An investment case for century bonds

Bonds or other forms of borrowing instruments have been around for millennia with the first bond ever recorded dating back to circa 2,400 BC whilst the first official bond, in a form closer to what we are used to in modern times, was issued by the Bank of England in 1693. Although the characteristics of bonds have changed significantly, the basic premise remains the same – the issuer borrows money from an investor and in return compensates the investor with some form of return.

One of the main characteristics of a bond is its maturity date which defines the number of years until redemption. This can vary from a few months in the case of Treasury Bills issued by several governments across the world to bonds in perpetuity. The latter do not have a maturity date and therefore the issuer has an obligation to pay the quoted coupon forever unless this is restructured at some point in time.

Local investors are mostly familiar with 10-year bonds as this is the most common redemption period used by corporate bond issuers. Meanwhile, government stocks tend to have longer maturities although Malta Government Stock issues have never had a term longer than 25 years. In international markets, most issues, both corporate and sovereign, have a maturity of not more than 30 years. However, in foreign markets longer maturities do exist. Apart from perpetual bonds, in foreign markets we also encounter 100-year bonds (known as century bonds) which fall under the ultra-long bonds category. Such bonds also have a long history with the first issues of this type being recorded as early as the twelfth century.

The latest examples of century bonds were evidenced earlier this year, with issues from Argentina and Austria. In June 2017, Argentina, just over a year after emerging from its latest default, issued a USD2.75 billion 100-year bond denominated in US Dollars and carrying a coupon of 7.125%. The issue, the only of its sort in Latin America, was very successful as demand reached USD9.75 billion at a yield of 7.9%. Three months later, in September 2017, Austria became the first eurozone country to issue a century bond denominated in euro. Demand for this bond was also high as Austria received €11 billion worth of orders for an issue of €3.5 billion with a yield of 2.1%.

Who would be interested in such long-term bonds? The main buyers of these type of bonds are institutional investors such as insurance companies and pension funds which need to cover long-term liabilities. Nonetheless, statistics from the recent Austrian issue indicate that participation from pension funds was lower than usual. This could possibly reflect the low yield on this particular bond as well as the increasing popularity of defined-contribution plans in which future benefits fluctuate in line with the pension plan’s investment returns and therefore no fixed future benefit needs to be met.

The risks attached to century bonds are similar to those found in shorter term bonds. However, the inherent risks are magnified by the fact that the bond has a much longer maturity. In this respect, it is noteworthy to highlight that in an article published by the Financial Times on 12 September 2017[1] [1], the author notes that the Austrian bond has a duration of 44 years. Duration measures the sensitivity of the price of a fixed-income security to changes in market yields which in turn are dependent on economic developments as well as changes to the creditworthiness of the issuer. The longer the duration, the more sensitive the price of the bond would be to changes in yields. The sensitivity is reflected in a larger percentage change in price than in the yield. Furthermore, bond prices and yields move inversely to each other. Therefore, when yields rise, bond prices decline and vice-versa. Hence, a bond with a duration of 44 years indicates a high level of sensitivity and as such when yields in the eurozone start rising the decline in price in percentage terms in this 100-year Austrian bond will be widely larger than the percentage increase in yields.

[1] [2] *Allen,K (2017, September 12). Austria sells record largest €3.5bn century bond. Financial*

Times. Retrieved from http://www.ft.com

Furthermore, investors in such bonds must have a high degree of trust in the issuer which has to survive 100 years and also be in a position to service the debt during the lifetime of the bond as well as payback the bond upon maturity. A common misconception in this regard is that when investors are contemplating an investment in such long-term bonds, they fail to consider the issuer's ability to repay the bond upon maturity since it is so far in the future and therefore difficult to assess. Moreover, many investors naturally reason out that this a problem that should be faced by their heirs.

Nonetheless, credit risk remains an important issue even for such long-term bonds. In fact, although there was strong demand for the century bonds of Argentina, the bond also attracted a lot of criticism. Various analysts referred to the turbulent history of Argentina which defaulted six times in the last 65 years including a USD80 billion default in 2001 which, at the time, ranked as the largest default by a sovereign nation. This is reflected in the country's credit rating. In fact, Argentina is classified as 'non-investment grade' with the three major rating agencies, namely Standard & Poor's, Moody's and Fitch Ratings, classifying Argentina's debt in the single 'B' category. Various articles also noted that it is also unusual for an emerging country to offer ultra-long bonds given their relatively unstable and vulnerable economic performance.

On the other hand, the credit risk is much lower for the Austrian century bond given that the country is rated by all three major rating agencies just one notch below the 'AAA' rating – the highest credit rating which only a handful of companies and countries currently possess. Additionally, whilst Austria's century bond was denominated in euro, Argentina's century bond is denominated in US Dollar, a foreign currency. This represents an additional risk for Argentina as the country needs to maintain enough foreign cash reserves to meet its debt obligations on time.

Critics of the Austrian century bond have highlighted the price risk inherent in this bond. At a coupon of 2.1%, this bond, given its long-term duration, is very susceptible to movements in bond yields. In a declining or low interest rate environment, a 2.1% return from a highly rated country may seem attractive. However, fixing this rate for 100 years could be detrimental for investors since within the context of a cycle spanning 100 years, interest rates are bound to increase especially in view of the recent actions by three of the major central banks. The US Federal Reserve has already started raising its reference rate and is expected to announce a further rate hike in December. Earlier this month, the Bank of England also announced its first rate hike in a decade and indicated that additional hikes may be necessary. Furthermore, last month the European Central Bank (ECB) announced a reduction in its asset purchases by half as from January 2018 and although inflation is still somewhat weak, the strong economic data emerging out of the eurozone could lead to a rebound in yields in anticipation of further monetary policy tightening by the ECB in the next decade let alone in the next century.

In the case of Argentina, the heightened price risk is partially mitigated by the relatively high coupon attached to this bond. Nonetheless, if the country does not improve its credit standing, investors still face a significant price correction if yields start rising as the premium over investment grade benchmarks would need to be maintained at current levels.

It is also noteworthy to highlight that this year the US was also considering issuing 50 and 100-year bonds. However, the Treasury Borrowing Advisory Committee (TBAC), which was mandated to study the appetite for such bonds, declared that although ultra-long bonds are most likely to be in demand by those with longer-dated liabilities, the committee did not see evidence of strong or sustainable demand for maturities beyond 30 years. This could be yet another indication that century bonds are heading for a tough time in the near future.

As such, whilst it is understandable that investors are frustrated at the lack of alternative investment options with a decent return, it is always important for investors to consider the inherent risks in any investment they are contemplating especially ones with innovative features or which extend way into the future and hence carry many more uncertainties.

URLs in this post:

[1] [1]: **#_ftn1**
[2] [1]: **#_ftnref1**