INVESTING WITHIN THE CAPITAL STRUCTURE: THE TIMES THEY ARE A-CHANGIN’

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Bob Dylan was ahead of the times when he wrote his hit single and album in 1964 – The Times They Are A-Changin’. In the current investment climate, one thing is certain: the times they are a-changin’. Four years ago, ‘income’ was a concept synonymous with tax efficient dividends and hybrid securities. Cashflows accumulated effortlessly and returns were ample. That was the ‘Old Normal’ – but the Old Normal is no more.

What worked before may seem unthinkable now. The core of many investors’ investment philosophies – that equities can indefinitely provide sustainable income streams – now may seem like the stuff of fairy tales. The combined tri-forces of deleveraging, deglobalisation and re-regulation have heralded a new era, replete with concerns surrounding European solvency, US financial and political repression and an international banking system under strife. Like a rolling stone, governments and investors alike are fighting daily to dodge the impending collision of hurricane forces. The playing field has changed, equities are more volatile, and now more than ever, investors find themselves asking: How can I preserve my wealth, harvest my income, and balance my portfolio?

In the New Normal, the answers are different

How can the investor adapt to these rapidly changing tides? ‘De-risk and delever’ seems to be a popular answer, and movements into cash deposits and bond funds over the last quarter of 2011 may be a testament to this. As Donald N. Sull, professor of management practice in strategy and entrepreneurship at the London Business School, points out in his book The Upside of Turbulence, heightened volatility calls for focus and flexibility.

While this year many investors will undoubtedly commit to short term quick fixes, we believe that the current crisis, unprecedented in its scale and breadth, calls for deeper introspection and the courage to rethink long-seated notions of income-oriented investing.

Previously, investors have been enamoured with returns. Going forward, investors should be prepared for depressed returns from all asset classes. Crucially, risk must again return to the forefront of investment planning. Over both the short and long term, risk is an important factor that drives return.

Capital structure: once forgotten, now here to stay

Too often during the boom years, investors fail to consider capital structure positioning when seeking regular income and capital protection. Yet, as the past four years have demonstrated, where investors choose to sit within the capital structure is an important determinant of risk and return.

As old relationships and assumed truths break down, consideration for capital structure has become increasingly essential. In the days of the Old Normal, the enthusiastic equity investor reigned supreme – the higher the risk, the greater the return. It was great while it lasted, but those days are more than likely, gone. In a volatile, low-growth environment in the New Normal, the relationship between risk and return has become inverted. Equity is no longer delivering the returns it once did.
Understanding Capital Structure

The relative positioning of an instrument in the capital structure of an organisation is as important for the investor as it is for the organisation itself. It determines the manner in which cashflow generated by the company is distributed, both as a going and gone concern. Capital structure is a pecking order: in the event of default, it decides who loses and by how much. As highlighted in Figure 1, the corporate capital structure is multi-tiered and flexible, with many variations existing across differing industries. Yet such similarities exist that the capital structure can be discussed broadly:

At the top of the capital structure, corporations issue debt to gain access to fixed, long-term financing. Typically, the longest dated securities (covered bonds, senior secured and unsecured debt) carry the highest seniority in the capital structure, and feature fixed-interest commitments (coupons) and known maturities, enabling corporations to match long-term liabilities against their projects. Underneath this lies unsecured and subordinated debt, which are typically more flexible.

Further down sits hybrid capital – typically, equity with fixed income characteristics (or vice versa) but almost invariably subordinated to all forms of debt. At the bottom, corporations issue equity capital to gain access to financing with an indefinite term and an often-indeterminable cost. To debtholders (creditors), equity and hybrid capital serve as a cushion, both in the everyday distribution of interest payments and in case of default.

In terms of risk, the crucial difference is that while equity represents an ownership stake, debt is a legal obligation that must be repaid. To enforce this, secured senior (higher-placed) forms of debt have a claim over the assets of the corporation (eg an underlying pool of mortgages or other assets) while more junior (lower-placed) forms of debt feature priority claims over equity holders.

