

Income Examiner

Lend like a bank



Investors willing to take on some risk can profit, by lending like a bank rather than lending to a bank through term deposits. Michael Korber, Head of Fixed Interest and Credit explains how.

How do banks make money?

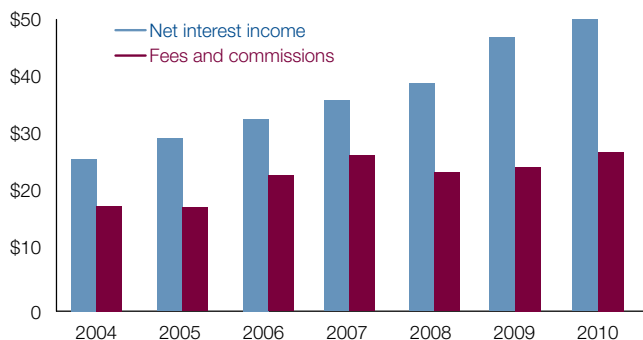
A core business of banks is to borrow money at a low cost and lend the borrowed funds out at a higher cost (see Figure 2), with the difference between these costs referred to as the net interest margin (NIM). The NIM is a key driver of banks' profitability.

Banks source the majority of their funds from depositors through term deposits and savings accounts, from shareholders through equity capital, and from institutional markets by issuing bonds. Customer deposits typically constitute around half of Australian banks' funding, while equity capital forms less than a tenth, and the balance is funded by the wholesale capital markets (including bondholders).

Introduction

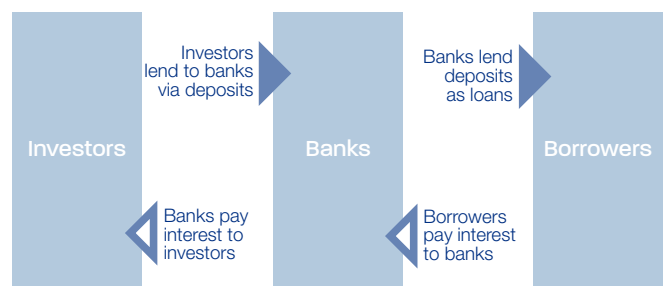
The major Australian banks performed well through the global financial crisis with resilient profitability (see Figure 1). They achieved a record combined cash profit of A\$21.7¹ billion for the financial year 2010, growing 25% from a year ago.

Figure 1 – Operating income of Australian retail banks (\$bn)



Source: Australian Bankers' Association, as at 31 December 2010.

Figure 2 – Lending to a bank



In turn, banks will lend out the bulk of their funds to Australian residential and commercial property owners, financial and non-financial companies, equipment buyers, and other banks (see Figure 3).

Figure 3 – Who do banks lend to?

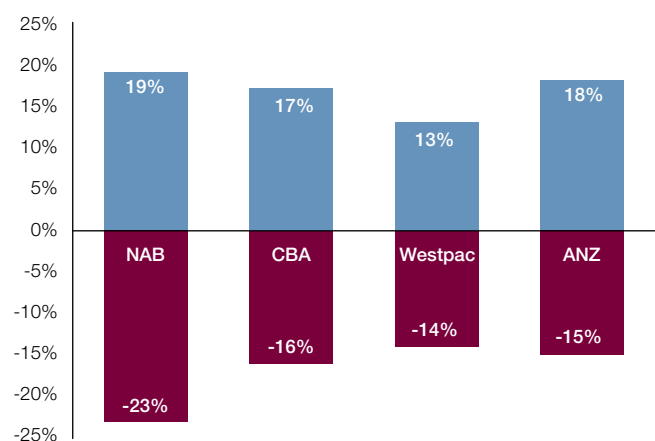
Banks lend to...	Such as...	For funding...
Companies	Woolworths, Tabcorp, Origin Energy	Working capital, business expansion, capital expenditure
Property trusts	Stockland, AMP, CFS	Property purchases, redevelopment
Financial companies	GE Capital, Colonial Finance, HSBC Financial	Financing activities
Individuals	Teachers, doctors, traders, mums and dads	Buying homes, credit card expenses, car and equipment financing
Other banks	CBA, NAB, Westpac, ANZ	Lending activities, business growth

As a result, part of the profitability of the major banks in Australia is due to lending at high rates of interest, and borrowing much more cheaply. Banks manage their risk by attempting to be well diversified and lending only to quality borrowers they believe will pay them back.

How can investors benefit?

