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DEBT MARKETS EXPLAINED

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"Risk is not knowing what you're doing."
- Warren Buffet

INTRODUCTION

Debt instruments, bond market investments and fixed income funds are simply not as well understood by investors as shares, equity instruments and equity funds. In our "Debt Markets Explained" article we explain the different classifications and their importance when looking at and understanding debt instruments and how they may further diversify an investment portfolio.

EXECUTIVE SUMMARY

Debt instruments typically include nominal bonds, inflation linked bonds (or ILBs) and money market instruments. These instruments are grouped under debt as their characteristics are similar to loans where an investor lends money to a company who pays back the "loan" with regular payments.

Debt instruments can either be listed or unlisted. Listed debt instruments trade on a bond exchange and are typically very liquid. Whether or not a bond is listed does not define the quality of the bond or instrument. Money market instruments are not listed on any exchange.

The quality of any debt instrument is defined by the ability of the issuer (company or government) to repay the interest during the duration of the loan as well as to repay the principal amount at the end of the loan period. Debt instruments are typically backed by cash flow streams, such as government taxes, income from toll roads or income from generating electricity. The issuer can also decide whether they will "secure" the cash flow by linking a pre-defined asset to the debt instrument that can be liquidated in order to repay investors should the cash flow stream not yield enough for the repayment of the debt. This is called secured debt.

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A French ballet term describing a dance step requiring dancers
to move **forward** and **onwards.**

Investors should be cautious to presume that secured debt which is backed by a pre-defined asset is of better quality than unsecured debt due to a better recovery rate on default. Government debt instruments are unsecured debt but are among the highest credit quality debt instruments available. In addition, assets used to secure debt instruments could decline in value and not be able to generate enough proceeds to recover outstanding debt (such as during the sub-prime crisis in 2008). Investors should make sure they understand the quality and liquidity of the underlying assets used to "secure" debt instruments. Credit rating agencies provide investors with information about whether bond and debt issuers can meet their obligations. The three biggest global ratings agencies are Moody's, Standard and Poor's and Fitch. These agencies will rate both corporate debt and countries' sovereign debt.

The seniority of a debt instrument is of utmost importance when analyzing the quality of the investment. Senior debt is always paid off first in the case where an issuer goes into a bankruptcy or a curatorship situation. Junior or subordinated debt is paid only once all the senior debt has been paid and equity investors are the last in line.

WHAT ARE DEBT INSTRUMENTS?

A company can source capital to finance its operations by making use of debt or equity instruments. As previously noted, debt instruments include nominal bonds, index linked bonds (ILBs) and money market instruments.

Bonds can be compared to loan transactions which is why bonds are referred to as debt instruments. The investor effectively lends to a company by buying its bonds and in turn the company "repays the loan" by making regular interest payments in the form of coupon payments and finally repays the principal (the original investment amount) at maturity.

Bonds can be issued for any maturity date from as little as 12 months to as long as 30 years. Debt instruments shorter than 12 months are classified as money market instruments. Although most coupon payments are paid semi-annually, payments can be set for any frequency from monthly, quarterly, semi-annually to annually.

Most nominal bonds and ILBs are listed and therefore traded through a recognised exchange. As noted, money market instruments are not listed and therefore are not traded through an exchange.

NOMINAL BONDS

Nominal bonds are issued with a fixed principal amount and a fixed coupon rate. As an example, a two-year bond that is issued with a principal amount of R10 million, a coupon rate of 5% and semi-annual payments, means that the investor will receive fixed coupon payments of R250 000 every 6 months (R10 million x 5% ÷ 2) for two years, and the principal amount (R10 million) is repaid at the end of the two-year period.

Nominal bonds make up the largest portion of the South African bond market and are available in a range of maturities from 12 months to 37 years.

