' bond.

Likewise, relying on household names and nationwide advertising campaigns are similarly unlikely to ensure one's capital is returned safely at the end of the investment period. Unfortunately, safety resides in careful-and-considered analysis of a company's ability to meet its financial obligations under a worst-case scenario (ie depression-like conditions).

2) THE ABILITY OF AN ISSUER TO HONOUR ITS ANNUAL PROMISE OF INCOME SHOULD BE MEASURED UNDER CONDITIONS OF DEPRESSION RATHER THAN PROSPERITY.

What began as a crisis in US subprime mortgages in 2007, spread with the failure of Lehman's and Bear Sterns (and the near-collapse of AIG and others) to become a global credit crisis. Renowned investor Warren Buffet observed

(1) Before computers a 'ticker tape' machine was used to continuously stamp share prices and volume on a thin ribbon of paper. The term 'ticker tape' comes from the sound made by the machine as it prints.

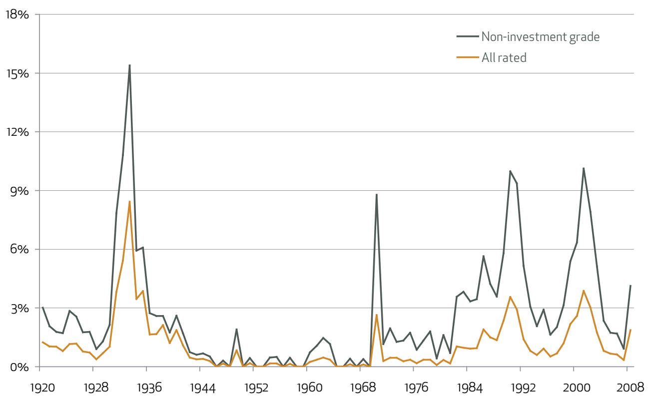
in a CNBC interview, "Unfortunately, the economy is like a bathtub where you can't have cold water in the front and hot water in the back", meaning it was inevitable that the crisis would spread throughout the world economies. By 2009, what had begun as a 'credit crunch' became a fully fledged global economic crisis.

The businesses that are failing today – and those that will fail tomorrow – have little or nothing to do with a credit crunch and everything to do with a global economic recession, the magnitude of which we have not seen since the Great Depression.

Therefore, a corporate bond's credit worthiness should be judged on the basis of a new-and-lower future level of profitability. Reliance by investors and bankers on historic profitability, which had been inflated by five years of synchronised global growth rather than prospective earnings power, will lead to investor misery. This is because corporate bond defaults lag an economic collapse. As the chart below demonstrates, it is not until after an economy has suffered for a year or two that corporate bonds begin to default.

Therefore, despite the collapse (or near collapse) of international household names such as General Motors, Chrysler, Circuit City, Waterford-Wedgwood and Nortel Networks, corporate bond defaults are not expected to 'peak' until 2010. When they do, the carnage is likely to rival the 1930s.

MOODY ANNUAL ISSUER-WEIGHTED CORPORATE DEFAULT RATES, 1920-2008



Source: BNZ, Westpac. *State-owned enterprise.

Those who question whether this international malaise will spread to New Zealand should consider the type of consumer electronics Circuit City (a venerable, 60-year-old household name in the US) was retailing? Household appliances, of course...

Academic Robert C Merton has long pointed to the strong correlation between the collapse of listed share prices and a subsequent increase in probability that the company's bonds will default[1]. However, retail investors have failed to notice the leading indicators.

Nuplex Industries and Fisher & Paykel Appliances have recorded falls in their listed share prices of -83.7% and approximately -80% respectively over the past 12 months, while PGG Wrightson's decline was a relatively 'modest' -54.5%. Nevertheless, some prospective and recent bond issuers have fared relatively well over the past year, such as Fletcher Building at -44.74%, Contact -33.2% and Tower -27.8%[2].

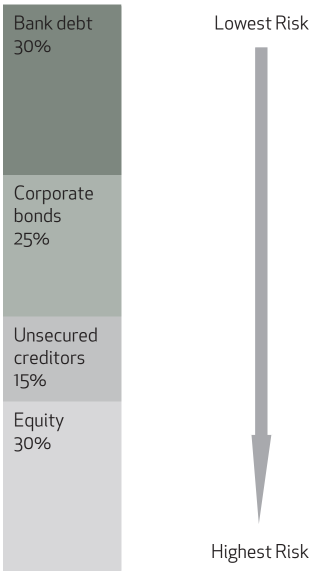
These dramatic declines in business value are not the work of some random event in equity markets; rather they're an adjustment of each corporation's enterprise value to reflect a significant decline in projected future cash flows. Remember, just because a bond's value may not fluctuate annually does not mean the risks associated with owning the bond will not rise dramatically as the recession bites. Only enterprises that meet the strict criteria of being able to repay principal and interest based on depression-like earnings should be considered for investment.

3) KNOW YOUR BOND'S RANKING IN THE CAPITAL STRUCTURE – IT MAY SAVE YOUR CAPITAL.