Investors who buy bank shares can benefit from bank profitability, but not every investor likes the volatility of buying shares (see Figure 4).

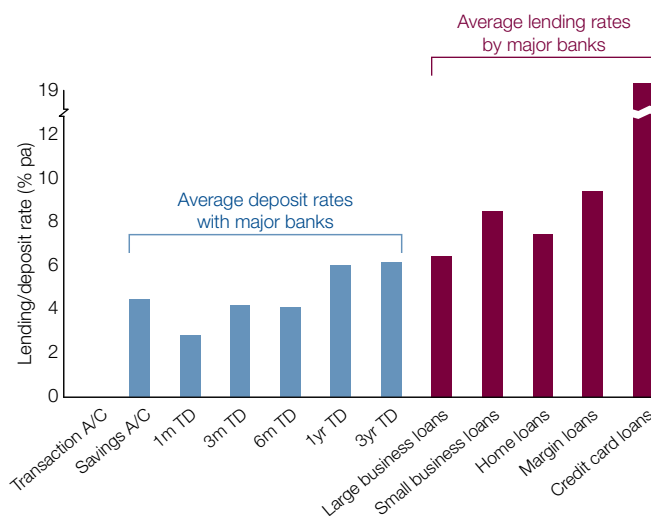
Figure 4 – Range of historical monthly returns of major Australian bank shares (2000 to 2010)



Source: FactSet, as at 31 December 2010.

For conservative investors, a common approach to benefiting from banks is to invest in bank deposits. When investors deposit money with a bank, they are effectively lending it to the banks. While it is depositors' objective to lend at the highest possible interest rate to banks, it is in the banks' interest to borrow as cheaply as possible from depositors (see Figure 5).

Figure 5 – Average lending and deposit rates of major Australian banks



* Weighted average rate on credit outstanding.
Source: RBA, as at October 2010.

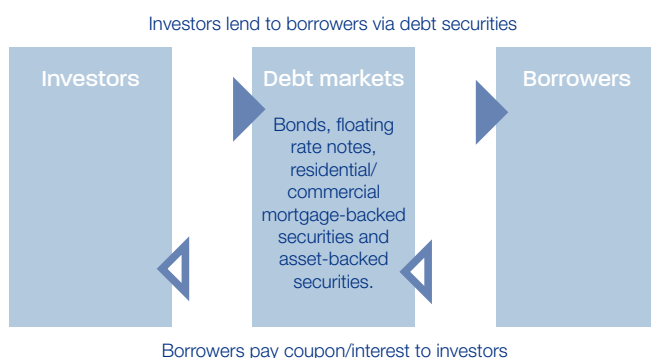
Therefore, bank deposits may not always be the optimal way of generating an income while preserving capital. Conservative investors could improve their income by lending directly to quality borrowers ie lending like a bank.

Investors who lend like a bank rather than lending to a bank are able to benefit from the additional income which a bank would normally earn by lending out their funds. They therefore have an opportunity to increase the returns from their conservative investments. This is not without risk. By investing in a managed fund, retail investors can benefit from experienced portfolio managers who seek to ensure funds are only lent to high quality borrowers.

How to lend like a bank

Investors can lend like a bank by buying debt securities in the debt markets (see Figure 6). A debt security is a loan made from the purchaser to the issuer of the security. The issuer pays interest periodically and repays the principal to the purchaser at a specified maturity date.

Figure 6 – Lending via debt markets



Example

When you buy a debt security issued by BHP Billiton or Westfield Group, you are effectively lending money to that corporation. You could also lend money to the Australian Government, home owners, banks, insurance companies or commercial property owners by buying the related debt securities issued (see Figure 7).

Lending to home owners and commercial property owners can be achieved by buying residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS) respectively. RMBS is a debt security backed by a pool of home loans or mortgages. These home loans are secured against residential properties. The holders of RMBS receive interest and principal payments from home loan customers.

As its name suggests, CMBS is backed by a pool of loans secured against commercial properties, and the holders of CMBS receive interest and principal payments from commercial loan customers.

In addition to lending to corporations, home owners and commercial property owners, investors can also lend to borrowers who require funding for purchases of motor vehicles and medical equipment, or for credit card expenditures. Typically, banks would pool together these loan assets into tradeable debt securities that can be bought and sold by fixed income investors. The holders of these securities will receive the interest and principal payments from these loan assets. Debt securities that are backed by credit card debt, leases or receivables are generally called asset-backed securities (ABS).

