

A Guide to Fixed Interest



Contents

Instruments Traded	1
Transaction Costs	4
What are the Risks?	5
Rating Definitions	6
How Fixed Interest is Priced	7
Taxation	7
Common Fixed Interest Terminology	7
Who are we?	9

What is Fixed Interest?

Fixed interest investments offer a range of products that are intended to provide investors with regular known cash flows and funds repaid on maturity. Since the deregulation of New Zealand's financial markets in the mid-1980's, the domestic debt market has developed steadily, and now provides retail investors with opportunities to invest in fixed interest products that expand beyond bank term deposits and savings accounts.

Debt instruments originate from the Government, Local Authority and corporate sectors' requirement for funds. The securities represent a contractual claim on an issuer (the borrower) to make specified payments such as periodic interest payments and principal repayments over a defined period. Existing debt instruments can be bought and sold in the secondary market providing

investors with liquidity and the ability to restructure portfolios in line with changing preferences for risk and return. The exception to this is Bank term deposits and Debentures which are not negotiable, although with the consent of the Issuer and usually with a penalty, they may be repaid ahead of the due date.

In contrast to equities where dividend payments are not guaranteed and there is no maturity date, debt products provide the holder with known cash flows and (generally) a maturity date when the principal invested will be repaid in accordance with the terms of the contract. Debt securities entitle the holders to a priority claim over equity holders to the profits of the borrower, and rank ahead of equity holders for payments in the event of liquidation.

Instruments Traded

The fixed interest market consists of many different instruments.

- Term Deposits
- Government Stock
- Local Authority Stock or Bonds
- Corporate Bonds
- Step-up Securities
- PIE's (Portfolio investment entities)
- Capital Notes
- Capital Bonds
- Redeemable Preference Shares
- Perpetual Preference Shares
- Convertible Notes
- Debentures

Term deposits: Are typically placed with banks. Investment amount, term, interest rate and payment dates are agreed on investment. There is not usually brokerage or fees charged for the investment.

Secondary Market: Term deposits are non-negotiable and early repayment will only be with the consent of the bank. There may be penalties in the form of reduced interest earned in this situation.

Government Stock (NZGS): Is tendered initially in institutional size parcels, with retail parcels being created by banks and other financial institutions in the secondary market. The Crown is considered the most credit-worthy entity in New Zealand as it can meet its obligations through its ability to raise revenue from taxation. Thus,

interest rates on all securities issued by the Crown are lower than those of similar securities issued by non-Government organisations. Government bonds are the principal benchmark against which rates on other long-term domestic securities are measured.

Secondary Market: Negotiability is excellent with a high level of liquidity.

Kiwi Bonds: Are issued by the New Zealand Government to provide retail investors with up to 2 year government risk. The interest rates on Kiwi Bonds are set at a margin below that of Government Stock of similar maturity. Investment is made by way of an application form, with a minimum investment of \$1,000 to a maximum of \$500,000. There are no fees or brokerage payable by investors.

Secondary Market: Kiwi Bonds have been well supported by smaller risk averse investors and are held until maturity. There is no secondary market although in certain circumstances early repayment can be arranged with the Reserve Bank registry, in which case the interest will be adjusted at a penalty rate of 2% p.a. lower.

Inflation Index Bonds: Are issued by the New Zealand Government and provide investors the opportunity to obtain some protection against inflation on their fixed interest funds. The bonds have a fixed quarterly coupon and on maturity, the principal and an indexed component of the Indexed Bonds are redeemable. The Consumer Price Index is used to calculate the indexed component of the bonds.

Resident withholding tax is deducted from interest payments and on the increase in the Indexed component.

Secondary Market: Bonds are not as popular as standard government bond issues, however there is reasonable liquidity.

Local Authority Stock and Bonds: Are issued by various local authorities, i.e. regional councils, city and district councils, to fund their capital expenditure. These bonds are similar to Government Stock in that most local authorities are considered to be very credit-worthy because they have the ability to levy rates. Most issues are secured by a rating charge. They offer a higher yield as the underlying risk is with the local authority rather than central Government, and the much smaller issue sizes means the securities are less liquid.

Secondary Market: Local Authority Stock can be traded on the secondary market, although may be limited by availability.

