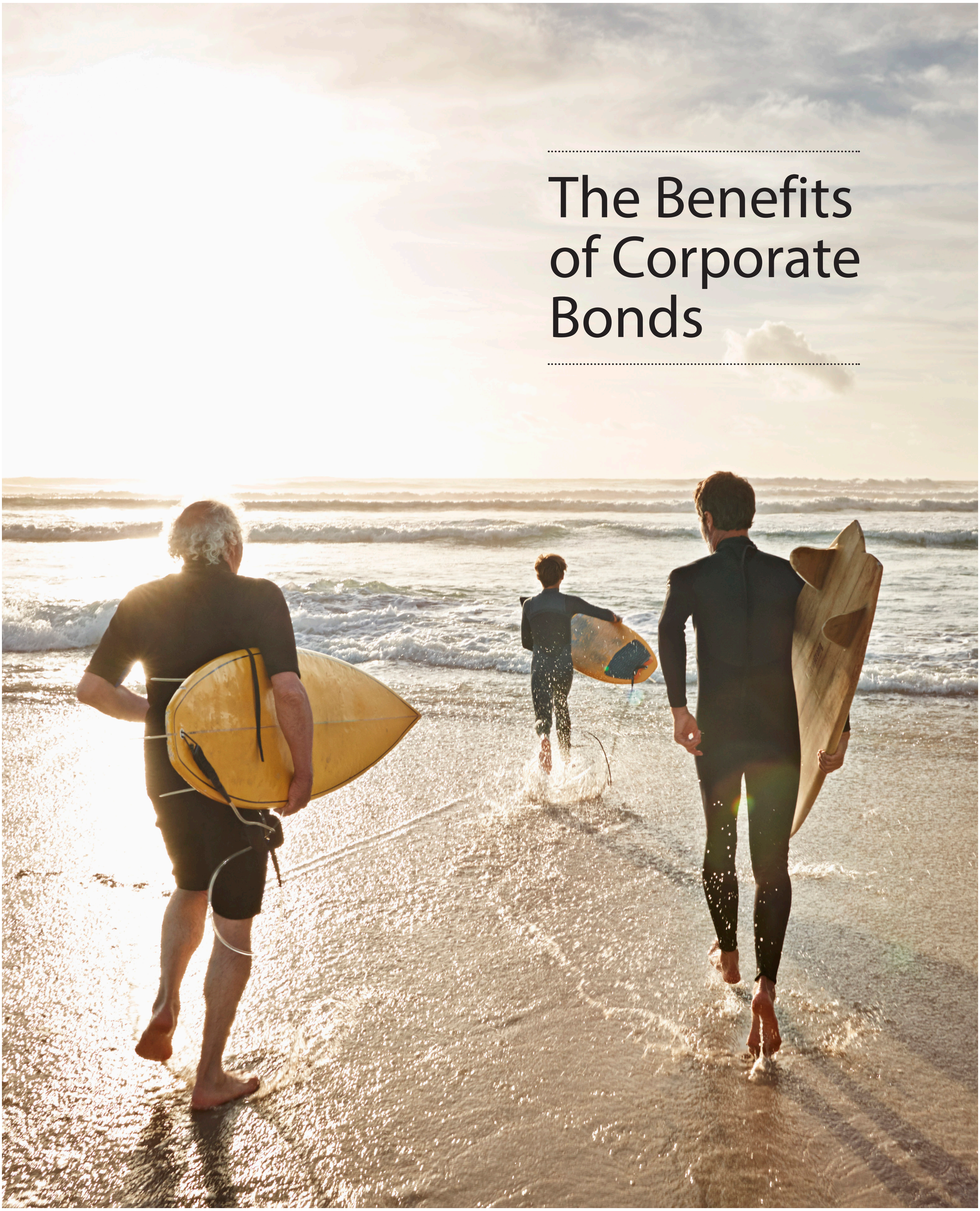
FIIG | The fixed income experts



The Benefits of Corporate Bonds

Contents

The role of Corporate Bonds in your portfolio

As inflation becomes the dominant theme of investing over the next few years, the volatility in riskier assets can be offset with a low-risk bond portfolio. The diversification benefits provided by a quality bond portfolio in terms of capital stability and secure income cushion investors from losses elsewhere in their other asset classes.

Whether you are looking to earn additional income from your capital while you work or replace your salary when you retire, income producing assets can deliver consistent, reliable income and capital stability.

That's why Corporate Bonds play such an important role in balanced investment portfolios – especially once you've optimised your earning potential and your asset base is at its peak.

In this guide, we look at the four fundamental reasons to invest in Corporate Bonds, and some key considerations for investors seeking predictable income and greater capital stability.

Investment principles

Generating a consistent income stream is fundamental for investors nearing retirement.

Think of your wealth as an aeroplane, taking off in your twenties with your engines powered by your salaries and other income sources. Over the years your wealth increases in altitude, and if one engine fails you still have the capacity to repair and recover.

