US high-yield bonds offer choice and depth

ELIZABETH MORAN

Government bonds have been on the nose since Donald Trump sent prices lower last year on the promise of tax cuts and increased spending.

But the underlying corporate bond market continues full steam ahead, with demand massively outstripping supply.

So much so that blue-chip, AAA-rated technology giant Microsoft was able to get the year's biggest bond transaction just a few days ago. Microsoft raised $US17 billion ($22bn) to refinance commercial paper used to fund the acquisition of LinkedIn and fund general corporate purposes, including share buybacks and capital expenses.

Despite the size of the transaction, some investors were left empty-handed with demand rumoured at $US38bn.

Our domestic corporate bond market mirrors that of the US in that demand far exceeds supply. Consequently, bond prices are rising and expected returns compressing. New investors may have to wait for reluctant sellers before they can access the bonds they want.

Typically, I would suggest to new investors they should expect to earn 1 to 2 per cent a year more than deposits for a low-risk, investment-grade bond portfolio, putting the expected yield at between 3.8 and 4.8 per cent a year. Not terribly exciting, but there are ways to improve returns for those willing to accept higher risk.

One of the best strategies at the moment for wholesale investors is tapping the US high-yield market where returns can be as high as 10 per cent a year.

The US high-yield corporate bond market is huge: worth about $US1.4 trillion of a total corporate market of about $US8.5 trillion. Issues sizes are usually large and provide good trading liquidity.

Many companies issuing bonds are listed, with good news flow and visibility over market capitalisation. I like those sectors with physical assets such as telecommunication and power generation.

If Trump succeeds in his proposed stimulus measures, both of these sectors are likely to benefit from improving business conditions.

An example of a corporate bond in favour is McDermott International, a global engineering, procurement, construction and installation business providing services for upstream oil and gas developments. McDermott has a fixed-rate bond due to mature in May 2021 that has a current yield to maturity of just less than 6 per cent per annum. The $US100 face value bond traded as low as $US63.50 in February 2016, but it has rebounded and is now trading around $US104.50.

The fluctuation reflected the company's exposure to oil prices, which dropped about 75 per cent over the same period. These bonds may be quite volatile but as long as the company continues to operate, investors can expect a return of $100 face value at maturity. For this company, volatility is somewhat mitigated by a strong backlog of work worth $US3.9bn as at September 30 last year.

The stellar move in the McDermott bonds along with others exposed to commodities — helps explain the 21.17 per cent return in the Bloomberg USD High Yield Corporate Bond Index last year.

There are significant risks involved in investing in the US high yield bond market, including currency and interest rate risk. However, as much of the return is a margin for credit risk (that is the possibility of the company not being able to pay interest or return capital at maturity), changes in interest rates are less likely to impact the price of the bonds, compared to government bonds that solely reflect changes in interest rates.

Government bond yields are a benchmark and the rising US 10-year yield has largely been mimicked by the Australian government 10-year yields on an upwards trajectory.

Both bonds have risen about 1 per cent from last year's lows to 1.46 per cent for the US and 2.72 per cent for the Australian bond. It's worth remembering that the yields convey what the markets expect, and will not necessarily eventuate.

Even though these benchmarks have moved higher, global demand for corporate bonds has pushed the spread over the benchmarks down, lowering overall corporate bond returns. This is illustrated by the Bloomberg USD High Yield Corporate Bond Index, up 21.17 per cent in 2016, up 1.61 per cent to December, averaging 5.13 per cent over the past three years.

The US high yield bond market presents more choice and potentially more depth than the Australian market but if anticipating volatility, timing of entry and product selection will be key.

The domestic corporate bond market is underdeveloped and I expect many Australian companies to continue to issue in US dollars where they can access larger volumes and often at better yields than what can be achieved in Australia.

Elizabeth Moran is a director of education and research at FIIG Fixed Income Specialists www.fiig.com.au

Clarity on new super rules

Understanding the new laws is key to taking timely action

MONICA RULE

AAP

Scott Morrison's controversial super changes come into effect in just four months

Perhaps the outstanding issue for wealth management in recent times has been the major changes announced for superannuation.

For many people, there is a sense that the changes have only become clear very recently as the final legislation did not get passed until the end of 2016. Worse still, many people were misled by earlier reports which attempted to capture the changes before they were finalised by the government.

Either way, we suddenly find ourselves in February 2016 with only four full calendar months before Scott Morrison kicks off the new regime on July 1. Self-Managed Super Fund members need to understand the basics: Today I want to spell out the key changes and importantly identify some variations that have become clear this year.

The $1.6m cap

The change most people are familiar with is the $1.6 million transfer balance cap. For the sake of convenience I will simply refer to this as the "cap". What you may not know is that the cap will apply in two instances.

First, it is the limit on the amount of net capital that can be placed on an SMSF member's pension account where the earnings are tax exempt. Amounts above the cap need to be moved to the accumulation phase or taken out as a lump sum. The second instance is where the cap will apply to a member's total superannuation balance. If a member's superannuation balance exceeds $1.6m, they will be prevented from making further non-concessional contributions into their SMSF.