Bank debt and corporate bonds form only a part of a company's capital structure. Other forms of capital funding include lower-ranked or subordinated debt (unsecured creditors), debt-to-equity hybrid instruments and equity. The diagram below provides an example of a simple, hypothetical company's capital funding structure:

(1) Robert C Merton, "On the Pricing of Corporate Debt: The Risk Structure of Interest Rates", Journal of Finance 29 (1974), pp. 449-470.
(2) As at 24 February 2009.

HYPOTHETICAL CAPITAL FUNDING STRUCTURE



The associated risk and expected return from different forms of capital is reflected in such a capital structure. Funding at the top of the structure has the least risk as lenders have first claim over a corporation's assets if it goes bankrupt. In return, owners of the 'first claim' must usually settle for the lowest expected returns (a bond paying 7%pa will never earn investors more than 7%pa). Bank debt is generally at the top of the capital structure.

Equity funding forms the bottom portion of the capital structure. Equity holders have the last claim on assets in the case of bankruptcy. To compensate for the increased risk, equity has the highest expected return. In general, where a company's profitability doubles, equity holders' returns will double (while bondholders will continue to earn 7%pa).

This caused Graham and Dodd to ask: "Is it worthwhile for the investor to limit his income return and forego all prospect of speculative gain if, despite these sacrifices, he must still subject himself to serious risk of loss?" (Securities Analysis, page 65.) The solution to this inherently unattractive feature of bonds is to ensure that, in return for limiting one's participation in future profits, a bondholder should obtain the strongest possible priority of claim – a philosophy with which we concur.

Fortunately, many corporate bonds tend to rank towards the top of the capital structure and may even be ranked at the same level as bank debt – such as the recent Fonterra bond issued in the New Zealand market (which was purchased by our Core Income Portfolio).

However, a company may also choose to issue subordinated bonds (or capital notes) which rank lower in the capital structure than bank loans and corporate bonds, but still ahead of equity holders. Recent examples of this include issuances by Fletcher Building, Infratil and SkyCity. We consider these issues more akin to shares than bonds and, therefore, hold them in our Australasian equity portfolio, the Dividend Yield Trust.

4) DEFICIENT SAFETY CANNOT BE COMPENSATED FOR BY AN ABNORMALLY HIGH COUPON RATE.

Let's dispel a financially dangerous theory that lurks in the subconscious of investment managers, advisers and retail investors alike. Self insurance is not possible. Graham and Dodd marvelled at the propensity for retail investors to accept a little more interest in return for assuming more risk. While it is a common investment generalisation that clients who are able to assume a higher level of volatility will ultimately enjoy a higher level of return, the misapplication of this principle to corporate bond investing is rife.

There is no logic in accepting a small increase in income (for example, an additional $50pa) in return for risking the permanent loss of all one's investment capital (say, $1,000). All too often, the risk associated with corporate bond investing is not volatility (although this too is possible), but a permanent loss of capital. As such, it is wiser to accept a lower level of interest on a high-quality investment and supplement one's income, if necessary, with the consumption of capital. For example, earn $50 of income (derived from consuming one's capital) with $950 of capital remaining, rather than earn $50 of income and suffer a total loss of capital.

This logic becomes more compelling when overlaid with the conclusions of Graham and Dodd's statistical analysis. After years of investing and analysing the results, they concluded there was no mathematical relationship between yield and risk. Therefore, one cannot assume that a high-yield bond is high risk, nor a low-yield bond low risk. A simple study of the current range of bonds on offer produces identical results.

DO RETURNS ON OFFER REFLECT THE RISK? APPARENTLY NOT...

Corporate bond	Maturity	Yield (return)	Rating (risk)	Spread over swap	Return per category implied by Fonterra bond **ie A-, A, A+ (%)**	Implied yield (given credit rating)
Fonterra	Mar-15	7.75%	A+	3.60%	0.72%	7.75%
Tower	Feb-14	8.50%	BBB-	4.46%	0.72%	11.47%
Contact Energy	May-14	8.00%	BBB	3.85%	0.72%	10.75%
Auckland City Council	Mar-14	6.00%	AA	2.00%	0.72%	6.45%

Assuming the Fonterra bond is correctly priced at 7.75%, each rung in the credit rating ladder is worth approximately 0.72% extra return over bank bills. Thus, a bond that has a credit rating one level below Fonterra (and is, therefore, a riskier investment) should yield an additional 0.72% to compensate investors for taking on that additional risk. However, recent issues ignore this logic.

The selection of all bonds for investment should be subject to rules of exclusion and to specific quantitative tests. Vaguely held beliefs about the quality of the corporation and any 'long-standing New Zealand heritage' are as dangerous as simplistic short cuts to analysis, such as 'lower yield must mean lower risk' or vice-versa.

We will continue to resist well-meaning advice by bankers, advisers and clients to pack our portfolios with household-name corporate bonds. Were Bridgecorp and Hanover not household names once too? The painstaking process of selectively purchasing bonds is born of the belief that the unavailability of sound bonds is no excuse for buying poor bonds.