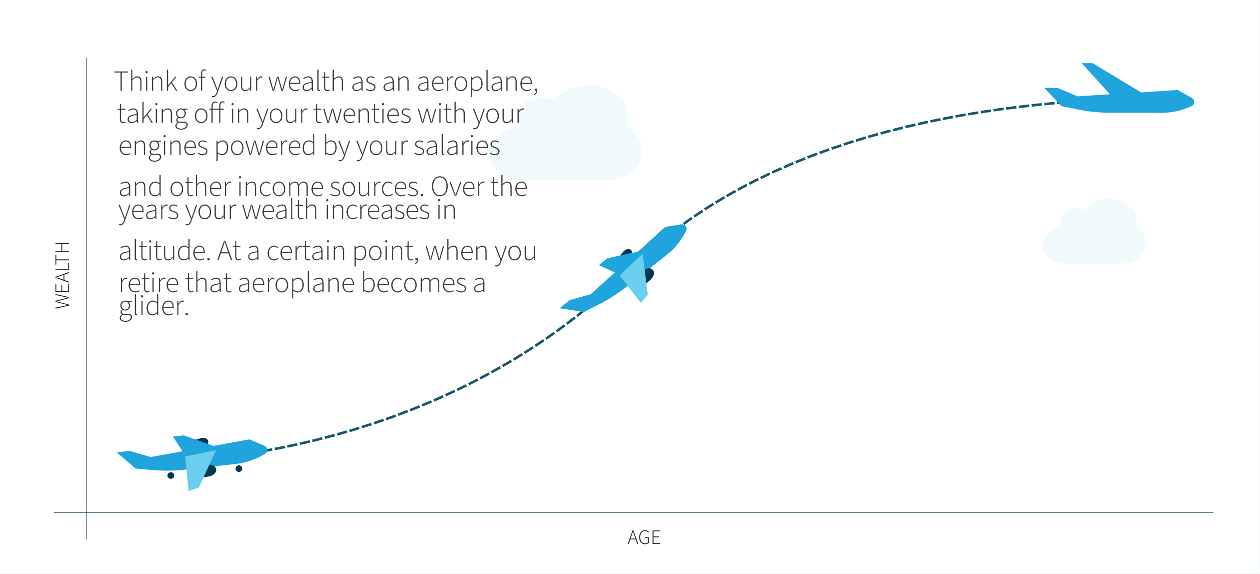
At a certain point, when you transition into retirement, that aeroplane becomes a glider.

You no longer have the salary engines, but you need to keep that glider in the air, navigating any air pockets, and have a plan to land safely beyond your life expectancy.

This is the fundamental principle behind building and managing wealth over your lifetime. Initially, you need to take risks to grow your wealth. As that hard work pays off, you need to preserve those assets, protect them from market volatility and reduce your risks.

With interest rates at historic lows, cash investments, including term deposits, are no longer enough to generate a sufficient income. Global equity markets are volatile and there is also less confidence in dividends or the possibility of higher share prices.

Corporate bonds offer predictable income, capital stability, diversification and the potential to earn better returns.



How bonds work

Companies or governments issue bonds as a way of raising funds. They borrow funds from investors in the form of bonds, making it a form of debt. When you purchase a bond, the bond issuer is legally obliged to pay you regular interest (referred to as coupons), and at the bond's maturity, the face value of the bond (which is the price the bond was issued at - usually $100) must be returned to you.

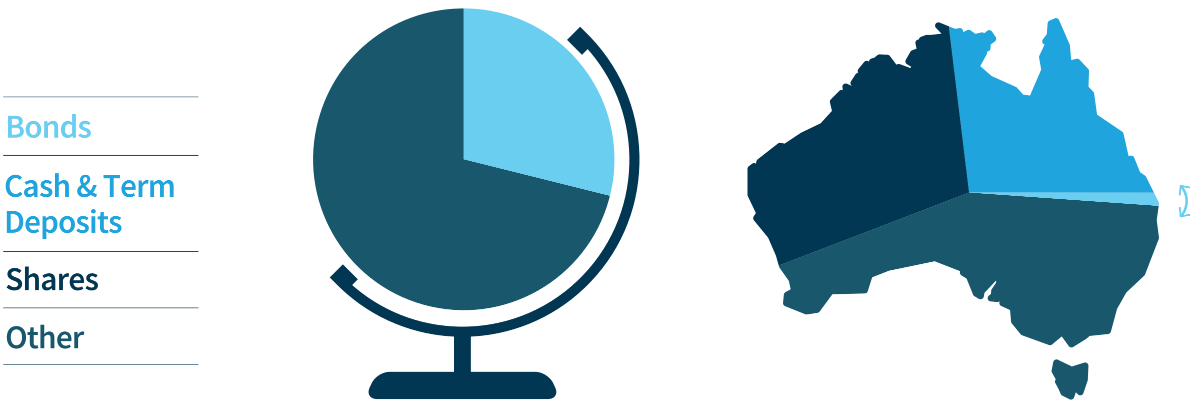
This provides investors a greater deal of certainty - as you are paid interest income, and your capital should be returned at maturity.

Bonds can also be readily traded in a similar way to shares in a secondary market. Whilst they are generally less volatile than equities, bond prices can move up and down, so there is the potential to realise higher or lower returns if you sell before maturity.

The vast majority of bonds are traded in the secondary market, giving investors access to liquidity and bonds with a shorter time to maturity.

While the value of your investment won't go up (or down) as much as a share in the same company, there will still be an impact from performance. For example, when Qantas posts good results, the value of its bonds might go up – and some bond holders may choose to trade at that point.

Bonds also provide the opportunity to diversify, by investing in government infrastructure or businesses not listed on the Australian Securities Exchange (ASX). Wholesale investors can also access foreign currency bonds, now available through FIIG's Foreign Exchange Service.



