NZ fixed interest - picking the highest yield is not enough

Christian Hawkesby | Harbour Asset Management | 13 May 2015 |

Building NZ fixed interest portfolios is arguably harder than it has ever been. The Official Cash Rate is still near record lows, the yield curve is flat, and credit spreads are near their tightest levels since the Global Financial Crisis (GFC). This is set in a global environment of all-time record low bond yields.

The challenge for practitioners has been compounded by a dearth of retail corporate bond issuers, as corporates have reduced borrowing and channeled the vast majority of bond issuance directly into the wholesale market.

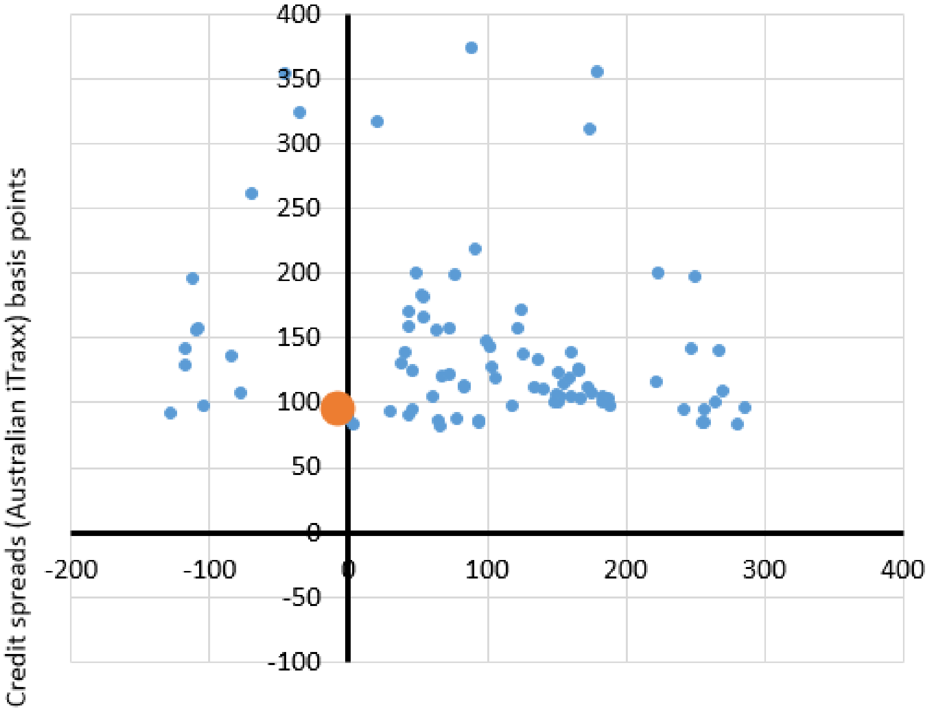
This paper argues that selecting retail corporate bond issues with the highest yield is not an appropriate strategy for portfolio construction practitioners. Equally, buying corporate bonds to replicate a bond index has many of its own pitfalls, potentially leading to a portfolio that suits bond issuers rather than bond investors. Portfolios need to be constructed for the specific needs of clients, and reflect a combination of liquidity, income, quality, and diversification. This paper introduces a framework for practitioners to build portfolios for the needs of clients.

THE CHALLENGES FACING FIXED INTEREST INVESTORS

There are two main challenges currently facing NZ fixed interest investors.

The first is that today there is little compensation available for either credit risk or duration risk. Credit spreads are near their lowest level since the GFC. At the same time, investors are receiving little compensation for duration risk. The yield curve is flat, with the NZ five-year swap rate currently in line with the 90-day bank bill rate. Figure 1 illustrates the slope of the yield curve against credit spreads since the GFC, with the latest observation highlighted. The top right quadrant is a more attractive environment for fixed interest investors – credit margins are wide, and yield curves are steep. Investors are currently facing more challenging conditions, towards the bottom left area, in recent experience.

