Debt shock horror!

Fixed interest has face-lift

A rash of corporate debt issues has prompted AMP Capital's Anthony Edmonds to revisit the fundamentals of fixed interest and why investors shouldn't buy on the headline alone

By Anthony Edmonds

I am concerned about the trend in the fixed interest market at the moment with many investors following what I call a *Woman's Weekly* approach to managing their fixed interest portfolios. That is, every time there is a new issue, they buy it.

Over recent months we have seen mum and dad investors pour millions of dollars into long-term corporate debt issues. These issues are particularly seductive with on-call and shorter-term interest rates having fallen from over 8% this time last year to as low as 3% today.

It is a fatal mistake to compare these types of securities to on-call and term deposit rates. While they look like a good buy, when you look globally at similar types of securities they are actually quite expensive. In addition, there seems to be little difference in the rate offered by different issuers, even though there can be material differences in the nature of the actual securities.

Now I know I have talked about this trend before, but this time I want to focus on two factors advisers should consider before recommending a particular fixed interest investment to their clients.

Instead of chasing returns, focus on two things

Last month we ran an educational series for the Institute of Financial Advisers on investing in fixed interest. Our messages were simple.

We told advisers that when you invest in fixed interest assets you – and your clients – get to play banker. In essence and practice you are making loans to a range of institutions including businesses, local authorities, and even the government.

And just like a banker, you should focus on two things:

1. The term of the loans that you are making – this is managing duration
2. Ensuring that the people you are lending to can afford to repay you – this is managing the credit quality of your portfolio.

Managing the duration of your loan portfolio increases returns

The term of the loans that you make to borrowers is a critical driver of your profit, or return. If interest rates are falling, you should make long-term loans at a fixed rate. This is like when bankers try to get their clients to buy fixed-rate mortgages when rates are falling.

Equally, if you think interest rates are going to rise, you should make loans that have a shorter term. Again, if you think in terms of banks and mortgages, you would be encouraging your clients to take floating rate mortgages in a rising interest rate environment.

Every New Zealander with a mortgage gets this concept, and we all want to beat the banker, picking whether we should take a floating or fixed-rate mortgage. Why then do most investors not pay the same attention to interest rate risk when managing their fixed interest portfolios? In essence, in managing a fixed interest portfolio an investor assumes the same role as a banker.

I think I identified the answer in the article '*Spot the difference: why bonds are not identical*' published in the March 2009 edition of ASSET. Essentially, the answer is that people haven't had to pay as much attention to interest rate risk in the last 25 years because just holding long duration bonds in your fixed interest portfolio came with little or no regret.

Long-term interest rates have been progressively falling in the past 25 years. But this buy and hold strategy won't work in every environment. So just because you, or your clients, haven't had to worry about interest rate risk in the past doesn't mean you won't in the future.

Measuring and understanding duration is crucial

If you don't measure and report on the duration of your clients' fixed interest portfolio, then it is safe to say you probably aren't managing the interest rate risk or trying to maximise the profit on your clients' portfolio of loans.

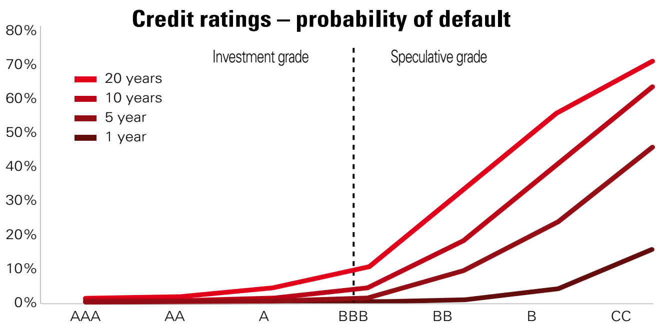
Duration is a critical risk measure that should be monitored, as it provides a simple metric that explains the sensitivity of the value of your fixed interest portfolio to changes in interest rates. If you struggle with the concept of duration, please either hit the books and learn, or outsource these types of decisions to someone who truly understands it.

Credit kills, or at least it might

Just like drinking and driving, taking excessive credit risk is dangerous. This is because the risk of default increases exponentially as you take more credit risk. When you invest in lower grade credit securities you should expect significantly higher returns because of the additional risk you are taking on.

Furthermore, the risk also increases exponentially as you extend the duration of your credit securities. For example, the risk of default from a seven-year BBB security is about five-times greater than a two-year BBB security.

The relationship between credit rating, duration and the probability of default is shown in the graph below.



How to determine what interest rate you should get

If you are trying to determine what interest rate you should get from a credit security, for example a corporate bond with a term of five years, you need to start by considering what the benchmark yield curve looks like. The common benchmark used for pricing credit securities is called the 'swap' curve.

As I write this, the benchmark is offering the following rates:

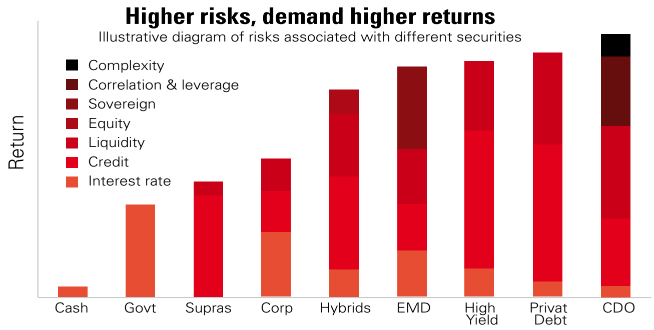
Term	Cash	3 month	1 year	2 years	3 years	4 years	5 years	7 years	10 years
Rate	2.50%	2.80%	2.90%	3.40%	4.00%	4.30%	4.60%	5.00%	5.40%

All corporate bonds get priced off this benchmark. By priced I mean that the yield for a specific corporate bond issue is a function of what the corresponding benchmark yield is plus a margin for the specific attributes of a security.

This includes features like: the term of the bond (interest rate risk); whether it is subordinated debt or senior secured debt (credit risk); or a perpetual security (equity risk); through to how the interest rate might be reset (complexity risk).

In determining what this margin should be, an investor should also consider factors such as what the margin for similar securities are globally.

The next graph shows how different types of securities contain these different types of risk:



Things to consider when choosing to invest

And here is where it is time to think about playing banker again. If suddenly you find a queue of corporates lining up trying to issue you long-term debt you might want to consider these things before advising your clients to buy it:

- Duration considerations: Consider where you think interest rates will go in the foreseeable future. If rates look like they will rise over the coming years, the duration (or term) of the loans should be shorter. Equally, if long-term interest rates look like they might fall, the duration of the loans that you are making should be longer.
- Credit considerations: When it comes to credit, consider what rates your competitors are offering to these customers. Consider this globally, as well as focusing on local rates. You could also check out what similar securities are trading at on the secondary market. This analysis might highlight that the rate being offered on new securities is too low.
- Also think about the terms and conditions of the loans that you are making and study the investment statement. For example, finding out that you have advised someone to invest in a perpetual loan without fully appreciating the nature of this might be costly and a little embarrassing.
- Importantly, you also need to think about whether the people you are lending to have a high certainty of paying you back.

Investing in corporate debt is not as simple as taking a *Woman's Weekly* approach and buying every issue. If advisers are going to recommend individual portfolios of securities, it's important they adopt sound approaches to managing both the interest rate (duration) risks and credit risks inherent in their clients' portfolios.

Simply buying every issue or anchoring investment decisions on the level of short-term interest rates in the chase for higher returns is likely to result in disappointment and could be costly. **A**