Income securities: a storm turns to fair weather

GEOFFREY MALKIN, a principal of Grange Securities, looks at debt securities from another perspective.

Perpetual floating rate income securities (“income securities”) took the market by storm last year, offering income levels fixed-interest investors had not seen for a long time. But by the end of the year the market was swamped by negative sentiment as an oversupply of these issues at more attractive rates forced down the prices of preceding issues. Now they are looking up again.

Income securities offer a fixed margin above the 90-day bank bill rate, so that in the current climate of rising short-term interest rates, the coupon income rises each time the bank bill rate goes up. Therefore, with 90-day bills trading at around 6.65%, additional margins of 1.70%-2.00% on income securities provide an attractive running yield in the 8.30%-8.60% range.

Table 1 shows the margin at which various entities issued income securities. Combine this coupon margin with the discount to $100 on some issues and this adds up to a margin “in perpetuity” of 1.70%-2.00% over bank bills.

WHAT WENT WRONG IN 1999?
First, there were in excess of $5.5 billion income securities issued in a short space of time. Much of this amount came from investors’ cash management accounts looking for a higher running yield; they thought income securities were secure and would remain at their issue price of $100. As more issues came to the market with higher margins, panic set in and the price became progressively discounted as investors realised that this was not, after all, a substitute for cash management trusts. Second, with the sharemarket booming in 1999, investors began selling their income securities at lower prices to get aboard the sharemarket bandwagon. Third, there was a significant amount of negative press contributing to the panic.

Several things have changed this year to improve the price and liquidity of income securities. First, an inverse yield curve appeared due to continuing tight monetary policy which put 90-day bill rates above longer-term rates. In comparison with a 10-year bond at 6.30%, income securities with a running yield over 8.00% look attractive.

Second, the market has become more educated about the nature of these securities and they are now bedded down with appropriate investors; ie, not-for-profit organisations or clients who used to roll term deposits and are now happy with a higher running yield.

The Australian Tax Office, which had indicated possible negative rulings to issuers of income securities last year (classing these securities more as equity raisings than debt for deductibility) has so far failed to implement this. If it does eventuate, issues trading at a discount to $100 may have to be redeemed by issuers at $100 (plus accrued interest). Since income securities have come under the spotlight of the ATO, it has failed to give a positive ruling to any prospective issuers. Consequently, there has been no new issuance of income securities this year.

However, it has been shown that, if placed with appropriate investors, income securities provide a high-running-yield component for a portfolio and are a suitable hedge against rising interest rates.