Figure 1: Slope of yield curve vs credit spreads (monthly since the GFC)



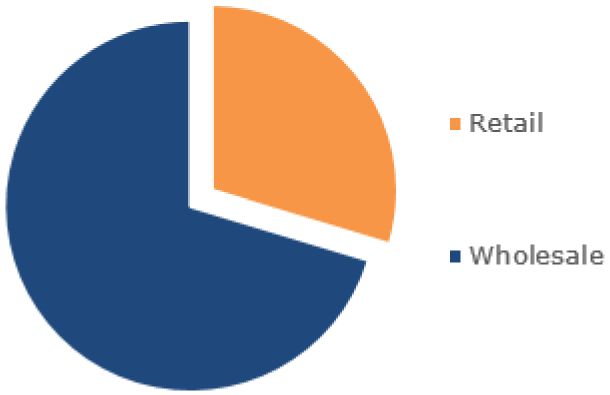
Source: Bloomberg. Note: Slope of NZ yeild curve – for example, 5 year yield is 100 basis points higher than the 90 Day Bank Bill Index)

The second challenge is that only 30% of corporate bond issuance that has occurred since January 2014 has been available for retail investors (Figure 2). This change in the composition of NZD corporate bond issuance away from retail has been influenced by two main factors:

1. The growth of Kiwisaver means there is a large pool of savings being intermediated through the fund managers, providing corporate bond issuers with a ready pool of wholesale demand.

2. Issuers have found it easier and faster to issue directly in the wholesale market, without the need for retail documents and longer periods of marketing. In this sense, stricter regulation to protect retail investors may have rerouted some corporate bond flows into the wholesale market.

Figure 2: Composition of NZD Corporate Bond Issuance (Jan 2014 to March 2015)

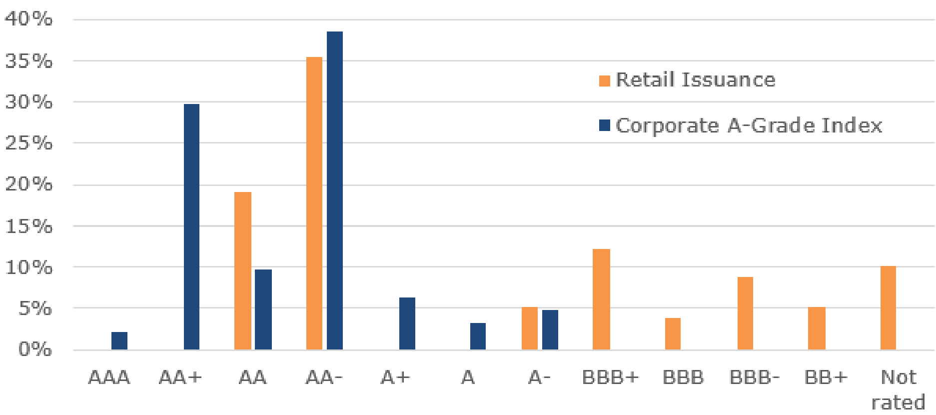


Sources: ANZ and Harbour Asset Management calculations

POPULATING PORTFOLIOS WITH NEW RETAIL ISSUES

Faced with this lack of retail corporate bond issuance, one approach for those constructing investor portfolios would be to purchase whatever retail primary issues are available, choosing the highest yields available. However, Figure 3 illustrates that the retail issuance that has occurred has often been tilted towards securities with lower credit ratings (e.g. BBB or below) or hybrid instruments lower down the capital structure (e.g. subordinate and convertible).

Figure 3: Composition of Credit Rating – Retail Issuance vs Corporate-A Grade Index



Sources: ANZ and Harbour Asset Management calculations. Retail issuance Jan 2014 to March 2015.

Instruments lower down the capital structure can behave more like equities than fixed interest. Indeed, since the GFC, bank capital regulation has been tightened so that hybrid instruments, such as Capital Notes, often contain an explicit trigger event that will see them converted into common equity in times of stress. Annex 1 details the terms of the new ANZ "Capital Notes" (full name "Mandatory convertible, non-cumulative perpetual subordinated debt securities").