“ For retail investors to lend like a bank, they could access opportunities by pooling their funds through an appropriate fixed income managed fund. ”

Figure 7 – Debt security sector definitions

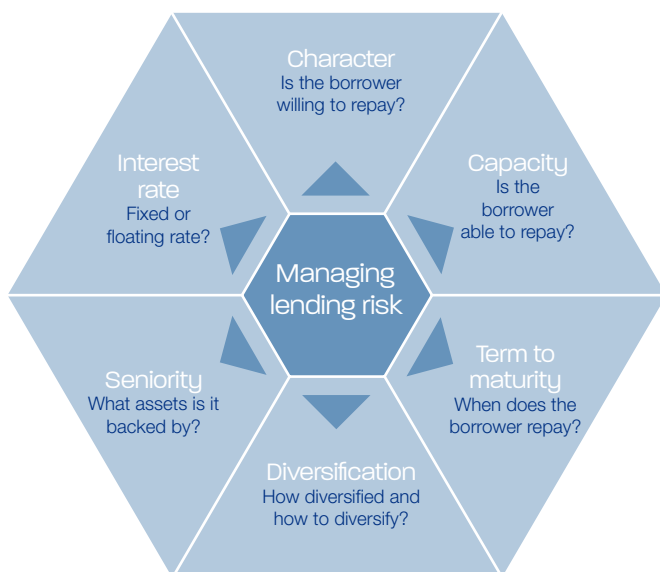
Debt security type	Definition
Corporate security	A debt security issued by a corporation that is not classified in the other sectors.
Asset-backed security (ABS)	A debt security secured by a pool of assets, or collateralised by cashflows from a specified pool of underlying assets. These asset pools can be made of any type of receivable such as credit card payments and auto loans.
Bank security	A debt security issued by a domestic deposit taking financial institution.
Commercial mortgage-backed security (CMBS)	A type of mortgage-backed security secured by loans on commercial property.
Finance security	A debt security issued by non-banking financial institutions.
Overseas bank security	A debt security issued by a foreign deposit taking financial institution.
Property security	An unsecured debt security issued by Australian real estate investment trusts.
Residential mortgage-backed security (RMBS)	A type of security with cashflows coming from residential debt such as mortgages and home-equity loans. Holders of an RMBS receive interest and principal payments from the residential mortgage borrowers. These securities are often 'AAA' rated.
Wrapped security	A type of security popular with lower rated non-financial corporate borrowers such as utility companies. The borrower pays a premium to a highly rated specialist insurance company who 'wraps' the issue and allows the borrower to raise funds at a lower spread than they otherwise could.

Understanding risks in debt investing

An investor could build a diversified portfolio of loans as a bank would, by buying corporate bonds, asset-backed securities and other income producing debt securities. To build a quality portfolio, investors would have to consider many aspects of fixed income investing such as whether the borrower will repay (credit quality), when the loan will be repaid (maturity), what assets the loan is backed by and diversification.

Just like bank depositors, fixed income investors want a predictable income stream and the return of principal at maturity of the investment. It is important to manage the downside risk by investing in fixed income securities with strong creditworthiness. In other words, investors should only consider lending their money to issuers of fixed income securities that have the ability to repay their loan. Weaker issuers will have to pay a higher interest rate or spread above the risk-free rate (represented by the Australian government bonds with equivalent tenure) than stronger issuers. This is because weaker issuers have a higher risk of defaulting or the risk of not meeting their obligations to pay interest and principal.

Figure 8 – Managing risk when lending like a bank



There is also a need to consider the risk arising from changes to interest rates. This risk affects fixed-rate bonds, where the price of the bond moves inversely to its yield. When interest rates rise, the price of a fixed-rate bond will fall (and its yield will rise). However, when interest rates fall, the price of the fixed-rate bonds will rise as investors are willing to pay more for it.

For floating-rate notes, the changes in interest rate only affect its price marginally because the coupon it pays adjusts to changes in interest rates typically every quarter. All else remaining constant, in a rising interest rate environment, the price of fixed-rate bonds will fall, while the price of floating-rate notes will stay relatively stable but its coupon will reset to a higher rate of interest.

Another consideration in lending is the term to maturity of the loan. Generally, debt securities that have a shorter term to maturity are lower risk than longer dated securities from the same issuer. This is because the longer the loan tenure, the lower the certainty on distant future interest payments and principal repayment.