Corporate Bonds: Are issued by companies usually to diversify funding from banks and as a means of meeting their long term funding requirements. Maturities range from one to fifteen years with the most common maturities being in the three to five year ranges. The coupon rate and frequency is specified when the bond is issued. Almost all retail bonds are issued at a fixed rate with coupons paid either semi-annually or quarterly. The yield premium above yields applicable to government bonds reflects the increased credit and liquidity risks associated with individual corporate securities. In many cases the issuer and/or the debt issue is assigned a credit rating from an independent rating agency (usually Standard & Poor's, See

later section on credit ratings). Retail investors may have the opportunity of investing as new issues are brought to the primary market. Bonds have the rankings of:

- **Senior Debt:** This can be either secured or unsecured and is often described as unsubordinated. Thus, if a company goes into liquidation, senior or unsubordinated debt holders are paid before subordinated debt holders or shareholders.
- **Subordinated Debt:** Ranks below senior debt for repayment in the event of liquidation. In the event of a company going into receivership, subordinated debt is repaid after all other debt but before shareholders and unsecured creditors.

In addition to the seniority ranking of the debt, corporate bonds can also be distinguished by the different redemption options.

Senior Bonds: On the maturity date the principal is redeemed to the holder in cash.

Secondary Market: Trading varies according to the credit rating of the bonds and liquidity. High quality rated corporate bonds are more actively traded without undue premiums added for risk or liquidity.

Step-up securities: Are typically issued with a fixed coupon rate until a set "Step up" date. On this date the issuer either redeems to the holder in cash, exchanges for shares, arranges for a resale facility or the security will have a new coupon rate set until the maturity date. The new coupon amount will be set at a higher margin above the benchmark rate than

the margin on the original instrument, providing some incentive for the issuer to redeem in cash to the holders. Usually the step up date is 5 years, and the maturity date is 10 years from the issue date, giving rise to the term 5+5 securities.

Secondary Market: Trading varies according to the credit rating of the bonds and liquidity.

Portfolio Investment Entities (PIE's):

Came into existence on 1 October 2007. A PIE is a pooled fund (such as a managed fund) that by gaining PIE status obtains the benefit of PIE regime tax rules. Generally they pay tax on investment income based on the prescribed investor rate (PIR) of their investors, rather than at the entity's tax rate. Natural person and most trustee investors are not required to include the PIE Dividends in their income tax return, which may provide tax advantages for investors in the higher tax brackets.

Secondary Market: Trading varies according to the credit rating of the security and liquidity.

Capital Notes: Are unsecured notes subordinated to all other debt obligations of the issuer. Rather than a maturity date, capital notes have an "election date" at which time the note holder may elect to invest for a further period on the offered new terms and conditions or convert the notes into ordinary shares of the issuer. In any event the issuer retains the right to pay note holders in cash on the election date.

Secondary Market: Trading is sensitive to supply and demand from investors. There may be delays experienced from when an order is placed and then executed.

Capital Bonds: Are similar to capital notes in that they are subordinated to other debt obligations, and at the "reset date" holders can elect to retain the bonds at the new terms or request the company sell their bonds at the issue price, using a resale facility established by the company for that purpose. If the company is unable to sell the bonds the holder can elect to have the bonds converted to shares. Note: Capital bonds are not always able to be redeemed for cash.

Secondary Market: Liquidity is the same as for Capital Notes.

Redeemable Preference Shares (RPS):

Can have different forms of security i.e. they may be senior or subordinated. RPS pay a dividend rather than an interest payment, and holders may receive a combination of cash dividends and imputation credits. The dividend rate may be reset, usually annually, at a margin over the benchmark rate. Most resettable RPS enable the issuer at a specified date, (which is earlier than the maturity date, and each dividend reset date after that time) to redeem or repurchase the security. If not redeemed earlier, the issuer is required to redeem for cash on maturity.

Secondary Market: Liquidity may be limited by appetite for resettable securities, the holders' ability to use imputation credits and subordination of the instrument.

Perpetual Preference Shares and Notes:

Are usually deeply subordinated ranking behind all other debt but ahead of ordinary shares of the issuer in the event of a claim on the assets of the company. The Shares pay a dividend and may make distributions to holders which are a combination of

Transaction Costs

cash dividend and imputation credits. The Notes pay an interest coupon. The rates are reset as a margin over a benchmark rate, typically annually or five-yearly. There is no specified maturity date for perpetual securities. The issuer must repurchase or holders must sell their holding via the secondary market to get their cash invested returned.

Secondary Market: Liquidity tends to be more limited.

