

New Zealand Debt Market

Most investors will be aware that companies raise capital as either debt or equity. What many may not realize however is that retail investors can invest and trade in debt securities in much the same way as equity securities.

The New Zealand Stock Exchange runs a debt market alongside the sharemarket. As at December 31, this market listed 67 securities with a total face value of \$4.7 billion (excluding government stock). Last year total value traded was \$1.5 billion.

Debt securities offer investors the opportunity to invest their savings productively, without exposing themselves to the risks inherent to equities. As holders of debt securities, investors have a claim on a company's assets ahead of equity holders. Whereas equity is a "residual claim" on these assets, debt securities are issued at a face value, a fixed amount that the issuing company agrees to repay at maturity. In the event of liquidation, all debt holders are repaid in full prior to shareholders receiving the remaining funds.

Debt securities pay coupon payments (interest) on prefixed dates, providing debt holders with a regular and reliable income stream.

The NZSE Debt Market provides a liquid trading environment for debt securities where investors can buy and sell debt according to their individual cashflow requirements and investment horizons. While the price will converge to face value at maturity, they may sell at either a premium (more than face value) or a discount (less than face value). The price of a debt security is determined by the market.

If the market believes that a security should be returning (yielding) more than the coupon payment, it will be sold at a discount; if the market believes that the security should be returning less, it will sell at a premium. Securities are generally issued at a face value of \$100 and tend to trade between \$90 and \$110. Unlike shares, debt securities are quoted on a yield basis (or more accurately yield to maturity) rather than price. The yield is the total return that investors receive if they hold a debt security to maturity. It is this rate that should be used to compare alternative debt securities, as it takes into account the effect of coupon payments and the purchase price.

The yield can be broken down into two components. One component is the risk free rate, which is known to be the rate of government debt securities (as it is assumed that no default risk exists). When this rate moves up or down, yields on corporate debt securities fluctuate alongside. The other component is the risk premium that the market attributes to each security. A higher yield indicates that the market perceives the security to be riskier investment. This risk is the (generally small) chance that the issuing firm will be unable to meet their obligation to repay debt holders in full. Investors should diversify this risk by holding a range of debt securities rather than just one or two.

A portfolio of debt securities will change in value when yields of similar duration government debt change. When yields fall, prices of debt securities will generally increase, and the value of a portfolio also increases. When yields rise the value of a portfolio will decrease.

In any financial markets, efficient pricing results in risk being rewarded with sufficient return. Each investor must evaluate their own risk profile according to this tradeoff. By using

combinations of government stock, corporate debt securities and equities, all of which can be traded through retail brokers, investors can set their portfolio to match their risk profile, and cashflow requirements.

The NZSE DebtMarket provides a transparent, competitive market for the exchange of debt securities. To find out more contact your broker or visit www.debtmarket.co.nz.

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