Now I should point out that there are some contributions which do not count towards the $1.6m pension cap or superannuation balance cap.

Compensation payments for personal injury, received by SMSF members and contributed into their SMSFs are not counted towards the $1.6m superannuation balance cap or the $1.6m pension cap. This means members can have a pension account in excess of $1.6m.

On the other hand, if a small business taxpayer transfers the proceeds from the sale of active assets up to the value of $1,415,000, or capital gains from the sale of an active asset of up to $500,000 into their SMSF (under the Small Business CGT concessions) the contribution will count towards their superannuation balance. If the amount exceeds $1.6m, then the member will be restricted from putting any more non-concessional contributions into their SMSF.

Transition

SMSF members turning 65 during the 2016-17 financial year need to understand the changes to the bring forward non-concessional contributions cap. There will be a transitional non-concessional bring forward cap of $460,000 or $380,000 depending on when the bring-forward cap was triggered. If you want to take advantage of the full $540,000 cap you need to make the whole bring-forward, non-concessional contribution of $540,000 before June 30, 2017.

There will also be a $500,000 limit that stops you from being eligible for the catch-up concessional contributions, where you can use any of your unused concessional contributions cap, from July 1, 2018, on a rolling basis for up to five years. Where an SMSF member exceeds their $1.6m pension cap by up to $100,000 at June 30, 2017, the new law allows the member six months to remove the excess from the member's pension account. However, the member will still be recorded as having exceeded their $1.6m transfer balance cap and will not be eligible for any indexed increases of the cap in the future, even if they reduce their pension account balance below $1.6m.

Different treatment

Members need to be aware that withdrawals from their pension are recorded differently depending on the type of withdrawal. While a partial commutation reduces a member's $1.6m pension cap, an ordinary pension payment does not. This is an important distinction for members who want to put more money into their pension account.

Reversionary pensions and death benefit pensions are also treated slightly differently under the $1.6m pension cap. Although both pensions count towards a dependant recipient's pension cap, reversionary pensions are not counted towards the cap until 12 months after the deceased member's death. The amount counted towards the cap also differs. For a reversionary pension it is the amount in the deceased's account at death whereas with a death benefit pension, it is the accumulated amount when it is paid to the dependant.

Estate planning also needs to be considered more carefully where the deceased member's children receive their superannuation entitlements. The children may not be able to take a pension of up to $1.6m, or may be able to take a pension in excess of $1.6m, depending on whether the deceased was receiving a pension at the time of their death. While the changes may cause concern, in my opinion knowledge is your best defence. Understanding how the changes will apply to you and taking early action will help you to navigate these changes with more certainty.

Monica Rule is an SMSF specialist and author of The Self Managed Super Handbook.

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Eden tempting as a concrete pick for the Trump trade

RICHARD HEMMING
UNDER THE RADAR

Searching the local small-cap market for stocks that will get a lift from the "Trump trade", one stock jumps out … it is Eden Innovations (EDE), until recently known as Eden Energy.

A year ago nobody expected it to be a success when its shares were languishing at about 6c. Now it is trading above 30c, delivering EDE a market cap of close to $400 million.

The company had produced no real revenues, but like Donald Trump it does make a lot of announcements!

Moreover, it has technology that plays perfectly into the infrastructure boom that is widely expected across the US as Trump's planned $US1 trillion ($1.3 trillion) infrastructure plans get off the ground. You could go as far as to say Eden Innovations has a technology which Trump can use to build his wall (as well as his roads and his bridges).

The company's "EdenCrete" product is a liquid additive used to strengthen concrete. The main component is carbon nanotubes. In the next couple of months the company should have a production facility up and running in Colorado to produce just over 2 million gallons of the stuff.

EDE's valuation shows what can happen when you combine a sexy technology with the Trump factor. Indeed, since Trump was elected in early November its shares have shot up 50 per cent.

Right place, right time

What initially impressed was EdenCrete's successful year-long trial on a 12m section of one lane of Georgia's Interstate Highway I-20. Then, a couple of weeks ago, EDE announced that EdenCrete has been put on Georgia's Transport Department's approved list for highway repairs products, for which the annual budget is about $US150m.

With the Trump administration touting its infrastructure focus from the get go and EdenCrete fortunate enough to have its products not just suitable but actually already in the mix for a key state's infrastructure project, no wonder many nervous investors have made the leap of faith that Eden could just have an ideal position to generate big money from US government initiatives.

Who are these guys? The executive chair and founder of the company is Greg Solomon, who alongside his brother Doug owns close to 40 per cent.

Greg Solomon is unabashedly optimistic about the prospect of a commercial contract with Georgia's Transport Department "in the next month or so".

Another iron in the EDE fire is that EdenCrete has also been approved to undergo trials for its product to be used in new highway construction in Georgia, for which there is an annual budget of more than $US850m.

Solomon expects that the trial will not take "nearly as long this time", but then the lawyer and company director in him adds that he isn't sure.

The group raised $35m last year and has about $20m in cash left. If it can sign a material deal sooner rather than later, it could come close to justifying its hefty market capitalisation.