Debentures: Are issued by financial institutions (primarily finance companies) and industrial and commercial companies. The debenture is a promise to pay, with a charge against the assets of the issuing company. If the company defaults on payment the asset can be seized by the trustee and sold to repay investors. The assets which secure the obligation are specified in the trust deed relating to the issue. There is not usually a brokerage or fee charged for investing.

Secondary Market: There is no secondary market as most debentures are not negotiable instruments and are unable to be transferred out of the holder's name before maturity.

Primary Market: In most cases when purchasing a new issue of a security from an application form, the cost of issuing the bonds (transaction cost of producing the prospectus etc) is met by the issuing company and is not reflected in the price the investor pays.

Secondary Market: Purchases or sales attract brokerage charges, which are usually a percentage of the value of the transaction.

What are the Risks?

Risk is present for every investment. By understanding investment risk and how it relates to returns, investors can help strengthen their portfolios.

The following outlines some of the common forms of risk and the ways in which they may affect the value of your fixed interest investments.

Credit Risk: If the issuer of a debt security experiences financial difficulty or fails, holders may not be paid the promised interest or the full amount of their principal. This is referred to as credit risk. To help investors understand the extent of credit risk associated with different bonds, third-party organisations such as Standard & Poor's (S&P's) evaluate and rate bonds. The higher the rating, the higher the probability of receiving repayment of your investment on maturity, and the promised interest payments. Lower quality bonds generally pay a higher interest rate to compensate investors for the greater credit risk.

Interest Rate Risk: For securities that are issued with a fixed rate of interest, their values fluctuate in response to changes in the current market interest rates. When interest rates increase, the value of an existing bond goes down because the present value of the fixed future income stream accruing to the holder diminishes. Conversely, when interest rates decrease, bonds increase in value. Generally, the longer the maturity of a bond, the greater its degree of interest rate risk. Changes to the capital value of your investment are only realised when you sell before maturity, therefore this risk is particularly



applicable to holders who may have the need to sell investments prior to their maturity date or for perpetual securities where the only avenue to exit is via the secondary market.

Inflation Risk: Because fixed interest investments generally have a fixed or guaranteed interest rate, there is a chance that the fixed rate may not keep pace with the rising costs of goods and services over time.

Liquidity Risk: Secondary market trades may be affected by a lack of buyers or sellers. The security may not be able to be quickly bought or sold without causing a significant movement in the price. As a guide, the higher the credit worthiness of the debt security, the lower the liquidity risk.

Rating Definitions

S&P's credit rating is a current assessment of a company's overall creditworthiness, and ability to pay its financial obligations. It is based on the likelihood of default, the nature and provisions of the obligations and the protection against bankruptcy, or other arrangements affecting the creditors' rights. Credit ratings of issues are noted on the daily quotation sheets.

The ABC's of rating scales		
A general summary of the opinions reflected by Standard & Poor's Ratings		
 Investment Grade	'AAA'	Extremely strong capacity to meet financial commitments. Highest rating.
	'AA'	Very strong capacity to meet financial commitments.
	'A'	Strong capacity to meet financial commitments, but somewhat susceptible to adverse economic conditions and changes in circumstances.
	'BBB'	Adequate capacity to meet financial commitments, but more subject to Investment adverse economic conditions.
	'BBB-'	Considered lowest investment grade by market participants.
Speculative Grade 	'BB+'	Considered highest speculative grade by market participants.
	'BB'	Less vulnerable in the near-term but faces major ongoing uncertainties to adverse business, financial and economic conditions.
	'B'	More vulnerable to adverse business, financial and economic conditions but currently has the capacity to meet financial commitments.
	'CCC'	Currently vulnerable and dependant on favourable business, financial and economic conditions to meet financial commitments.
	'CC'	Currently highly vulnerable.
	'C'	A bankruptcy petition has been filed or similar action taken, but payments of financial commitments are continued.
	'D'	Payment default on financial commitments.

Ratings from 'AA' to 'CCC' may be modified by the addition of a plus (+) or minus (-) sign to show relative standing within the major rating categories.

Credit Watch: highlights an emerging situation, which may materially affect the profile of a rated corporation and can be designated as positive, developing or negative. Following a full review the rating may either be affirmed or changed in the direction indicated.

Source: Standard & Poors

How Fixed Interest is Priced

When an issuer brings a new security to the market the coupon rate is set as an aggregate of either:

- i) the current market risk free rate (i.e. government bonds with the same time to maturity) or
 - ii) a bank swap benchmark;
- plus an added margin reflecting the credit risk of the security.