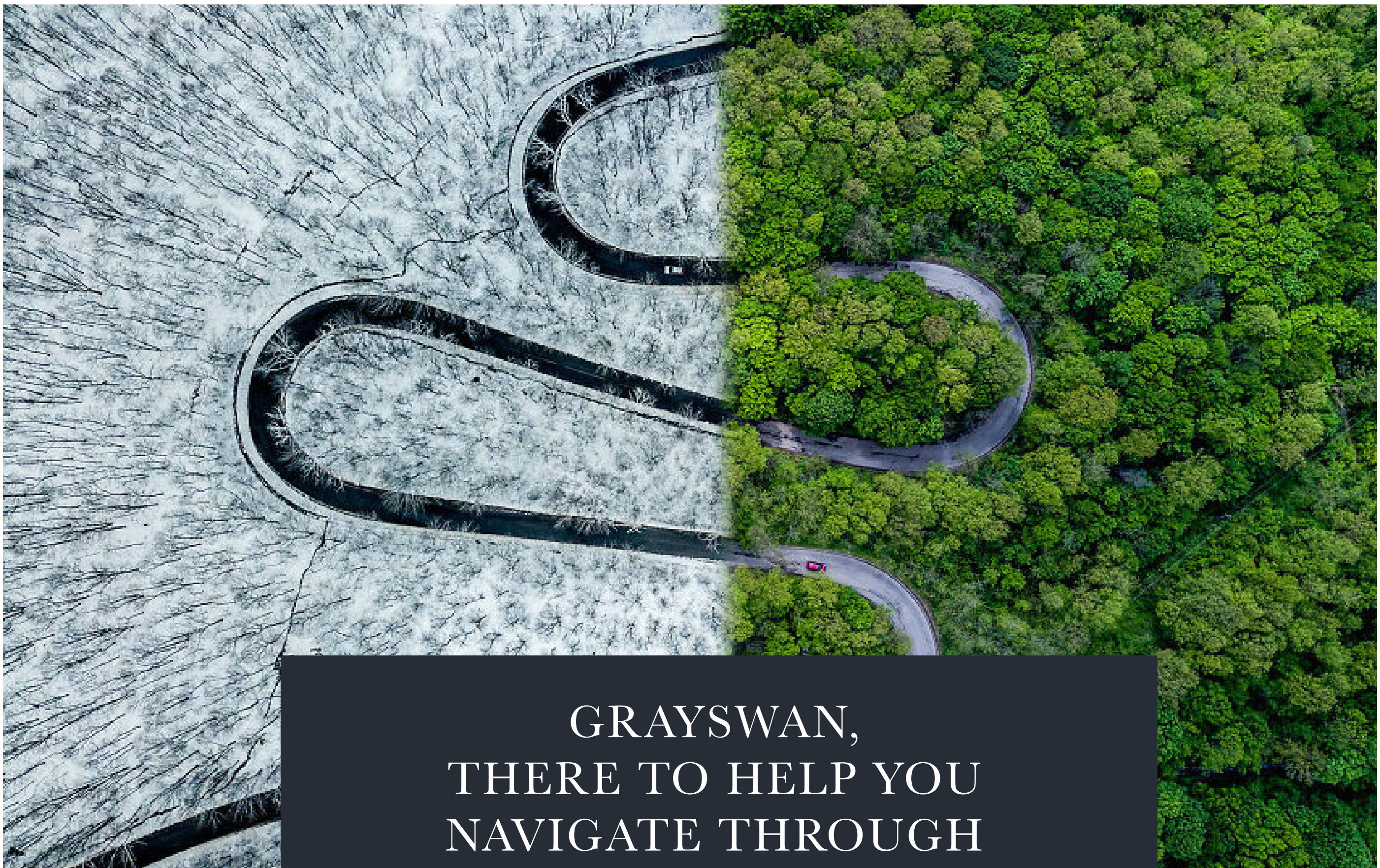
INDEX LINKED BONDS

Index linked bonds (ILB's) are bonds where the coupon is fixed but the principal is adjusted to changes in the index to which the bond is linked. Inflation linked bonds are a form of index linked investment where the where the index it tracks is headline inflation (CPI). Although the coupon rate is fixed, the regular coupon payment will change as it is based on the inflation-adjusted outstanding principal amount. Therefore, if the inflation rate increases, the coupon payment will also increase. Unfortunately, the converse is also true that if inflation decreases so will the coupon payment. Inflation linked bonds are also referred to as real-return bonds.