Global asset allocation [1]

Australian asset allocation [2]

Australian SMSFs hold less than 2% of assets in bonds, but hold 26% in listed shares and 22% in cash and term deposits. [2]

Australia's growing appetite for direct bonds

Although many Australians are already invested in Corporate Bonds via a managed fund, growing numbers are choosing to invest directly to deliver income and preserve their capital. The seven countries with the largest pension funds in the world allocate 29% of funds to bonds.[1] In Australia, SMSFs currently hold less than 2% of their assets in bonds, but this is growing as investors understand the importance of diversification.

The global bond market is worth $87.7 trillion, which is more than the global share market ($67.1 trillion). Culturally, Australian investors have a bias towards property, and also enjoy franking credits on their dividends, however the characteristics of bonds, with their reliable income and capital stability, make them necessary for retirement capital.

> One reason fewer Australians invest in direct Corporate Bonds than their US, UK and European counterparts is that until 2010 Corporate Bonds were only available in parcels of $500,000, limiting access to this market.

1 Global Pension Assets Study 2020, Thinking Ahead Institute Research
2 ATO SMSF data as at March 2020

When FIIG Securities launched the DirectBonds Service in 2010, it changed that. Around 2% of Australia's bond market is now directly held by personal investors, and growing fast. FIIG's vision is to see at least 10% of Corporate Bonds held directly in the hands of personal investors.

Jack Bogle, founder of Vanguard investments, recommends holding "roughly your age in Corporate Bonds" – for example, at age 50 around half your portfolio should be allocated to high quality Corporate Bonds because you have more wealth to protect and less time to recoup unexpected losses on the stock market.[3]

If you want to protect your SMSF or retirement savings, the most relevant benchmark is to look at what global pension managers are currently doing. They manage the retirement capital of the world.

Shares and Corporate Bonds are both complementary and necessary parts of a portfolio

Generally, when shares underperform, Corporate Bonds outperform – and vice versa.

When markets are declining or unpredictable, Corporate Bonds look more attractive as a way of locking in returns and preserving capital.

As a defensive asset, Corporate Bonds present slightly more risk than bank deposits for slightly higher returns of around 1 to 2% per annum throughout the economic cycle – although there are high risk Corporate Bonds earning as much as 12% per annum.

Including Corporate Bonds in your portfolio helps you smooth out overall returns over time, especially when markets are stressed or volatile. Over ten years, the AusBond Corporate Index returned 7.21%, while the ASX 200 benchmark returned only 5.48% for 10 year annualised returns in the same period.[4]

Three types of bonds

A balanced bond portfolio will include different weightings of these three types of bonds, depending on your expectations for interest rates and inflation.

1 **Fixed Rate Bonds** pay the same interest amount throughout the life of the bond. When interest rates are low or falling, these give you better income certainty. As interest rates fall, fixed rate bond prices will rise in the secondary market. The reverse is also true, when interest rates rise, fixed rate bond prices will fall. The majority of bonds are issued as fixed rate, because the largest issuers of bonds are governments and that is their preference.

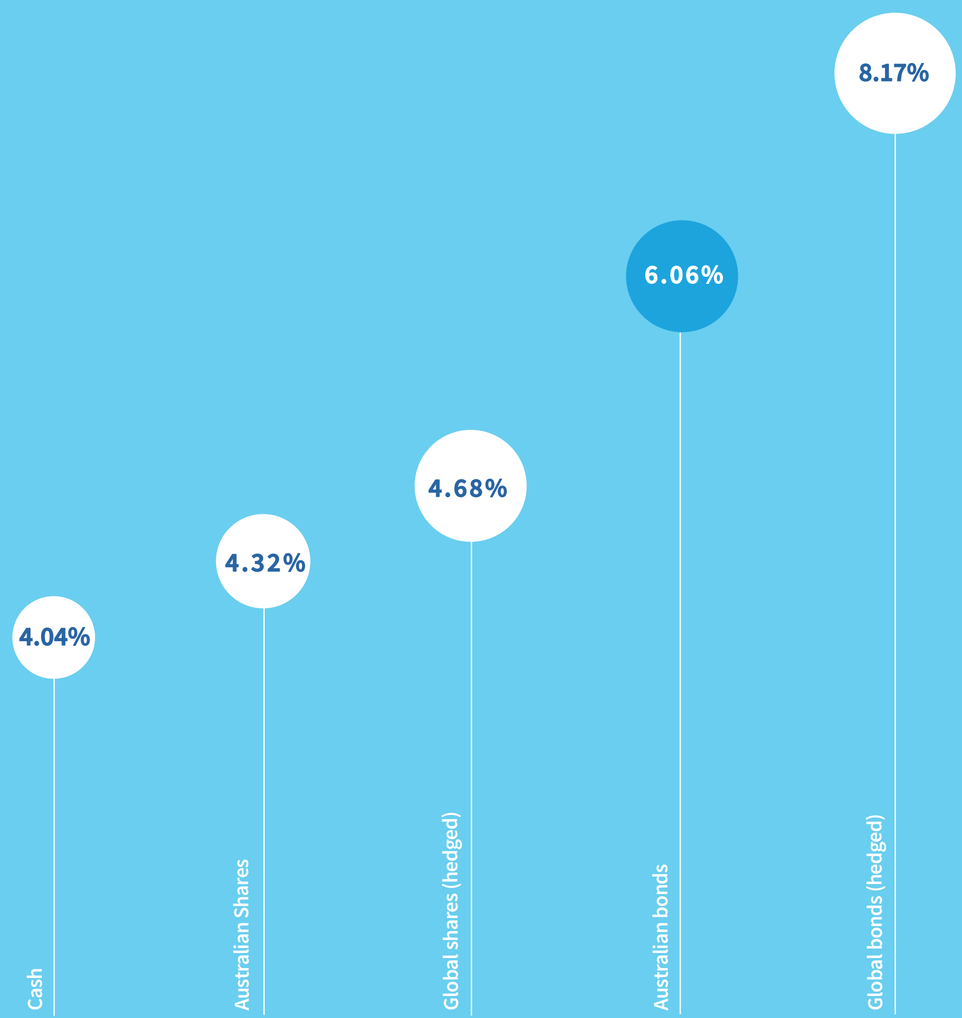
2 **Floating Rate Bonds** pay a variable income based on the bank bill swap rate (BBSW). If the market expects interest rates to rise, your income will increase. Equally, if the market expects interest rates to fall, then your income will also fall.