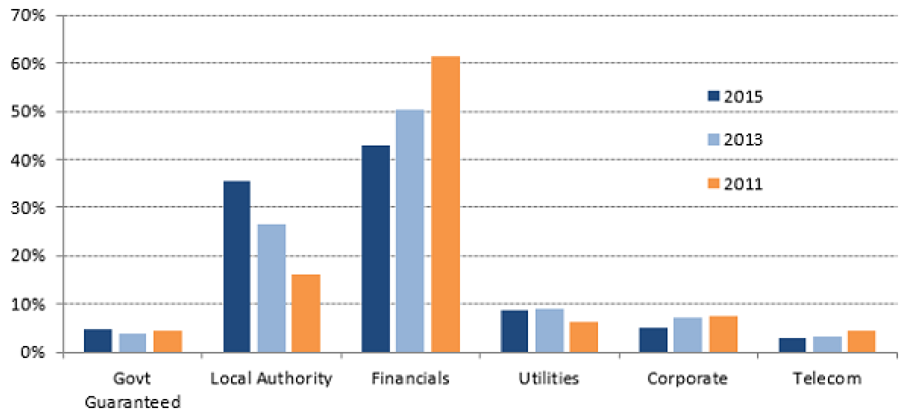
FOLLOWING THE CORPORATE A-GRADE INDEX

An alternative approach would be to populate a corporate bond portfolio to broadly match a bond index, such as the ANZ Corporate A-Grade Index. The criteria for inclusion in this issuance-weighted benchmark is outlined in Annex 2, and is currently under consultation.

While equity markets have a long history of indices weighted by market capitalisation, applying this approach to fixed income markets can result in an undesirable composition of assets for the investor. For example, issuance-weighted indices encourage investors to hold higher weightings of debt as an issuer borrows ever more (sometimes a sign of lower credit worthiness).

In the case of the ANZ Corporate A-Grade Index, the weight of the benchmark in local authorities has increased from around 15% in 2011 to over 35% in 2015 (Figure 4). This is largely due to the creation of the NZ Local Government Funding Authority (NZ LGFA), which is pooling the funding needs of local authorities across the country.

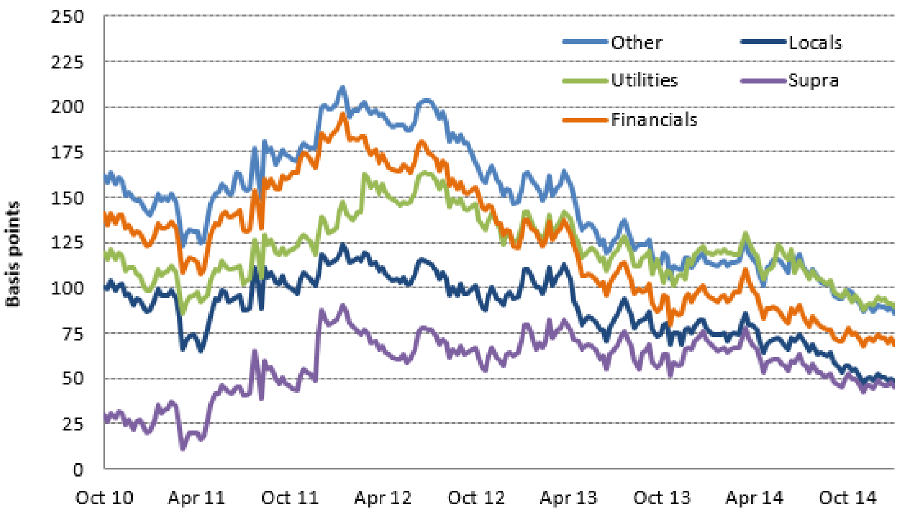
Figure 4: Sectoral composition of the Corporate A-Grade Index



Sources: ANZ and Harbour Asset Management calculations.

The key features of the NZ LGFA, including membership and structure, are summarized in Annex 3. It is a highly rated entity with a strong capital structure and liquidity support from the NZ government. So, in that sense, it does not cause the usual problem of large issuers lowering the average quality of bond on issue. Indeed, it has created the opposite problem – that is, as a highly rated issuer, it has lowered the average credit spread available from investing in the ANZ Corporate A-Grade Index. For example, NZ LFGA corporate bonds currently trade at a credit spread of only around 50 basis points above equivalent government bond maturities, whereas registered banks on average trade at around 75 basis points above (Figure 5)