Inflation linked bonds were first introduced in South Africa in 2000. Government inflation linked bonds have increased from one in 2000 to more than 10 today with different maturity dates from 3 to 37 years. Similarly, corporates have followed the trend with increasingly more inflation linked bonds in issue.

MONEY MARKET INSTRUMENTS

Money market instruments are similar to bonds but are short term debt instruments with maturities less than 12 months. These instruments are not traded through an exchange but rather Over the Counter (OTC).



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DEBT MARKETS

The first time that a debt instrument is issued, it is issued and listed in the “primary market”. Debt instruments are issued through a panel of primary dealers in a weekly auction. Only banks are allowed to be part of the primary market. The primary dealers in South Africa are companies such as ABSA, Citibank, Deutsche Bank, Investec, JP Morgan Chase, Nedbank, Rand Merchant Bank and Standard Bank. Government bonds dominate primary listings, accounting for more than 60% of all nominal bonds issued.

Subsequent to the debt instruments being issued and listed for the first time in the primary market, they can be bought and sold in the “secondary market”. The Bond Exchange of South Africa (BESA) is a wholly owned subsidiary of the Johannesburg Stock Exchange (JSE) and is responsible for operating and regulating the secondary market in South Africa. Secondary market investors include banks, pension funds, insurance companies and investment management companies.

South Africa has a highly liquid and sophisticated bond market. The South African bond market is ranked as one of the ten largest bond markets in the world by the World Federation of Exchanges.

The South African money market is an Over the Counter (OTC) market which means the buyer and seller are in direct contact and the transaction does not go through an intermediary.

LISTED VS UNLISTED DEBT

Many investors believe that the main indicator of risk in a debt instrument is whether the debt instrument is listed or unlisted. This is not necessarily the case. If a debt instrument is held to maturity, the investor only needs to transact once and does not need the flexibility of a listed or more liquid trading debt market. Therefore, in this case, the investor should be indifferent to whether the instrument is listed or unlisted. Investment managers that manage bond funds may trade more actively depending on expectations for interest rates and would therefore prefer to trade liquid listed bond instruments.

LISTED DEBT

Listed debt instruments are listed on an exchange and can be bought and sold in the secondary market. These debt instruments are generally more liquid than unlisted debt instruments. However, there are some listed debt instruments that are owned by a small group of investors and not traded actively and are, despite being listed, still very illiquid.

One benefits of listed debt instruments is that pricing is conducted by an independent entity and all instruments are priced with the same methodology.

UNLISTED DEBT

Unlisted debt instruments are not traded through an exchange, but through the Over the Counter (OTC) market. Market makers such as investment banks facilitate the buying and selling of unlisted debt instruments in the OTC market.

In some cases, investment managers may originate the debt themselves. In these cases, the investment manager will negotiate the terms of the debt with the issuing company. These terms include the principal loan amount, the coupon/ interest payment, the maturity or duration, the seniority of the loan in the capital structure of the issuer and any security. This type of debt is referred to as private debt and has been covered in our previous article on which discussed alternative credit in more detail. Investors could think of unlisted debt in the fixed income asset class similar to what private equity is in the broader equity asset class. Investment managers who originate debt privately may provide all the finance for the loan or may bring in other co-investors.

A possible drawback of unlisted debt instruments is that pricing may be conducted by the issuer of such instruments. This creates a potential conflict of interest and may open it up for perceived manipulation. It is therefore very important that investors are fully aware of their investment manager's valuation process. Typically, investment managers investing in private debt have a credit committee of highly experienced individuals who are able to value the ability of the issuing company to pay back. They will also typically engage legal experts to draft the loan agreements and will require significant security on the loan. Loans may be to finance growth, corporate actions, management buy-outs or infrastructure and development projects.

