

The Australian Guide to Fixed Income

Foreword by Ian Macfarlane AC

Former Governor of the Reserve Bank of Australia
1996 - 2006

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Reserve Bank of Australia 1996 - 2006*

Volatility in financial markets over recent years has caused many investors to reappraise the level of risk in their investment portfolios and has led to heightened interest in prudent asset allocation and hence fixed income investments.

Direct investment in the fixed income asset class such as corporate bonds remains underdeveloped in Australia compared to other developed countries. Over recent years, governments, regulators, political and business leaders, economists, financial commentators and the media have all called for greater effort to be put into the development of the corporate bond market in Australia. This would provide greater opportunities for companies seeking additional means of raising capital as well as for investors seeking lower risk investments.

Investment in fixed income such as corporate bonds is designed mainly to conserve capital and provide income. Generally, fixed income investments exhibit both lower volatility and more certain returns than equities over long periods and, because returns from fixed income and other asset classes are not highly correlated, incorporating bonds into a balanced investment portfolio can reduce expected risk for a given rate of return.

Investors new to the fixed income asset class can sometimes feel inundated with new terms and calculations. In response to this, in 2009 FIIG published The Australian Guide to Fixed Income as a reference book to demystify fixed income investments and to provide information about how to access fixed income financial products. In this Second Edition, as well as updating the entire book, important additions have been included. PricewaterhouseCoopers has contributed a chapter on tax which most investors will find useful. Also there are new chapters on hybrids, inflation linked bonds, an introduction to credit analysis, and investment and trading strategies.

Education is a vital element for developing corporate bond investment and issuance in Australia. The Second Edition of The Australian Guide to Fixed Income is a welcome addition to the information available to investors, issuers, legal and accounting professionals, financial and wealth advisors, educators, students and anyone interested in understanding the fixed income asset class in Australia.

I recommend The Australian Guide to Fixed Income to people interested in expanding their financial literacy on this most important topic and commend FIIG for producing this excellent reference work.

A handwritten signature in black ink, appearing to read 'I Macfarlane', written in a cursive style.

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The Australian Guide to Fixed Income

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Key aspects of fixed income

1. Fixed income securities are low risk and provide a defined income stream and capital stability.

2. Fixed income securities include: deposits, bonds (senior secured, senior and subordinated) and hybrids.

3. Unlike ordinary shares, the structure of fixed income securities can vary significantly between issues. Investors can tailor their holdings based on term, interest rate structure and sensitivity, issuer credit quality, subordination and other factors.

4. Practically all fixed income securities rank higher in the capital structure of an issuer than ordinary shares. This means that if the company enters liquidation, fixed income securities are repaid before any funds can be returned to shareholders.

5. Bonds provide good portfolio diversification as returns typically have low correlation with property and equity.

- 6.** Commonwealth government and state government bonds provide greater diversification than corporate bonds as they have no link to corporate performance.

- 7.** AUD bonds are issued by ASX listed Australian companies as well as non listed and international corporations.

- 8.** The global bond market provides an opportunity to invest in foreign currency bonds issued by domestic and international issuers.

- 9.** Inflation linked bonds are the only direct hedge against inflation.

- 10.** Bonds are generally liquid investments and while some have very long terms to maturity, there is an active secondary market. Investors do not have to hold investments until maturity.

- 11.** There is an opportunity for capital gain or loss however investors will typically receive a positive return if they hold the securities until maturity.

Fixed income – a definition

Fixed income refers to debt securities that pay a defined distribution (*the interest*) for a given period of time (*the term*) and repay the face value of the security at maturity. A fixed income security or bond is a loan from an investor to the issuer of the security. Issuers of fixed income securities in Australia include the Commonwealth Government, state governments, banks and corporations. The specific structure of a fixed income security can vary significantly depending on the issuer, term and maturity, coupon type and level of subordination.

Section 1.

The fundamentals

Chapter 1. Why fixed income?

Chapter 2. Features of fixed income - what you need to know

Chapter 3. Fixed income products

Chapter 4. Capital structure

Chapter 5. Risk versus reward continuum

Chapter 6. Asset allocation

Chapter 7. Building a fixed income portfolio

Chapter 8. Regulators of the Australian fixed income market

Chapter 1.

Why fixed income?

From an investor's perspective, the fixed income asset class covers a multitude of variables but the main purpose of investing in fixed income (such as corporate bonds) is to provide a low risk, reliable income stream and preserve capital.