Figure 5: Credit spreads over NZ government bonds, by sector



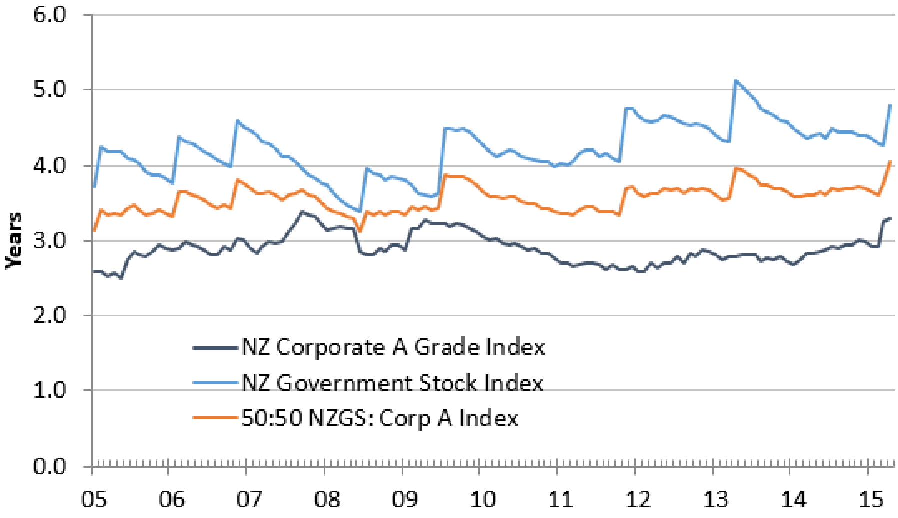
Sources: NZFMA and Harbour Asset Management calculations.

The other pitfall of following an issuance-weighted bond index is that if borrowers issue bonds at maturities they see as good value, these indices encourage investors to hold bond at maturities that suit the borrower more than the investor.

Since the NZ LFGA was established in 2012, the duration of the ANZ Corporate A-Grade Index has lengthened from a little over 2.5 years to just under 3.5 years, significantly increasing the sensitivity of the value of the index to changes in the level of interest rates. A key motivation of the NZ LGFA has been to lengthen its funding profile, and to match the maturities of outstanding NZ government bonds.

The lengthening in duration of the ANZ Corporate A-Grade Index is part of wider trend, as shown in Figure 6. Since the GFC, the duration of the NZ Government Stock Index has extended from below four years to around five years. At the same time, the duration of the Barclays Global Aggregate Index has lengthened well beyond six years. Governments and corporate issuers have been using the opportunity of low interest rates to lock-in funding for longer.

Figure 6: Duration of the Corporate A-Grade Index



Sources: ANZ and Harbour Asset Management calculations.

CLASSIFYING THE ROLE OF FIXED INTEREST SECURITIES

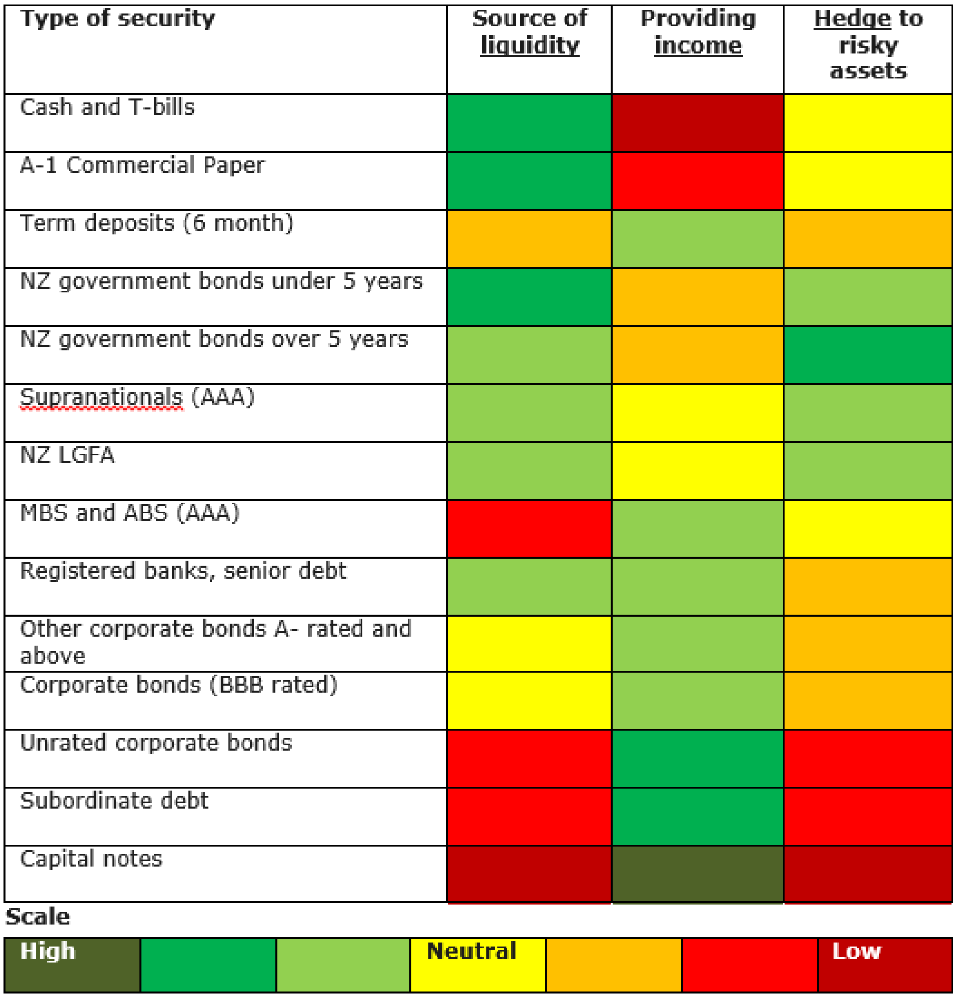
Rather than focusing on the flow of new retail issuance or outstanding wholesale bonds in a benchmark, an alternative is to populate the portfolio taking into account the needs of the clients. This raises the fundamental question – why should investors hold fixed interest securities? The answer will differ depending on the specific needs of the investor.