3 **Inflation Linked Bonds** provide a direct hedge against rising inflation.

3 Asset allocation, Bogleheads.org
4 Bloomberg 9 November 2020

BENEFIT OF CORPORATE BONDS NO.1

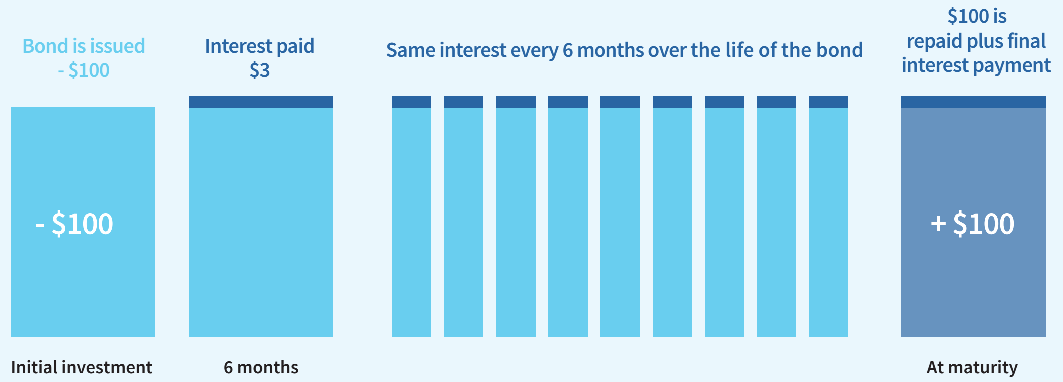
Earn a better return



Gross returns for 10 years to December 2017 - ASX 2018 Long-term Investing Report July 2018

BENEFIT OF CORPORATE BONDS NO.1

Earn a better return



The life of a typical Fixed Rate bond at 6% for 5 years, face value $100

Corporate bonds offer a low-risk alternative to term deposits and historically have offered a 1-2% extra return. As term deposit rates rise, bond yields rise in turn and offer investors a similar regular stable income stream but at higher yields.

In general, Corporate Bonds pay higher income than term deposits. A highly rated sample portfolio created by FIIG pays over 3%* per annum.

Corporate Bonds can be traded, whereas term deposits cannot. If an emergency arises – such as unexpected healthcare costs – you may be able to access term deposit funds but you'll usually forgo interest and new banking requirements now carry a 30 day notice period. However, you can trade your Corporate Bond, similar to a share.

And unlike deposits, Corporate Bonds can earn higher than expected returns, albeit with greater risk.

CASE STUDY

Seeking high yielding Corporate Bonds in early retirement >

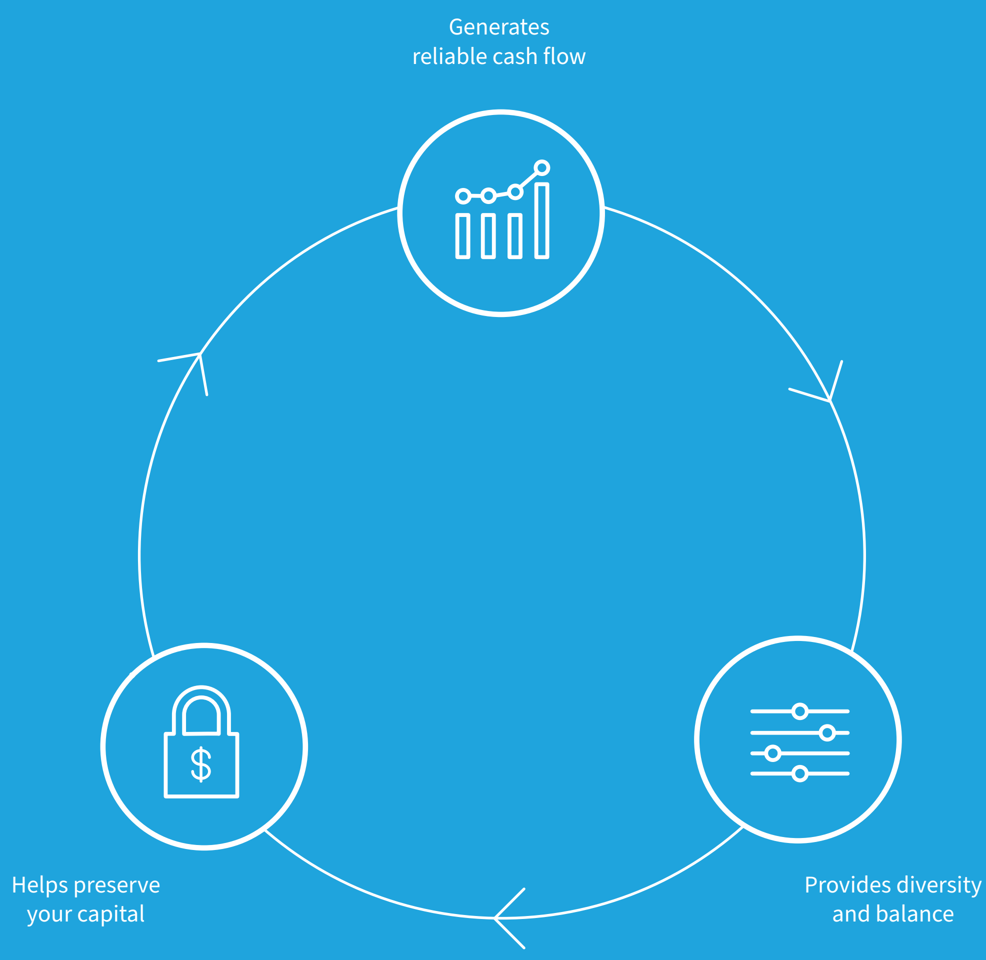
Roger and Jackie recently retired. When they calculated the interest income on a cash deposit, they were concerned they would have to dip into their superannuation capital to start covering their living expenses. Plus, they wanted to invest for some growth to ensure they'd have enough to cover a long life together and make their own choices about where and how they lived their life.

