THOUGHT PIECE

IAM
INCOME ASSET MANAGEMENT

Buying Bonds in New Issues Makes Good Sense

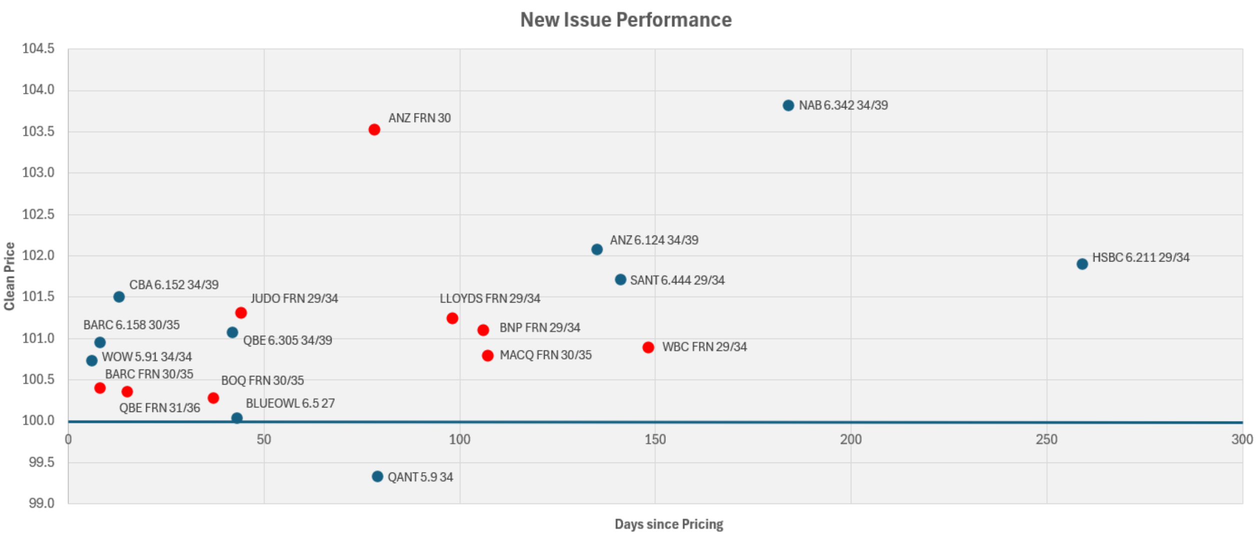
By Darryl Bruce and Ellen Allardice

Over recent months we have seen a consistent stream of new issuance in the AUD investment grade bond market. Almost without exception, these issues have been met with very significant demand –up to 10 times oversubscribed within hours of the order books opening.

Investors are typically attracted to these new issues due to the income of c.6%, or higher. However, it is hard to ignore that the capital performance post issuance has also been solid in almost all cases too. This is despite a sharp jump in underlying yields which acts as a significant headwind to capital gains.

A heavily oversubscribed orderbook at new issue time often results in some 'tension' in the secondary market. Investors that have been scaled scramble to buy bonds in the secondary market to achieve their desired position size. This often results in the capital price of the bond gravitating higher.

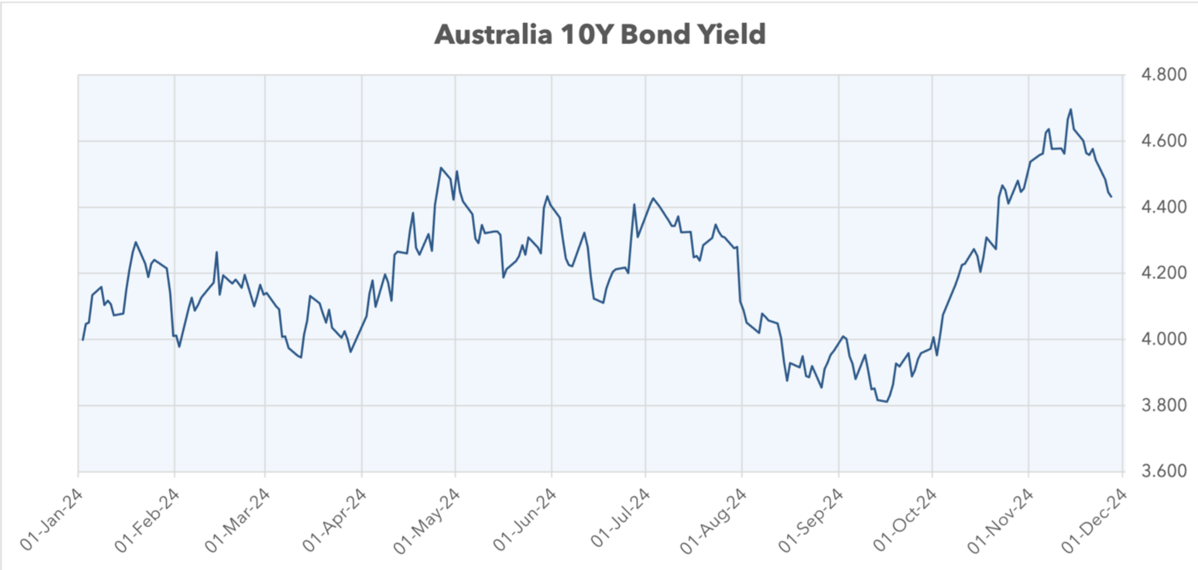
The chart below reflects the current mid-prices on a range of bonds and the number of days since those bonds were issued. Aside from Qantas, which has been a notable underperformer, the rest of the issues have generated some capital growth on top of strong income accruals. Qantas is one of the few that is offering a fixed income of <6%, with a coupon of 5.9%, which makes it look relatively unattractive against most other investment grade bonds.



Source: Bloomberg

The blue dots reflect fixed rate bonds and the red dots show floating rate notes. The chart illustrates that both have moved higher with the strongest performance coming from ANZ floating rate note and an NAB fixed rate bond. Both are trading at a c.103.5, or higher, on top of strong income accruals. That is a great outcome for investors who participated in those issues only a few months ago.

As alluded to above, these gains have been achieved despite a sharp move higher in underlying yields. For almost all of August and September, the Australian 10-year yield was below 4%, as the market was convinced that cash rate cuts were on the horizon. During October and November yields has jumped sharply to sit just below 4.5%. This is a sharp headwind for capital values, especially those of fixed rate bonds.



The exciting thing from a bond investors point of view is not only the performance that we have seen from new investment grade issues over recent months. It is also the fact that while the underlying yields remain elevated, new issues should continue to come out offering healthy c.6%+ coupons. I firmly believe that capital committed to bonds at current yields will generate solid, dependable, returns for investors over the medium term.

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