In the secondary market the yield comprises the appropriate benchmark and the credit margin. There may be further premium added if the security is perceived to be illiquid.

Taxation

There is no stamp duty, security tax or capital gains tax in New Zealand, although there is an extended definition of interest, which is not just confined to coupons but includes the difference between money lent and money paid. Investors should check with their accountant or financial advisor regarding any tax implications of an investment.

Resident withholding tax is deducted at source unless the investor has a certificate of exemption, in which case interest is paid without deduction.

Common Fixed Interest Terminology

Bond: A written contract by an issuer to pay to the lender a fixed principal amount on a stated future date, and a series of interest payments on the principal amount until that payment date. Colloquially, used to mean any debt instrument if it is registered into the name of the investor.

The Time Value of Money

The fundamental concept when pricing fixed interest is that a dollar held today is worth more than a dollar promised in, say, a year's time. Bonds, capital notes and securities with similar characteristics are priced by converting and then aggregating all the future coupon (or dividend) payments and the principal repayment amount at maturity into a value as at today - this is the capital value of the bond.

If the debt issue is registered for the Approved Issuer Levy (AIL) the non-resident withholding tax can be reduced to 0% and the AIL levy of 2% paid. Of special note are the Government debt issues where the Government pays the 2% levy, with the effect that interest is paid gross to the non-resident investor.

Maturity Date: on which the principal or stated value of a debt security becomes due and payable in full to the holder.

Accrued Interest: Interest earned from the last interest payment to the settlement date, but not due and payable until the next coupon payment date.

Principal (face, or par value): The amount the bondholder receives upon maturity. Also the amount which, when multiplied by the percentage coupon rate, gives the amount of interest payable to the bondholder annually.

Coupon Rate: The annual rate of interest that the borrower promises to pay to the bondholder. It refers directly to the cash income the owner of the bond will receive annually. Coupon payments are usually semi annually or quarterly.

Yield: The effective annual rate of return expressed as a percentage. Not to be confused with the coupon rate as the two will differ in the secondary market. The bond pricing formula assumes, in calculating the yield, that the interest coupon is reinvested at the purchase yield for the life of the bond.

Present Value: The worth of the future cash flows (coupon payments and payment of principal amount at maturity) as at the settlement date.

Price: Is the value of the bond on the settlement date before any brokerage is added. There is a standard bond pricing formula. The formula gives the present market value of a series of future cash flows, with coupon interest payments, principal at maturity and accrued interest part of the price. Reset and perpetual securities trade on a price and there is no "yield" formula generally used in the market. Part of the difficulty is that the cash flows are uncertain, if the interest rate/dividend rate is reset during the life of the investment and any principal repayment date may be unknown.

Liquidity: The measurement of the ease with which an item can be sold without undue change of value.

Settlement date: A transaction can be organised today but will not be executed until a specified date when the money and securities will change hands. This date is used to calculate the accrued interest portion of the bond price.

Risk free market rate: The interest rate that reflects no added premium for credit, liquidity or business risk. Government bonds are considered to give the zero or risk free rate because the Government has the ability to raise funds through taxes to meet its funding obligations.

Primary market: The market in which new issues are initially distributed. The majority of funds raised will go to the issuer of the bonds.

Secondary market: The market in which existing securities are traded. New securities issued in the primary market benefit from liquidity in the secondary market.

Swap Rate: The swap rate is the aggregate of the interpolated NZGS curve and a margin called the swap spread. The swap is an agreement to swap interest payments and has been considered synonymous with what banks had to pay to fund themselves. It is becoming irrelevant in many ways as banks can no longer borrow at the swap rate so technically it is no longer useful as a benchmark.

Who are we?

Craigs Investment Partners is one of New Zealand's leading investment firms, offering personalised investment solutions to private, corporate and institutional clients.

We are one of New Zealand's leading NZX participant investment advisory firms, with 17 branches throughout New Zealand, approximately 110 Investment Advisors and over \$5 billion in funds under management and administration. We are an accredited NZX Firm and operate under the rules of the New Zealand Exchange (NZX).

All our Investment Advisors are accredited NZX Advisors or Associate Advisors.

What do we do?