Because many of their expenses were now linked to inflation (such as healthcare, and helping with their grandchildren's education), they weighted 45% of their bond portfolio towards inflation linked bonds. The rest was split between fixed rate bonds, which provide predictable income every six months, and floating rate bonds to hedge against interest rates rising. When choosing their Corporate Bonds, they looked for opportunities with higher yields.

* Rate as at 08.04.21. Subject to change without notice and is before fees. See our FSG for any applicable fees.

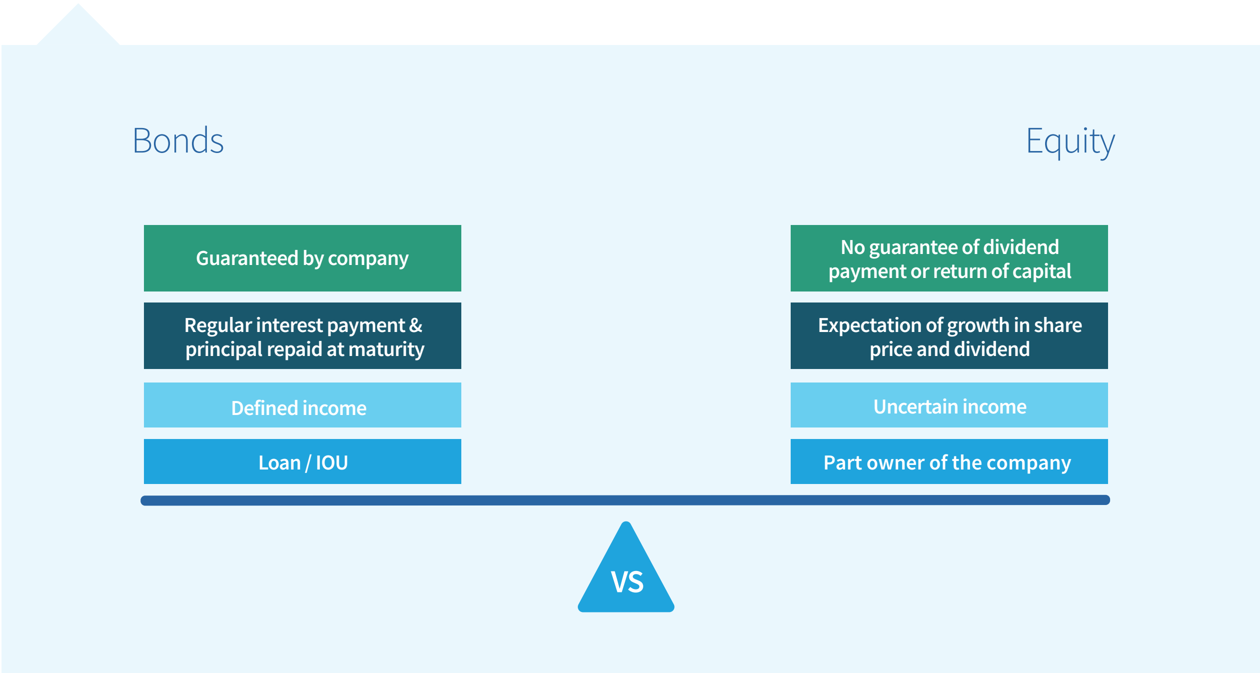
BENEFIT OF CORPORATE BONDS NO.2

Predictable income



BENEFIT OF CORPORATE BONDS NO.2

Predictable income



As we've seen, Corporate Bonds offer a better return than cash – and income is more predictable than dividends on shares.

As a legally binding obligation, Corporate Bonds are the only investment instrument apart from deposits that give you income certainty – crucial if you're making plans for your retirement. Replacing your salary with regular interest income gives you more freedom to make choices about everyday expenses and bigger lifestyle decisions. You can plan your cash flow with some certainty, including major lump sum payments.

