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Investors warned- not all bonds are equal

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Mum and dad investors holding hundreds of millions of dollars of perpetual bonds may be unaware that they're lower in the food chain if things turn to custard.

According NZ Funds Management head of income Mark Brooks, New Zealand bank bonds are in for a downgrade shock as agencies change their rating criteria.

Prior to the financial crisis, ratings agencies such as Moody's factored in an expectation that national governments would bail out troubled banks and their investors.

This confidence in government support benefited not just the bank's senior creditors and depositors but also investors in subordinated capital securities and perpetual preference shareholders.

But Mr Brooks said that banks were unable to bail out all banks during the financial crisis.

And mostly the bits that were bailed out were deposits and senior debt, with the likes of perpetuals being left to the mercy of the market.

"Subordinated capital securities around the world experienced losses, both in the form of principal write downs and coupon suspensions."

So the ratings agencies have amended their criteria, with future ratings for subordinated and preferred securities reflecting only the bank's standalone strength.

Mr Brooks has warned investors that perpetuals are more like shares than bonds, and in the still unlikely event that the bank involved fails, they will be further down in the pecking order.

"As many investors in finance companies have recently found out, there is a big difference if things go wrong between being first in the queue and second in the queue."

Since 2005 nearly $2.7 billion of perpetual bond-type securities have been issued, the largest being a $900 million issue by Rabobank in October 2007.

However, what many investors didn't realise about the Rabobank offer was that it had a one-year reset on interest rates.

The first coupon was at 9.5%, which reset to 7.5% in October 2008 and then dropped to 4.1% in October this year.

This is reflected in the current price of the security, which is hovering at about 85c in the dollar.