Copyright Agency licensed copy
(www.copyright.com.au)

STORY SUSAN HELY

Interest issues

Low saving rates and a volatile sharemarket have prompted investors to consider corporate debt and other bonds

IT WASN'T LONG AGO THAT bonds were out of the reach of most investors – unless they bought into a managed fund. Direct bond investment was the domain of institutions as the minimum investment was so high (often $500,000). Perhaps this is why our portfolio exposure to bonds is the lowest of any developed country; we prefer Australian equities – especially those with robust dividends.

But skimpy yields from term deposits and savings accounts mean investors are more interested in bonds. Those who have retired or are in the rundown to retirement want to preserve their income-earning capital and the sharemarket's volatility has encouraged a shift from equities.

Charles Thomas, of Vanguard's investment strategy group, says bonds reduce risk in a portfolio, providing stability and downside protection regardless of interest rates, even though their prices have fallen recently.

Importantly, access to bonds has become easier as bond brokers have lowered minimum investments to attract the fast-growing self-managed superannuation fund (SMSF) market and retail investors. One fixed-interest broker that has had success in attracting new clients is FIIG, which has cut the minimum subscription from $50,000 a bond to $10,000.

"This means the average SMSF investor, and many other people too, can now buy a diversified bond portfolio," explains Mark Paton, chief executive officer at FIIG. He says FIIG is signing up 200 new clients each month.

Paton says the main difference between a bond investor and a share investor is that a bondholder focuses on getting the highest yield rather than searching for a security whose capital value will grow.

Most investors have an allocation to bonds through the fixed-interest (or defensive) component of their super fund, typically about 30% of a balanced portfolio. The investments include government and corporate bonds, hybrids and bonds with fixed, floating and inflation-linked rates.

Paton says FIIG has issued eight bonds, paying up to 8.25%, from mid-cap companies such as Silver Chef, Mackay Sugar and G8 Education in the past 18 months, totalling $400 million in debt.

Interest from floating-rate bonds and inflation-linked bonds is usually paid quarterly, while fixed-rate bonds generally pay half-yearly. Your initial investment will be repaid at maturity and you can sell before the maturity date because bonds are tradable securities.

Paton says a strategy for investors who are uncertain about the direction of financial markets is to allocate funds across three types of bonds: fixed, floating and inflation-linked. Fixed-rate bonds outperform as interest rates come down. An allocation to floating-rate bonds with interest rates tied to an underlying benchmark – usually the bank bill swap rate (BBSW) – ensures a rise in interest rates will be captured.

The value of inflation-linked bonds (ILBs) rises with inflation and when interest rates are low an ILB can be the right vehicle. Some infrastructure companies offer ILBs, such as prisons, coal handlers, ports and pipelines.

The risk in bonds is that the company may collapse and you will lose all your money. Paton says bondholders have priority over equity investors in the event of liquidation.

Diversification can reduce this risk and bond exchange traded funds give you low-cost exposure to a basket of diversified bonds. For example, Vanguard Australian Government Bond Index ETF (VGB) invests in 80 Australian government and state government fixed-income securities.

In FIIG's example portfolio of retail corporate bonds below, the yield to maturity shows the expected return if the bond is held until its expected maturity date. The portfolio's average yield to maturity is 5.68%. Its projected income for the next 12 months is $2940, or about $735 a quarter. ***M***

RETAIL CORPORATE DEBT PORTFOLIO

ISSUER	MATURITY DATE	BOND TYPE	YIELD TO MATURITY	MIN INV
Bendigo and Adelaide Bank	29-Jan-19 (=call date)	floating	5.94%	$10,000
DBCT Finance (Dalrymple Bay Coal Terminal)	9-Jun-16	floating	4.50%	$10,000
JEM (Southbank TAFE)	28-Jun-18 (=call date)	fixed	5.00%	$10,000
Silver Chef	14-Sep-18	fixed	6.49%	$10,000
Southern Cross Airports Corp (Sydney Airport)	20-Nov-20	inflation linked	6.25%	$13,073
			Total portfolio	$53,073

Source: FIIG Securities. Prices as at 17 March and subject to change. The Sydney Airport bond has increased with inflation since its issue.