The key issue in optimising any corporate capital structure is balance. Like any form of leverage, a company that finances its operations with as much debt as possible can, in theory, maximise returns to shareholders (return on equity). Debt is also cheaper and more flexible to issue. International corporates opportunistically issue debt in low interest rate jurisdictions (e.g. BHP’s $US3bn and Woolworths’ $US850m bond issues, both of which were issued in the US bond market in 2011). Furthermore, debt is tax deductible and often sends strong signals (if deployed correctly) about a corporation’s solvency, and the managerial confidence in its long-term prospects.

Debt, however, introduces financial risk to the organisation and too much debt can result in bankruptcy. Therefore, organisations need to balance their desire to maximise shareholder returns while minimising the negative implications of having too much debt.

Don’t overstep or overcommit: a company’s agenda may not always align with the goals of investors

An investor’s choice of financial instrument – equity, hybrid, fixed interest – has a real impact on returns. In pursuing high yielding equities and hybrid instruments, investors often forget that equity (and often hybrid) distributions are discretionary and variable. In times of stress, organisations can and often do cut dividends.

As shown in Figure 2, over the past six years, only fixed income as an asset class (both Australian and global) has outperformed cash.

This comes as no surprise to many investors relying on equities and hybrids to meet lifestyle and retirement outcomes.

Many investors rely on hybrid instruments to diversify portfolios – often as a substitute for fixed income. But does this pay off? Both Figures 2 and 3 highlight that hybrid instruments, for all their ‘fixed income characteristics’, act more like equity in bear markets and fixed income in bull markets, diluting returns but not necessarily able to diversify risk.
Looking ahead: why it pays to be the bondholder

Going forward, the resurgence of re-regulation and higher capital buffers for the financial sector, alongside muted business investment prospects, may generate more opportunities for bondholders. How? There is more capital and a bigger equity/hybrid cushion which can strengthen the reliability of timely coupons and moreover the return of principal at maturity of the bond.

Conversely, equity and hybrid investors sitting lower in the capital structure, who have traditionally relied on fully franked dividends (and lots of them), are likely to be forced to reflect upon their investment approach as market forces throw the sustainability of current return on equity into doubt.

A weak and deepening economic slowdown means equity holders may face the increasing likelihood that companies will cut dividends to maintain necessary liquidity, in an environment where capital markets remain closed to most but the highest quality companies or those that are likely to receive government support.

Some organisations may even look to hybrid instruments as a source of ‘cheap’ financing – potentially at the cost/subordination of equity investors. For example, a recent retail hybrid issue for a well-known, blue-chip Australian company yielded 325 bps over the 3 month Bank Bill Swap rate (BBSW; around 4.6% at the time) – giving a total return of around 7.85%. While this may seem like an impressive return, at the same time the company was yielding approximately 3.79% in the US, which when hedged back to AUD will return approximately 8% given the interest rate differential between AUD and USD. This example shows that the compensation for holding an unsecured note can be similar or even greater than for a hybrid, yet at the same time an unsecured bond, which sits higher in the capital structure, incurs far less volatility and risk and should see a more positive risk adjusted return.

Simply put, investors today are likely to be better off lending at the top of the capital structure than owning at the bottom of the capital structure. Tight credit and financial conditions may see investment grade companies paying 6%-12%, and high-yield companies paying up to 15% to access new capital. While such onerous interest burdens may shrink corporate profit margins and even crush highly leveraged companies with precarious balance sheets, investors in high-quality, well-capitalised multinationals can benefit from this.

Additionally, investors may increasingly find that conservatively positioned portfolios, especially those emphasising quality and liquidity through a diversified holding of senior securities, can deliver a better relative risk adjusted real return.

Australian investors who cannot adapt to the challenging environment will start to face struggles to preserve their wealth and harvest their income. The age of high income and high returns at the bottom of the capital structure are likely over and in order to continue to maintain good sources of income, investors must place themselves at the front of the line and climb the ladder of corporate structure. FS

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