The role of fixed interest will typically fall into three categories:

- A source of liquidity – an asset that can be turned into cash quickly without having to pay a penalty or sell at a discount;
- Providing income – an asset that can provide income over and above that available on cash; and,
- Hedge to risky assets – an asset whose value will increase in market conditions when the price of risky assets are falling. This is particularly important for a balanced portfolio which holds equities and other risky assets.

Figure 7 provides an illustrative example of the roles played by different type of NZ fixed interest securities.

Figure 7 NZ fixed interest securities and client needs



Source: Harbour Asset Management

This framework enables us to identify the choices and trade-offs facing fixed interest investors.

- Capital notes and subordinate debt are attractive for the additional income they provide, but fail to meet the needs of investors requiring liquidity and resilience in all market conditions.
- Senior debt in registered banks have appeal by providing income, good liquidity in most conditions, and the protection of being further up the capital structure. However, large holdings of these securities will provide insufficient diversification, especially for investors already holding term deposits at banks.
- Corporate bonds from other A-rated and BBB-rated corporates provide the attraction of additional diversification alongside registered banks, but in NZ their scarcity

means they tend to provide only modest additional credit spread for their extra credit risk.

- The NZ LGFA is less appealing to income investors given its narrower credit spread than registered banks, but may have attraction to investors in a balanced portfolio as an alternative or complement to holding NZ government bonds.

This framework also highlights unusual anomalies:

- Asset backed securities can be structured with good income and high credit quality, but can turn out to be very illiquid.
- Term deposits (TDs) have appeal in providing attractive income in an environment where liquidity and funding regulations encourage banks to pay a premium for retail TDs. However, those same regulators will ensure that TDs become illiquid in stressed market conditions, unable to be broken early without a large penalty.

PORTFOLIOS TO MATCH THE NEEDS OF CLIENTS

These are challenging times for fixed interest investors, with little compensation available for credit or duration risk. It may be difficult to meet the high return expectations of clients.

This paper highlights the pitfalls of populating portfolios by focusing on the flow of new retail issuance or outstanding wholesale bonds in a benchmark. The analysis in this paper points to an approach similar to the smart beta or advanced beta approaches developed for equity market investors. In that case, portfolios are benchmark aware, but tilt towards quantitative factors that benefit the investor over the long run, such as size, earnings growth, dividend yield, or valuation metrics.