For example, if you want to help your children with a home deposit or education costs, or make major travel plans, a predictable income will give you more confidence – as the dates and amounts of income payable from Corporate Bonds are clearly defined and not subject to the profitability of the issuer.

The income from Corporate Bonds remains certain even during times of economic downturn, whereas a third of S&P/ ASX100 shares reduced, deferred, suspended or cancelled dividends since the February reporting season in response to the COVID-19 pandemic in 2020.

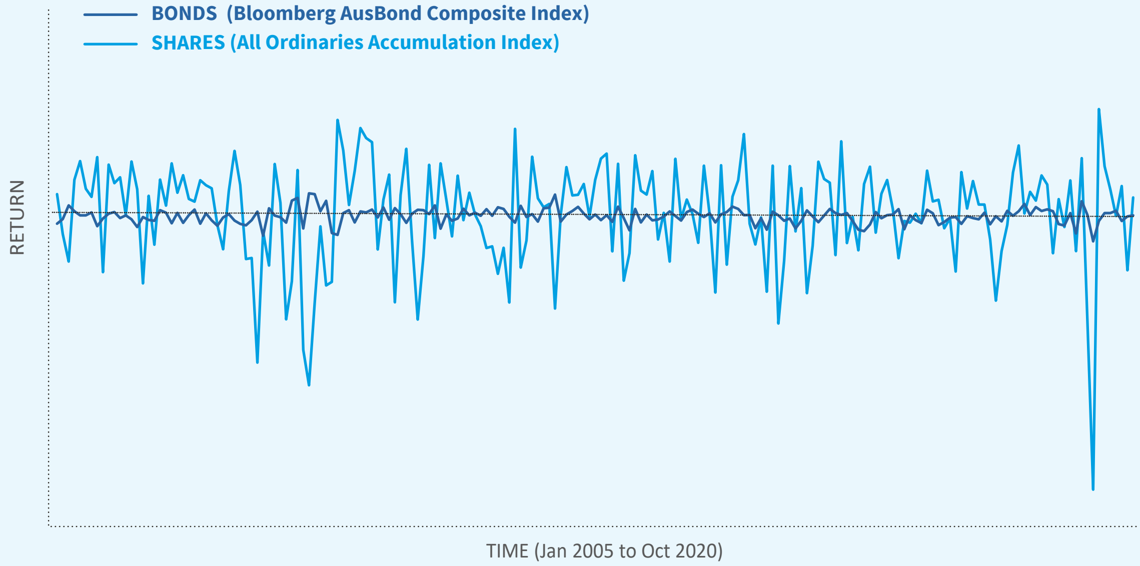
This was also the case during the 2008 global financial crisis, where approximately 65% of shares had their dividends cut.

A reliable income stream in uncertain market conditions, gives investors peace of mind.

Corporate Bonds versus equities

There's no comparison between bond income and share dividends, because dividends aren't guaranteed. When companies cut dividends, it's good news for bondholders in those same organisations – because the capital is preserved for ongoing interest and maturity payments.

When we look at how bonds and equities have returned over a 15 year period, the difference is clear.



(source: Bloomberg)

CASE STUDY

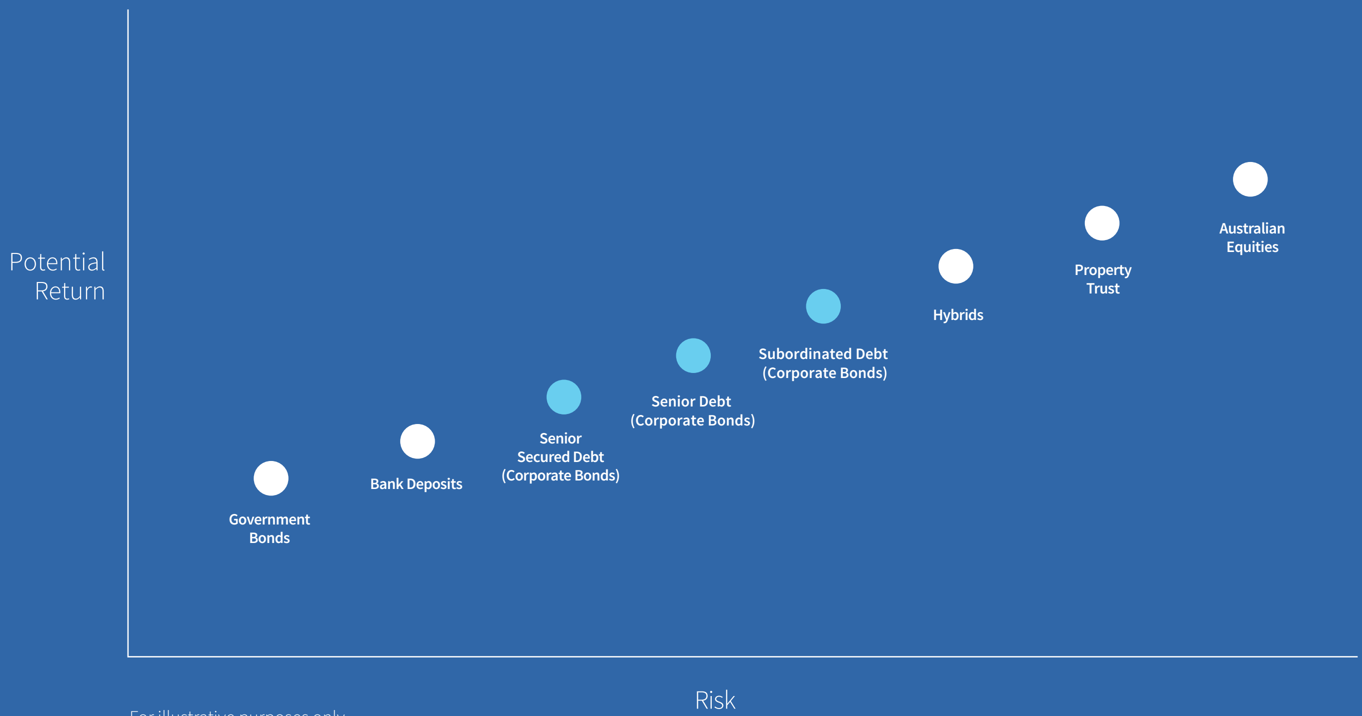
A simple approach in a low interest market >