Fixed income offers investors:

1. Capital stability
2. Regular income
3. Diversification
4. Ability to earn better returns than term deposits
5. Ability to diversify the range of portfolio maturities
6. Liquidity
7. Protection against loss in a cyclical downturn

1.1 Capital stability

One of the key characteristics of most fixed income investments is the repayment of the initial investment at maturity, or in some cases, over the life of the bond. Of course, capital repayment is subject to the ability of the issuer of the bond to meet this obligation. Fixed income includes a spectrum of issuers with different risks, however, all fixed income securities are guaranteed by their issuers, so assuming the government or the corporation or the issuer of the security remains solvent and does not go into liquidation, investors receive repayment of their capital at maturity.

One of the lowest risk fixed income products is an Australian government bond issued by the Commonwealth government of Australia (AAA rated) which returns face value at maturity. Higher risk products like subordinated debt (bonds) and hybrid securities issued by a range of corporations (including high and low risk entities) offer much higher returns than government bonds. As long as investors are comfortable with the underlying credit quality of the issuer, these assets can provide stability and diversity in a portfolio.

1.2 Regular income

Bonds provide a regular income stream through coupon (interest) payments where the dates and amount of the coupon payable are defined at the time of issue. A portfolio of bonds can be tailored to meet investors' cashflow requirements.

1.3 Diversification

Diversification spreads investment across a range of assets, maturities, industries and risks with the aim of reducing the impact of any one investment in a portfolio. Fixed income allows investment diversification away from the two most highly cyclical asset classes – equities and property.

Fixed income products can counter balance higher risk investments in a portfolio and they can serve to even out returns in times of high volatility. Most, if not all, balanced investment portfolios should contain a significant fixed income allocation to assure investors of their continued ability to meet ongoing business and personal commitments. The fixed income asset class offers a broad spectrum of products, risks, returns and maturities to provide a diversified and balanced portfolio solution for investors.

1.4 Ability to earn better returns than bank deposits

Term deposits provide minimal risk but earn relatively low returns. Investing in lower ranked, but still high quality assets, issued by the same institution can provide higher returns. By undertaking this strategy, the investor retains exposure to the same company (assured of its credit quality and ongoing viability) but improves overall return by taking a subordinated position within the overall capital structure of the issuer (see *Chapter 4 Capital structure*). *Table 1.1* provides an example of how expected returns change within the same major Australian bank as an investor takes on different levels of risk. At the time of writing, term deposit rates offered by major Australian banks were good relative value, with better returns than equivalent risk government guaranteed senior debt and higher risk senior unsecured debt.

Snapshot returns of securities offered by a major Australian bank (rated AA- Stable by S&P) as at 8 November 2012

Securities	Maturity	Yield*
Term deposit	90 days	4.30%
	1 year	4.40%
	3 years	4.40%
Government guaranteed senior debt	3 years	3.10%
Senior debt	3 years	3.60%
Subordinated debt	3 years	4.70%
Hybrids	3 years	5.65%

Table 1.1 *Source: FIIG Securities Limited*

* Yield is a fixed rate equivalent.

1.5 Ability to diversify the range of portfolio maturities

Bond maturities typically vary between one and ten years although some inflation linked bonds are issued in Australia for 25 or 30 years. It is not uncommon for international companies or banks of very strong credit quality to issue bonds in their domestic markets for 50 or even 100 years. Investors do not need to hold a bond until maturity as bonds are tradable securities and can be sold prior to maturity. The investment return in this instance may differ from the initial yield due to the price of the security in the market at the time of sale.

1.6 Liquidity

Cash is an important component in a portfolio, allowing investors to pay their bills and maintain their positions. Equally, very low risk, highly liquid fixed income investments like government bonds can be sold at short notice if needed (see definition of cash in *Section 3.3.1.1*). Liquidity is a fundamental factor in building a portfolio. Assets that cannot be easily sold or traded in a secondary market need an appropriate return to compensate for illiquidity. An important function of liquidity is being able to sell an asset quickly without significant loss (see *Section 2.8 Liquidity* for more detail).

1.7 Protection against loss in a cyclical downturn

Generally, a fixed income allocation in your portfolio will act to protect it during a cyclical downturn. A greater allocation will provide greater protection. Setting your asset allocation and regularly rebalancing your portfolio, assuming a set fixed income allocation, should provide ongoing protection (see *Section 6.3 Fixed income in a balanced portfolio* and *6.4 Rebalancing a fixed income portfolio*).

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