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Income Opportunity - Floating Rate Notes

By Darryl Bruce

Income is one of the key attractions of an investment in bonds. This week I had a client wanting to add some strong income producing assets to his portfolio. He is largely an investment grade only investor, so he wanted to achieve a high income without sacrificing the safety and security of the investment.

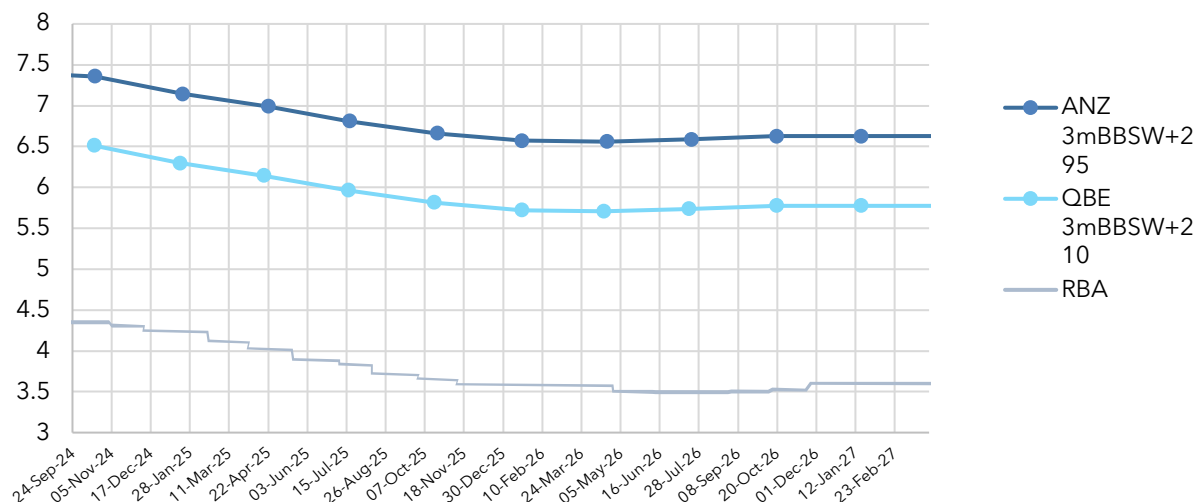
Like many people, he felt like fixed rate bonds would be the best option given that we are at/near the top of the interest rate cycle. This makes logical sense however the market is forward looking and is already pricing in five interest rate cuts by the end of next year. For fixed rate bonds to outperform from here, we will need to see more than five interest rate cuts. If we see less than five cuts, fixed rate bonds would be expected to underperform.

This doesn't make fixed rate bonds a bad investment per se, but it is important to understand this dynamic when considering allocating between fixed and floating. A number of the higher coupon fixed rate bonds are now trading on large capital premiums, some up c.110+, which dents the benefits of their high coupons. In comparison, I think that the income on some of the floating rate notes is looking quite compelling at the moment. In many cases, the capital premiums are also lower, around 105.

Obviously, if we do see cuts to the cash rate then the income will dip. However, the income is coming from such a high level that there is room for a number of cuts and for income to remain robust. My client added holdings in ANZ BBSW+2.95% 2030 (BBB) and Liberty BBSW+3.75% 2029 (BBB) both of which are investment grade rated. The ANZ issue is subordinated debt, and the Liberty is senior which helps to answer the question 'Why do the ANZ and Liberty issues both have a BBB rating?'.

The current coupon on the ANZ issue is 7.37% and on the Liberty issue it is 8.16%. If we make the fairly reasonable assumption that BBSW consistently tracks the cash rate lower, then even after the projected five interest rate cuts, the coupon on ANZ remains above 6% and Liberty is bang on 7%. That level of income looks quite attractive now, for high quality investment grade assets, and it will feel even better in a much lower interest rate environment.

Projected Coupons - ANZ and Liberty FRNs



Predicting the future path of interest rates is obviously an imprecise science however it is comforting to know that your income will hold up well even if we do see a succession of rate cuts next year. If they don't eventuate then your income will stay higher for longer. Interestingly, Ellen (my colleague here at IAM Perth) and I attended a breakfast with an economist from ANZ recently and he felt that we would only see three cuts in the next easing cycle from the RBA.

I think that both issues look like solid additions to most portfolios. For investors currently sitting on the sidelines I believe that these issues offer a great entry point into the market and a solid base from which to build a portfolio around.

If you are interested in either of the above issues, or if you have any other questions please do not hesitate to get in touch.

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