Karen and Paul like to keep things simple. They've worked hard to build their savings, and they want to know exactly what their income will be so they can cover all their expenses in retirement. They like to travel overseas, and plan to do this for many more years.

Paul is confident Australia's low interest rates will continue for some time, so they've decided to invest all their fixed income portfolio into fixed rate bonds. They've staggered maturity dates to allow for cash at specific periods of time.

BENEFIT OF CORPORATE BONDS NO.3

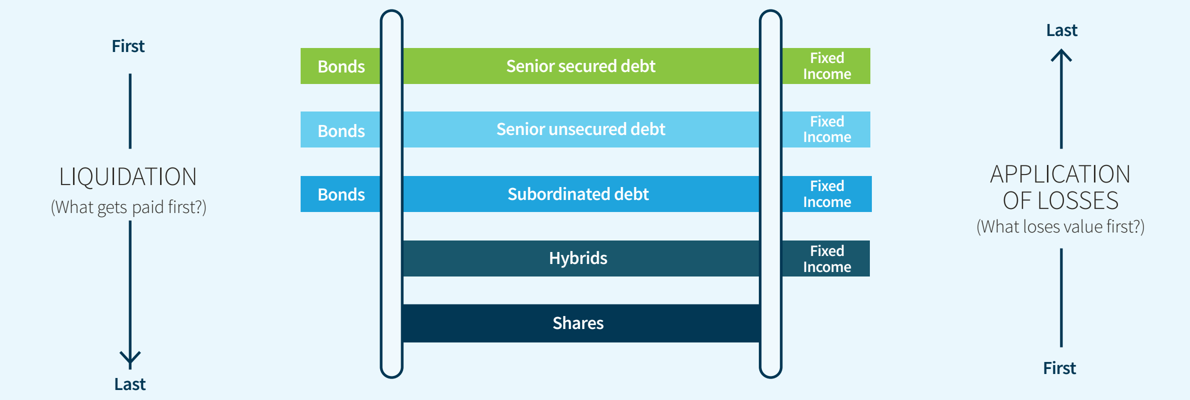
Capital preservation



For illustrative purposes only.
Source: FIIG Securities Limited

BENEFIT OF CORPORATE BONDS NO.3

Capital preservation



Capital preservation ladder

As a defensive asset class, Corporate Bonds are a lower risk investment than shares because your principal must be repaid at the end of the term.

People buy shares because of their potential promise for capital. With Corporate Bonds, the promise is that you'll get the face value of the bond back.

Most Corporate Bonds have a known maturity date, so you can invest to ensure those dates coincide with your plans. Investing directly also gives you control over which companies you invest in, and the timing of buying and selling for tax purposes.

Where do you sit in the capital structure?

Let's say the worst possible scenario occurs, and your bond issuer becomes insolvent. You will have priority over hybrid or equity investors when the proceeds of asset sales are applied.

Corporate Bonds have different levels of risk, and are classed as senior secured debt, senior unsecured debt or subordinated debt. Where they sit in the capital structure will determine their risk and return – and the likelihood of getting your capital back in the event of wind up or liquidation.

Any funds must legally be paid to the most senior investors first, before they are paid to investors on subsequent levels. This also works in reverse with losses applied from the lowest rung up. So even though shares may promise potentially higher returns, they are a riskier investment than bonds. It's a useful way to measure your appetite for risk and return while thinking about how your portfolio balances risk and return.

CASE STUDY

Giving their family more certainty and support ›

Pamela and Barry want to pay the private education costs for their five grandchildren, so preserving their capital is crucial. They also need to protect their investments against inflation, as the school fees will go up every year.

