MEDIA MONITORS

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Bonds good but be wary

Equity-weary investors seeking palpable returns are flocking to bonds. But could the rush on this sweetheart market be another finance company fiasco in the making? **Amanda Morrall** looks at some of the lesser-known pitfalls.

Property is flat, equities are limp and term-deposits rates are tepid. Bonds, on the other hand, are giving investors reason for hope. Amid otherwise saggy bottom lines, they're the new sweet spot in the portfolio.

Over the past two years, the value of bonds posted on the NZDX has climbed from $12.4 billion in September 2008 to $15.49b in 2010.

For corporate issuers at the receiving end of this dash for cash, bonds have been a saving grace. A worldwide clampdown on lending has made capital raising a challenging proposition at best for companies ground down by the recession. By promising returns of 125 basis points or better than bank deposits, the bedraggled corporate sector has found an eager suitor in the investing public.

BNZ economist Craig Ebert says the current low interest rate environment is one factor driving the love affair with bonds.

"There's been a number of issues go off, even lately. There's a perception of them being a good solid investment."

And while benchmark returns bear that out with Government bonds up 7.8 per cent in the past nine months compared with New Zealand share at 0.1 per cent so far this year, bonds are far from bullet proof as an investment.

Rabobank's coveted bond offering of 2007 is a reminder of that, says Chris Wasley, of Myles Wealth Management in Christchurch.

When the Dutch deposit taker launched a bond three years ago dangling a juicy 10 per cent return, it attracted a rush of investors. The romance was short-lived.

Subsequent to the launch, interest rates halved, grinding almost 6 per cent off the yields that in turn caused the market to discount prices 20 per cent. "Those who went into it were facing something like a 27 per cent drop," says Mr Wasley, using it as a cautionary tale for today's bond-crazed investors. Those looking to lay blame have only themselves to reproach, he says.

"It's not Rabobank's fault, or its security. It was just a pricing issue because it happened to be a perpetual bond with a floating rate."

It is those kind of devilish details that do-it-yourselfers gloss over in their excitement over promises of high yields, warns Mr Wasley.

Like others in the financial advisory sector, he worries that the current rush on bonds could end badly for those investors who don't do their homework.

"The returns from bonds can be very good, normally higher than bank deposits, however there are much greater risks associated with bonds than what most people are aware of."

So what is a bond?

There are three types: corporate, government and bank.

All of them, at heart, are loans, explains Mark Brooks, principal and head of income for New Zealand Funds Management.

In the case of corporate ones, "a company promises to pay interest on the money borrowed and to repay the money at an agreed time".

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Slowdown in building work

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Jennie Moreton: Capital gains tax is a reason investors should not take bonds lightly.

Chris Wasley: "There are much greater risks associated with bonds. . ."

It sounds simple enough and yet because each bond and issuer is different there are layers of complexity underlying them.

On the return side, Mr Wasley breaks it down into two components.

"One is the interest rate it pays you. Two is the price you pay. If you subscribe to a bond when it is issued and hold it until maturity, at the end of the day your return is the interest rate. The price is only relevant if you choose to sell it at some point before it matures."

What many Rabobank bond investors from 2007 failed to take into account was the term of the offering – it didn't have one.

The bond was perpetual and therefore buyers were at the mercy of a fickle market if they ever wanted to sell.

To that end investors need to be aware of the circumstances and forces at play that can push prices up and down and also their ability to sell on the secondary market; a Trade Me-like channel for buying and selling bonds once an issue is closed and before they mature, if ever.

Jennie Moreton, an investment adviser with Craig Investment Partners, says while the secondary bond market is robust she encourages clients to hold the course.

"We advise clients to hold till maturity.

"The most important thing is return on capital at the end of the period and the interest on it during the time of ownership."

Like Mr Wasley, Ms Moreton cautions investors about waltzing into bonds without fully understanding the built-in risk and return.

The security of a bond – and the issuer – is a prime consideration, she says. Essentially, what that boils down to is the issuer's ability to return your money, ideally with a level of interest that made the loan worthwhile.

Not many bond issues come out with the golden stamp of security because there's not many in the position to make those guarantees. That's why secured bonds issuances by the likes of Fonterra, Auckland City Council and Tauranga have proven so popular with institutional investors more attuned to the risks of the bond market.

As A-rated issuers, they are far less

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likely to run into financial problems and default on payouts, when it comes time to redeem. In the case of Auckland City or Tauranga, the bonds have the added benefit of being tied to the rateable income of the district. If they ever ran short of money, all they would have to do is raise rates to reliquefy.

For the same reason government-issued bonds are in hot demand. And yet nations like Greece and Iceland have proven even government bonds can be risky these days.

Mr Brooks says the safest way to avoid disappointment is by reading the investment documents – that would be the prospectus – with a magnifying glass and a strong cup of coffee.

Even then, he admits all but the most astute investor can be left wondering.

"They may not have the history to understand what it means when something is a tier one deeply subordinated instrument."

One might expect the obfuscating language has led to a stronger demand for financial advisers and brokers able to translate but so far that hasn't been the case. The majority of those snapping up the bonds are reportedly mums and dads with low-level investment acumen, says Mr Brooks.

Take a typical retail-focused new corporate issue (BBB rated). Around 75 per cent of the uptake is by retail mum and dad investors and 25 per cent institutional.

Among unrated corporate issues (for example, Trustpower or The Warehouse), the retail weighting would be even higher, around 85 per cent, says Mr Brooks.

That's because institutional buyers are often restricted from buying bonds that do not have an external credit rating. By the same token, institutional buyers also take up a bigger portion of those issues that come from highly rated issuers with rated offerings.

The danger for DIY investors is buying too much of one bond and buying directly, says Mr Brooks.

"We often see individual portfolios that people have put together themselves or through brokers with 10 names at best. Whilst corporate bonds as an asset class are very stable, individually bonds can have some rocky experiences. You might get all your money back if you hold on but it can be a pretty rocky road at times."

The popularity of bonds among institutional buyers has resulted in a decreased pool of issues for the public. At the same time it has stimulated a secondary market for bonds in New Zealand. That's not such a bad thing for investors looking to offload bonds for quick cash, and also those wanting a piece of the action, but it comes with a price. Investors trading in seconds usually pay a premium on their purchase, as well as brokerage fees.

While the gains are making up for it these days, the numbers won't always stack up, says Ms Moreton.

Taxes are one reason. Unlike the equity market, investors are required to pay capital gains tax on bonds. Ms Moreton says it is just one more reason investors should not take bonds lightly.

"It's not a simple case of putting your money into a bond, holding it until maturity, getting your money out and it's a risk-free adventure," adds Mr Wasley.

"And yet the number of corporate bonds being promoted by investment banks and brokers has resulted in New Zealanders becoming DIY bond investors without the technical knowledge to protect themselves."

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