Current hits turbulence

Of course Eden Innovations is not the only local small cap well situated for the Trump trade: I have previously looked at two ASX listed suppliers to US defence: the ship builder Austal, which produces warships for the US Navy and Quickstep, which produces parts for the F-35 Joint Strike Fighter.

Then I remembered a high-profile negative report before Christmas talking mainly about the F-35 program that also asserted that the Austal's LCS vessels were plagued by performance issues. Even if not true, it cannot help in the current environment of changing priorities at the top. My ardour for both stocks cooled.

In case you missed it late last year I also put forward three favourite small caps for 2017: Cabcharge, Sundance Energy and Pacific Current.

One of these 2017 choices, Pacific Current, may get some useful pick-up from the Trump trade. Pacific Current was previously known as Treasury after its merger of sorts with the US-based Northern Lights.

The merger was consummated in the form of an opaque trust which investors struggled to fully understand.

However, it now has an interesting link with the US.

As I mentioned late last year PAC, a "global boutique multi-asset manager" has kicked out the old guard and employed a new management team.

There is also much more transparency at the restructured group. If the equity markets keep strengthening, so will its share price. Indeed at $5.20 this week it has climbed from below $3.50 late last year.

Originally, I had put Pacific Current into the Trump trade but standing back from it I think Trump is too erratic to trust on this one. In contrast, Eden Innovations is literally in the mix.

Richard Hemming is an independent analyst who edits undertheradarreport.com.au

FLOAT WATCH

Attractive mix from property investor

Eildon Capital

ASX CODE: EDC
SHARES ON OFFER: 9.4 million
LISTING PRICE: $1.06
MARKET CAPITALISATION: $32m
LISTING DATE: February 28

SIMON HERMANN

Property investment company Eildon Capital, previously known as CVC Private Equity Limited, is seeking to raise up to $10 million to list on the ASX at the end of this month. The company has extended the offer but stated the minimum target has already been exceeded.

Eildon Capital Limited is an Australian investment management company focused on real estate. The company's portfolio comprises property investments in the retail, industrial, residential and commercial sector and has a total value of $22.4m at the date of the prospectus. Since 2009 the Eildon Capital management team has invested more than $282m across 48 property investments. The proceeds from the offer will be used to invest in new opportunities, which have yet to be identified.

An Australian investment management company focused on real estate

Eildon Capital's management team has a strong track record in investing in real estate assets having achieved a pre-tax profit of 20.9 per cent per annum over the past seven years. Going forward, realising value from property transactions while building a sustainable base of recurring income through rental payments and loans will be the key value driver for this stock. Management hopes to lure investors with the distribution of a quarterly dividend that will yield about 5 per cent per annum.

However, even though the fund offers diversified exposure to various sectors in the property market, it is vulnerable to general property market trends. As the portfolio is relatively small, unfavourable transactions or price deterioration could have a significant impact on its net asset value and share price.

Track record and the quarterly dividend are attractive qualities but tightening conditions in the property market may impair the company's ability to realise value from its transactions. The IPO seems balanced and the listing price is consistent with Eildon Capital's net asset value. In conclusion, the float offers an attractive mix of capital growth and income for those seeking to gain exposure to the Australian property market.

Simon Hermann is an analyst at wise-owl.com

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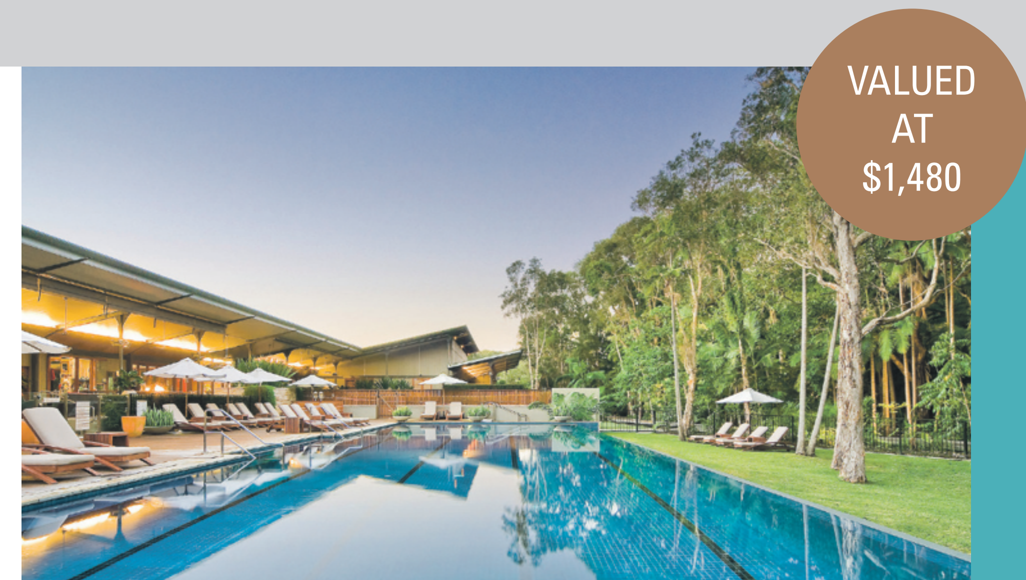

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