SECURED VS UNSECURED DEBT

Whether a debt instrument is secured or unsecured could be an important indicator of risk in debt instruments. This does not protect the investor from the issuer going into default but protects the underlying cash flow stream used to make coupon payments on the debt instruments.

SECURED DEBT

Secured debt is tied to a pre-defined specific asset that is considered to be collateral for the debt. Mortgage and car financing are both examples of secured debt. For example, a mortgage loan is secured by a home. Similarly, car financing is secured by a vehicle. If the user of such finance become delinquent on these loan payments, the lender can repossess and sell the asset to try to recover the outstanding debt.

Similarly in the bond market, secured debt is backed by physical assets that have been securitised such as mortgage-backed securities (MBS) and asset-backed securities (ABS). These assets can be repossessed and sold in order to recover the outstanding debt.

Only a small portion of the listed debt market (on the bond exchange) consists of secured debt. Many of the unlisted debt instruments are secured debt and backed by physical assets such as a solar power plant or commercial buildings. This is primarily due to the fact that investment managers have better negotiation power in the unlisted and private debt market and are better equipped to negotiate attractive loan terms.

However, in some cases, secured debt might provide a false sense of security. During the sub-prime crisis in 2008, the underlying mortgages used as security for mortgage-backed securities, declined in value and therefore could not be sold to generate enough proceeds to recover the outstanding debt. Investors should make sure they understand the underlying assets used as security in "secure" debt instruments.

UNSECURED DEBT

Unsecured debt is not backed by any physical asset or securitisation vehicle and lenders do not have rights to any collateral for the debt. This is not to say that unsecured debt is not backed by a stream of cash flows. For example, government bonds are unsecured debt securities as they are not backed by any physical asset that can be repossessed and sold. However, government bonds are backed by tax revenues and the government can just raise taxes when it needs to make debt payments. Other examples of cash flow streams are toll road revenues and power plant revenues.

SENIORITY OF DEBT

The third indicator of risk in debt instruments is the seniority of debt in the capital structure hierarchy. This provides differing levels of protection to the investor should the issuer go into default.

The capital structure that companies use when sourcing capital to fund its operations is broken up into three main levels. The top two are debt instruments namely Senior Debt at Level 1 and Subordinated Debt at Level 2. Debt can be either secured or unsecured. The bottom level is equity namely Preference Shares and Ordinary Shares. An instrument that ranks above another in this table is senior to the instruments below.

Investors holding debt or equity instruments are creditors in the eyes of a company sourcing capital through these instruments. These seniority levels are important in the instance when a company faces bankruptcy or any other liquidation event. Debt holders will always trump equity holders and senior debt holders always trump subordinated debt holders.

SENIORITY
Senior Debt - Secured
Senior Debt - Unsecured
Subordinate Debt - Secured
Subordinate Debt - Unsecured

Whether the debt is secured or unsecured is not as important as its seniority level as senior unsecured debt has priority over subordinated secured debt. Generally, the lower a bond ranks on the seniority hierarchy, the higher the risk and thus the higher the expected return from that bond.

SUMMARY

Debt instruments can be classified as listed or unlisted debt, secured or unsecured debt, and senior or subordinated debt and can vary significantly in their terms and duration and characteristics and risk profile.

The seniority of debt is always the important factor to consider when analyzing the risk of a debt instrument. In the end, even money market instruments that are considered “low risk” do not always provide investor protection if they are subordinated below more senior instruments.

GraySwan recommends accessing debt instrument exposure by investing with multiple investment managers who have expertise in each of these specific areas and are able to advise clients on the potential performance as well as the risks. Diversification of investments across investment managers who focus on different parts of the debt market ensures the most efficient allocation of capital to ensure that your portfolio can fully benefit from exposure to this less well understood asset class.