GOAL-BASED PORTFOLIO CONSTRUCTION 101

We have been at pains to explain how a sound investment process might avoid the pitfalls associated with security selection, but it is in portfolio construction and risk management that we endeavour to add most value. In our view, successful investment management of a goal-based advice process requires not only that the preservation of capital take priority, but that clients participate in profitable investments in a way which does not lead to highly correlated outcomes across the goal-based categories. While we utilise corporate bonds in three of the goal categories, they are managed in very different ways. Each exposure is designed to capture a different aspect of the asset class's returns and thereby minimise the degree to which returns are correlated.

The inclusion of corporate bonds in the long-term-orientated growth portfolios will raise some eyebrows with the establishment. However, let us reiterate our thesis. Firstly, to mitigate the risk of a worsening economic outlook (which might damage the ability of our corporate bonds to meet their interest obligations), we hold an actively managed allocation of domestic and US government bonds. Secondly, globally issued corporate bonds now offer returns commensurate with the long-term performance of equities, though with considerably less volatility. Our selection of global corporate bonds yielded a healthy 7.2%pa[3] on purchase. Finally, should credit spreads contract from approximately 3.80%pa over cash to the traditional 0.35%pa over cash, our corporate bonds should deliver very 'growth-like' capital gains of 17.25%pa.

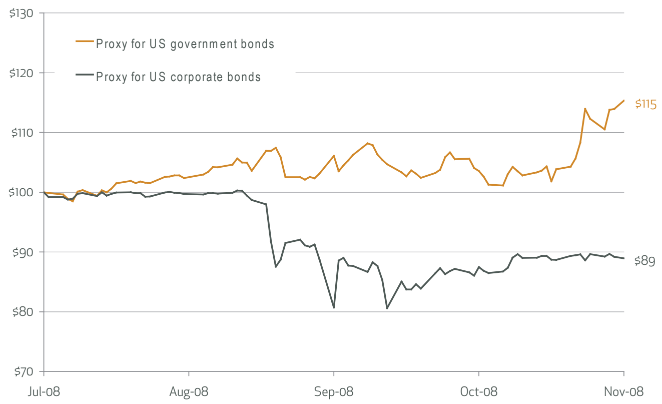
GOD DEFEND NEW ZEALAND… SOVEREIGN BONDS!

What of capital preservation? A variety of capital preservation tools can be used in conjunction with corporate bonds – in particular, credit default swaps and futures. However, both pale in comparison with the mighty New Zealand government bond (or, for that matter, almost any nation's sovereign bonds). During periods of significant economic contraction, government bonds have traditionally delivered positive returns. The global economic crisis which began in 2007 is no exception. Since November 2007 global equities (as measured by the MSCI World Index in local currency terms) have delivered a withering -49.3%, while the New Zealand government bond index has increased in value by +17.9% over the same period.

(3) Weighted average yield to maturity (NZD equivalent) as at 11 February 2009.

Long-term, fixed rate government bonds rise in value when investors flee to their comparative safety. Additionally, the worse the economy gets, the more central banks are obligated to cut interest rates; and the more central banks cut interest rates, the more government bonds rally. As the chance of corporate bonds defaulting increases when economic activity falls, government bonds are almost the antithesis of corporate bonds. This combination enables us to accumulate corporate bonds just as they enter what is widely expected to be the worst default cycle since the Great Depression. For, if the global economy deteriorates further, our actively managed government bond exposure should help preserve clients' capital until we can all enjoy the rewards of selectively purchasing undervalued assets, including corporate bonds.

CREDIT CRISIS IMPACT ON CORPORATE VS GOVERNMENT BONDS



Source: Bloomberg.

SUMMARY

"I've just done a commercial in the US in which I talk about stocks, shares and bonds. Everyone is amazed. They ask me: 'You really know about that stuff or did you just learn it for the commercial?' I tell them I wouldn't do it unless I understood and had an interest"

– Anna Kournikova, Russian professional tennis player and model (1981-)

Too many New Zealander's view corporate bonds with the enthusiasm of a teenaged professional tennis player/model. Our role models (Graham, Dodd and Mellon) are far less eager. Were he alive today, Andrew Mellon would likely approve of our defensively diversified approach to corporate bond investing. For, while in public he proffered 'gentleman's preference for bonds', in private he amassed a fortune (estimated at between US$300m-US$400m) by investing both in the bonds and equities of a diversified range of enterprises which included oil, steel, shipbuilding, construction and coke ovens. Follow his actions and not his advice; be selective and diversify across income and growth.

"I thought nothing could stop me from loving you, but time changes everything"

– Johnny Cash, American singer/songwriter (1932-2003)

New Zealanders' love affair with corporate bonds issued by household names will be short-lived. The rule that bonds should be bought based on their ability to withstand depression has been part of a long-standing investment tradition. However, the importance of this maxim was eroded over the extended period of prosperity that led up to mid-2007. The collapse of structured credit and the finance/debenture market has served as a painful reminder to investors that irrational exuberance for any 'hot' asset class is fraught with peril. We will not make the same mistakes with corporate bonds.