When debt becomes an investment

(the rise of corporate debt)

If you have a well-balanced investment portfolio, you can be sure that some of your money has been invested in debt. 'Debt securities' is just another term for fixed interest investments, which form the second largest asset class in Australian managed funds, after shares. Fixed interest investments are issued by governments and companies as a way of raising money, and when you put your money into these investments, you are lending money to the issuer and receiving interest payments in return.

Fixed interest has been a preferred investment for those looking for a low-risk (albeit low-return) investment that would provide a reliable income over the long-term. These investments become particularly popular when shares are highly volatile or giving poor returns as they are seen as a safe haven in troubled times. This has been seen over the last three to four years, when a series of events – the fall of technology companies in 2000, the terrorist attacks of 2001, corporate collapses at home and abroad (from Enron to HIH) and then the build-up to the war in Iraq in 2003, rocked sharemarkets and sent investors in search of more secure earnings.

The decline in government debt

Traditionally, the mainstay of fixed interest investments has been Commonwealth Government bonds. But over the last five to ten years the market has changed, with the government gradually reducing the number of Commonwealth Government Securities (CGS) it issues.

Under the banner of fiscal responsibility, both State and Commonwealth governments have been paying off their debts and aiming for balanced budgets. The sale and float of government assets – including the State Bank of New South Wales, the Commonwealth Bank and Telstra – have also brought money into government purses, reducing the need to borrow so much money from the public. In 1996–97, Commonwealth bonds on issue were worth $100 billion and by early 2002, this had fallen to $60 billion a decline that mirrors governments overseas. The Australian government remains committed to maintaining low levels of debt and Treasurer Peter Costello has even said that he would prefer to close the market for government bonds altogether.

At the same time, as government's have reduced their levels of debt, companies have filled the gap with their own debt securities.

The rise of corporate debt

While the Commonwealth government has been reducing its fixed interest offerings, the appetite for this type of investment has grown, for several reasons:

- By 31 March 2004, Australians had $596 billion[1] invested in superannuation accounts, of which $93 billion was invested in fixed interest. All but the most aggressive superannuation portfolios include fixed interest investments, to balance the volatility of share and property assets.
- The number of retirees is growing. This group commonly invests for a secure income over the long-term, which fixed interest investments can deliver. With the Baby Boomer generation starting to retire, this trend will continue.
- There has been a flight from share investments in the troubled times of the last five years to the greater security of fixed interest.

Australian companies have increasingly stepped in to take advantage of the opportunities that have opened up in a changing investment market:

- It was estimated in 2001 that the market needed $1 billion of new bonds issued a week, in order for investment managers to keep enough money invested in fixed interest to maintain their portfolios. And, the government was not going to meet that need.
- Companies had observed the growth of corporate debt overseas. In the United States for instance, $594 billion of corporate bonds were issued in 2002, making a total of $4.1 trillion in the US market at the end of 2002.
- Companies could make themselves less dependent on banks and other financial intermediaries by borrowing money directly from the public through offering debt securities themselves.
- Investment markets have also become increasingly sophisticated and accepting of new kinds of investments.

The result is that the value of non-government bonds on issue rose from $10 billion in 1996–97 to $77 billion by June 2002[2]. And where, seven years ago, only 2 per cent of fund managers held non-government bonds in their fixed interest portfolios, by 2004 the proportion had reached more than 30 per cent.

Rating Agency grades

S&P	Moody's	
AAA	Aaa	Investment Grade ↑
AA	Aa	
A	A	
BBB	Baa	
BB	Ba	
B	B	
CCC	Caa	
CC	Ca	↓
C	C	High yield/"Junk" bonds

But even the biggest and wealthiest companies can't compete with the security of government investment offerings. To offset the higher risk, companies have had to offer higher interest rates, which has encouraged investors to take up these new offerings. The interest rates vary according to perceived risk of the investment and that's where ratings come in.

The ratings game

When companies issue corporate bonds, they may pay an independent ratings company to assess the quality of their issue. The rating depends on the view of the company's ability to pay interest and also repay the principal at maturity (their creditworthiness). Bonds rated between the top AAA rating and BBB are described as 'investment grade' and are viewed as relatively safe investments. These high ratings indicate that there is little likelihood that the issuing companies will default on loans – in other words, fail to pay interest or repay the capital.

Bonds rated BB or below are described as 'junk bonds' or 'high-yield securities'. They are seen as being more speculative issues, where default is more likely than in investment grade bonds and so the companies issuing the debt securities have to offer considerably higher interest to compensate for the higher risk of investing in them. They are increasingly sought out as a way of increasing returns.

If an investment is not rated, that does not mean it is a poor investment, only that the issuing company has chosen not to pay for the process of rating.

At home and abroad

Without enough local fixed interest investments to satisfy demand, Australian investment managers also invest in corporate debt overseas and in foreign companies offering their bonds in the Australian market (these are called 'kangaroo bonds'). This satisfies the need for quality investments and also contributes to diversification, which reduces risk.

The overseas market in corporate bonds is bigger and better developed than Australia and there is a much stronger acceptance of high-yield fixed interest investments, such as junk bonds. More lower-quality bonds are also issued overseas than in Australia. In the year to August 2004, European companies had sold $16.5 billion of junk bonds. The appetite for these investments continues to increase, particularly as the number of companies defaulting on loans falls: the proportion of junk-rated companies defaulting fell to 0.7 per cent in July 2004, continuing a steep decline since the beginning of 2003.

What all this means

The need for low-risk, income-producing fixed interest investments is likely to increase in the future, as investment portfolios continue to grow and investors seek assured incomes from their investments. Corporate debt will undoubtedly continue to grow alongside declining government issues. What we are likely to see is a broader range of debt issues, from a greater variety and number of companies, more high-yield issues, the continuing creation of new kinds of investment products and longer terms to maturity.

[1] Media release 02 August 2004, 04.26, (APRA's latest edition of Superannuation Trends', www.apra.gov.au
[2] 'The Australian Debt Securities Markets' data file series 2003 www.axiss.com.au/content/pubs/_data_file_series/debt_debt_secutrities.asp

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