Our core business and expertise centres on investments. We are focused on helping clients meet their investment goals. Therefore we dedicate resource to market research, and have experienced and knowledgeable individuals who partner with clients in order to develop highly tailored investment solutions.

at a glance

Craigs Investment Partners

A Full Service Investment Advisory and Investment Management Firm

Global Research,
Local Market Knowledge

Strength by Ownership

Research based Investment and Risk Management Strategies

Accredited NZX Participant Firm and NZX Investment Advisors

National branch network

Any recommendations made in this publication (expressed or implied) is general in nature and does not constitute investment advice under the Securities Markets Act 1988. For specific investment advice in relation to this publication and your personal circumstances please contact your investment advisor.

BRANCH DIRECTORY

HEAD OFFICE

TAURANGA

Craigs Investment Partners House
158 Cameron Road
PO Box 13 155, Tauranga 3141

KERIKERI

Hobson House
14 Hobson Avenue
PO Box 841, Kerikeri 0245
Tel: (09) 407 7926
Fax: (09) 407 7429
Email: kerikeri@craigsip.com

WHANGAREI

1 Robert Street
PO Box 573, Whangarei 0140
Tel: (09) 438 1988
Fax: (09) 438 5167
Email: whangarei@craigsip.com

NORTH SHORE

Level 3, Takapuna Finance Centre
159 Hurstmere Road
PO Box 33 352, Takapuna 0740
Tel: (09) 486 6567
Fax: (09) 486 6607
Email: northshore@craigsip.com

AUCKLAND

Level 32, Vero Centre
48 Shortland Street
PO Box 1196, Auckland 1140
Tel: (09) 919 7400
Fax: (09) 303 2520
Email: auckland@craigsip.com

HAMILTON

Cnr Rostrevor & Victoria Streets
PO Box 1282, Hamilton 3240
Tel: (07) 838 1818
Fax: (07) 838 0828
Email: hamilton@craigsip.com

TAURANGA

Craigs Investment Partners House
158 Cameron Road
PO Box 13 155, Tauranga 3141
Tel: (07) 577 6049
Fax: (07) 578 8416
Email: tauranga@craigsip.com

ROTORUA

Level 3, 1109 Fenton Street
PO Box 1148, Rotorua 3040
Tel: (07) 348 1860
Fax: (07) 348 1863
Email: rotorua@craigsip.com

GISBORNE

75 Childers Road
PO Box 153, Gisborne 4040
Tel: (06) 868 1155
Fax: (06) 868 1154
Email: gisborne@craigsip.com

NEW PLYMOUTH

54 Currie Street
PO Box 8011, New Plymouth 4342
Tel: (06) 759 0015
Fax: (06) 759 0016
Email: newplymouth@craigsip.com

WANGANUI

41 Victoria Avenue
PO Box 63, Wanganui 4540
Tel: (06) 349 0030
Fax: (06) 348 5523
Email: wanganui@craigsip.com

PALMERSTON NORTH

First Floor
Corner Broadway Avenue & Vivian Street
PO Box 1543
Palmerston North 4440
Tel: (06) 953 3460
Fax: (06) 953 0640
Email: palmerstonnorth@craigsip.com

WELLINGTON

Level 11, Craigs Investment Partners House
36 Customhouse Quay
PO Box 10 556, Wellington 6143
Tel: (04) 917 4330
Fax: (04) 917 4350
Email: wellington@craigsip.com

BLenheim

52 Scott Street
PO Box 678, Blenheim 7240
Tel: (03) 577 7410
Fax: (03) 577 7440
Email: blenheim@craigsip.com

CHRISTCHURCH

Level 3, Craigs Investment Partners House
Cnr Armagh Street & Oxford Terrace
PO Box 90, Christchurch 8140
Tel: (03) 379 3433
Fax: (03) 379 5687
Email: christchurch@craigsip.com

DUNEDIN

1st Floor, Craigs Investment Partners House
330 Moray Place
PO Box 5545, Dunedin 9058
Tel: (03) 477 5900
Fax: (03) 477 6743
Email: dunedin@craigsip.com

GORE

120 Main Street
PO Box 317, Gore 9740
Tel: (03) 208 9310
Fax: (03) 208 4161
Email: gore@craigsip.com

INVERCARGILL

49 Kelvin Street
PO Box 1246, Invercargill 9840
Tel: (03) 214 9939
Fax: (03) 214 9933
Email: invercargill@craigsip.com

FREEPHONE: 0800 272 442

WEBSITE: www.craigsip.com

A Disclosure Statement is freely available on request - visit www.craigsip.com