Investors should also understand the seniority of debt securities in the context of an issuer's capital structure. Holders of senior corporate debt will have first claim to assets of the issuer in the event of default followed by subordinated debt holders and then equity investors. This means that senior debt holders would have higher chance of getting part or all of their capital relative to other debtors. Generally, this also means that a senior debt holder would be safer with more subordinated debt and equity.

The upside for a fixed-income investor is limited, but the downside is the risk of total capital loss (risk asymmetry). Therefore, in addition to considering creditworthiness, term to maturity, interest rate risk and debt seniority, it is always important for a fixed-income portfolio to be sufficiently diversified across a number of issuers, sectors and industries.

Accessibility

Typically, only institutional investors with large pools of funds have access to bond markets, as the minimum tradeable parcel for bonds is generally A\$500,000 per security, per trade. A well diversified portfolio of bonds would have over a hundred securities and issuers. In addition, effort is required to ensure they are buying high quality securities and constructing an appropriate portfolio.

For retail investors to lend like a bank, they could access opportunities by pooling their funds through an appropriate fixed income managed fund.

Advantages of lending like a bank through managed funds include:

- Access to global debt markets and institutional pricing
- Active portfolio management by using relative value, sector rotation, arbitrage and roll-down trades
- Risk management and diversification to reduce the risk of default
- Liquidity when redemptions are required
- Transparency with periodical reporting.

The Perpetual Diversified Income Fund – lending like a bank

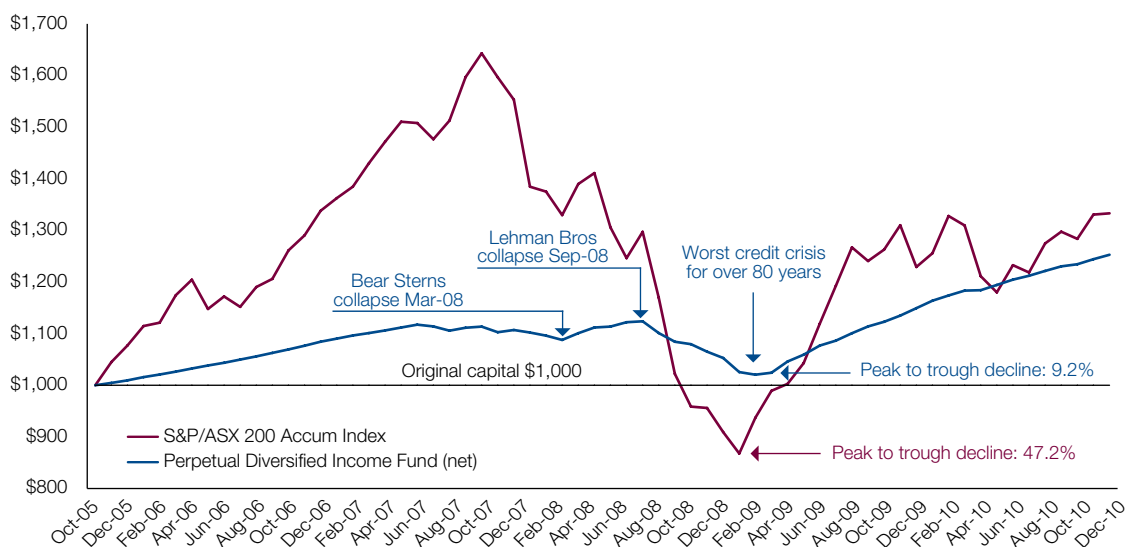
The Perpetual Diversified Income Fund offers a diversified and defensive way of lending like a bank. It is a fixed income fund that invests in high quality debt securities with relatively short maturities referenced to a floating rate benchmark. It provides consistent income which is distributed quarterly and it offers daily redemption facilities.

We believe the fund offers investors the following benefits:

- Potentially higher income and returns relative to the cash rate
- Returns rise when interest rates rise all else being equal
- Highly diversified and defensive investment
- Liquidity when redemption is required
- Low correlation to fluctuations in equity markets (See Figure 9)
- Actively managed by a professional and stable investment team.

Figure 9 – Perpetual Diversified Income Fund has low correlation to fluctuations in equity markets

Growth of \$1000 invested in October 2005



Source: Perpetual and DataStream, as at 31 December 2010. Performance is net of fees, before tax. Past performance is not indicative of future performance.

Want to learn more?

For more information on fixed income markets or accessing them through the Perpetual Diversified Income Fund, please contact your Perpetual Account Executive or contact Perpetual's fixed income team on the numbers below:

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