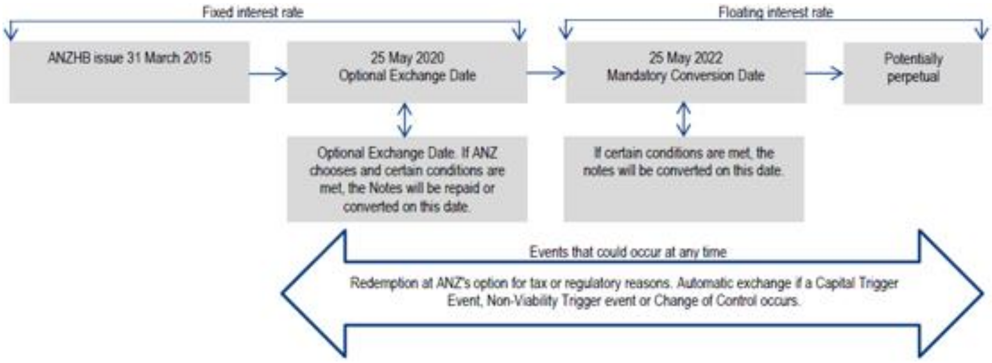
In the case of fixed interest, it implies portfolios are constructed using benchmarks as a starting point to represent the investible universe and to provide diversification, but then the portfolio is tilted towards the specific needs of the clients. For income investors, it points to portfolios tilted towards yielding credits, with small holdings of subordinated debt and capital notes. For "balanced" investors, it points to portfolios tilted toward quality securities like government bonds, supranationals and the NZ LGFA. For investors seeking capital protection and liquidity, it points to shorter duration portfolios.

The approach advocated in this paper does not make current market conditions any easier. However, it does help focus investors on their long-term aims and objectives, and steers them away from the short-term trap of picking the security with the highest yield.

ANNEX 1. ANZ CAPITAL NOTES

The full name of these securities is "Mandatory convertible, non-cumulative perpetual subordinated debt securities". Their structure provides a number of possible outcomes, from redemption in full after five years to a full write-off.

ANNEX 1. ANZ CAPITAL NOTES



NZDX code	ANBHB
Margin	350bp to 360bp
Coupon	7.16% to 7.26%
Amount on issue	Up to $250m (plus unlimited oversubscriptions)
Optional Exchange date	25 May 2020
Mandatory Conversion date	25 May 2022
Maturity date	Perpetual (unless repaid or converted)
Credit rating	BBB-

Source: Forsyth Barr

ANNEX 2. CORPORATE A GRADE INDEX CRITERIA[1]

- Securities must be issued in $NZ into the NZ domestic market (EuroKiwis and Samurais are excluded.)
- Underlying credit rating of issuer or security issued (where a security is specifically rated) must be A- or better (Standard and Poor's) or A3 or better (Moody's).
- Minimum issue size: $NZ50 million.
- All securities must bear fixed rates of interest.
- Securities may be senior debt, subordinated debt or capital notes. Collateralised Debt Obligations are excluded.
- The issue must be reasonably available for purchase by a range of investors. A security issued by private placement will usually be required to be well spread across a minimum of five unique institutional investors.
- Where securities have dual maturity dates or callable/putable features, they will be priced to the first maturity date or call/put date, as is market convention.
- When a new tranche of corporate bonds is issued that satisfies the requirements of the index, it will be added to the portfolio at the end of the first month following the issue. Issues must have settled at least 5 days prior to the month end to be added to the index at the end of that month. Issues with a settlement date less than 5 days before the end of a month, will be added to the index at the end of the next month – provided they meet all of the requirements of the index.
- When a tranche is issued over a range of dates, it will be entered upon the first available month end if sufficient volume has been issued to that date to see it comply.
- When bonds are redeemed by the issuer, the appropriate adjustment will be made to its face value at the end of the first month following redemption.

ANNEX 3. NZ LOCAL GOVERNMENT FUNDING AUTHORITY

- Enabled by Local Government Borrowing Act 2011, established December 2011 and commenced borrowing in February 2012.
- Primary objective is to optimise debt funding terms and conditions for New Zealand Local Government sector.
- Council Controlled Organisation (CCO) operating under Local Government Act 2002.
- Same credit rating as the New Zealand Sovereign.
- Repo Eligible Securities and 20% risk-weighting with the RBNZ.
- 31 shareholders, including the New Zealand Government at 20%.
- Strong liquidity position supported by NZ$1 billion New Zealand Government liquidity facility.
- LGFA's obligations are guaranteed by the local authorities.
- A similar structure to established local government funding authorities (see below)
- Current bond outstandings of NZ$4.775 billion as at 16 April 2015, estimated to grow to approximately NZ$7.8 billion by June 2018.
- Objective to have $1billion size tranches, to provide liquidity.
- 45 to70 basis point pick up in yield over comparable NZGB maturities.

European local government funding authorities

ENDNOTES

1. https://www.nzx.com/files/assets/ANZ Debt Indices Descriptions.pdf

DISCLAIMER

Christian Hawkesby is Head of Fixed Income at Harbour Asset Management.