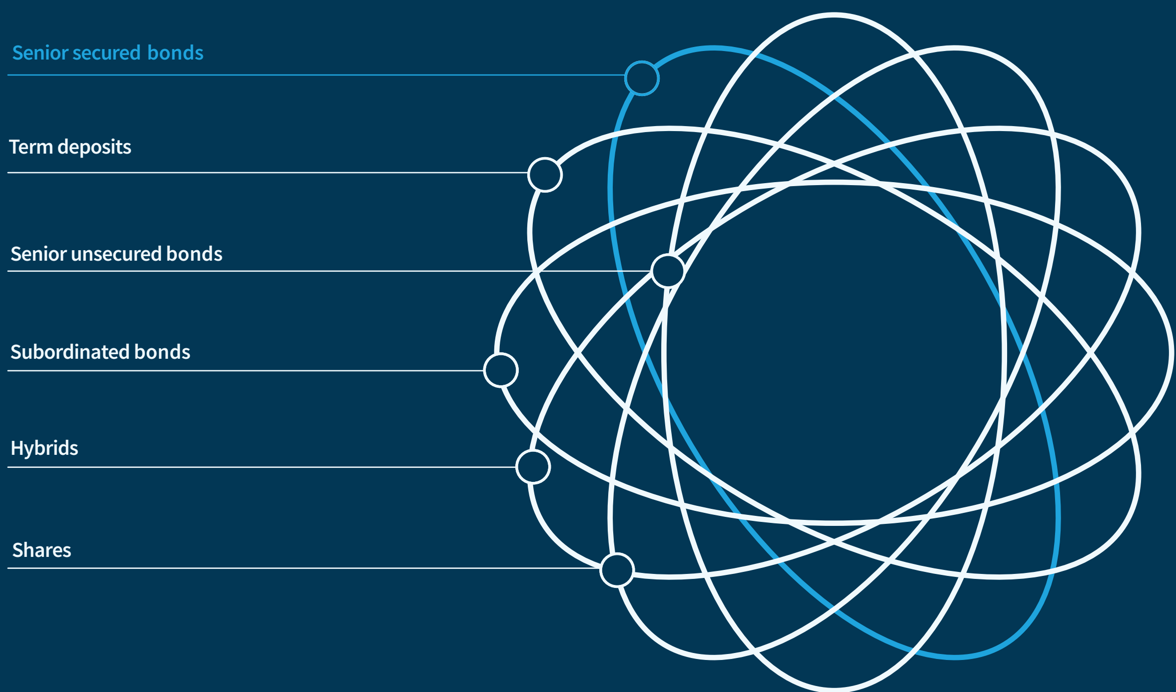
By investing in inflation linked bonds, with some allocation to fixed rate bonds for regular income, they can be more confident their savings will keep pace with inflation and be best placed to meet ongoing rising education costs. They've focused on low risk Corporate Bonds, as their holdings are large enough to generate the income they need without seeking high yields.

Their bond maturity dates are staggered to provide for their grandchildren at different ages, and they can sell down part of their holdings if they need to – for a special school trip overseas, for example.

In this way, Pamela and Barry can give their family a great start in life without needing to dip into their retirement savings capital – and they have more certainty of how much their holdings are worth at any given time.

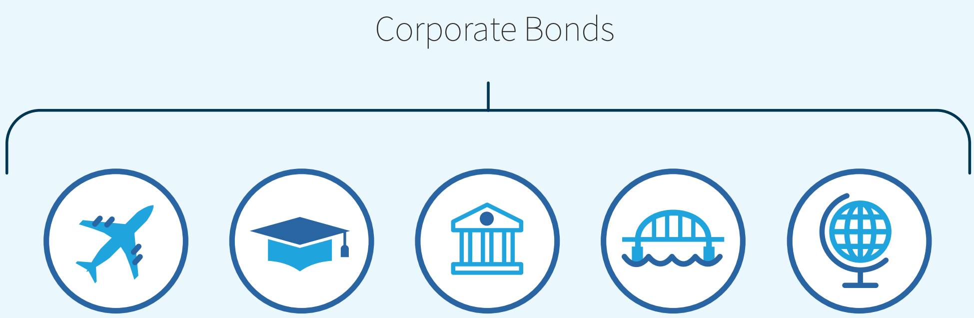
BENEFIT OF CORPORATE BONDS NO.4

Diversify your portfolio



BENEFIT OF CORPORATE BONDS NO.4

Diversify your portfolio



Through direct Corporate Bonds, you can also access investments that would otherwise be difficult to reach

Diversifying your investments across different asset classes and markets is an important way to protect your wealth from market volatility, currency fluctuations and inflation.

Investing directly in Corporate Bonds lets you customise your portfolio to meet your appetite for risk and objectives, as well as your view on the market. Need a lump sum at a specific date, or a specific yield over time? Or do you believe interest rates will rise, or the USD will strengthen? With the help of one of our Relationship Managers, you can design a portfolio to achieve your investment goals and pursue your convictions in the market.

Through Corporate Bonds, you can also invest in assets that would otherwise be out of reach – including long-term income producing infrastructure (like airports or toll roads), universities and foreign companies not listed on the ASX, like Apple or international banks.

Holding a portfolio of all three types of Corporate Bonds – fixed, floating and inflation linked bonds - will help protect your portfolio from the risks of interest rate fluctuations and inflation.

CASE STUDY

A liquid asset to diversify investments ›

Peter and Anne have built their wealth through several commercial and residential property investments, but now that they've retired they want to diversify some of their holdings into a less risky asset with predictable returns.

Given some of their investments are in Perth and Darwin, they've recently felt the impact of the market downturn and they don't want to be forced to sell before the market has had time to recover.

Investing in Corporate Bonds lets them diversify into investments which they are interested in, with fixed income certainty and the expectation they'll get face value of the Corporate Bonds back at maturity. They can also sell these Corporate Bonds in the secondary market if they need cash unexpectedly, rather than taking months to sell one of their properties.

How to invest in Corporate Bonds

You can invest directly in Corporate Bonds through FIIG. It's accessible, straightforward and transparent. There are two options, depending on how much time you want to spend thinking about your choice of Corporate Bonds.

DirectBonds

DirectBonds Service

When FIIG launched this service, it meant Australians could invest directly in Corporate Bonds from $10,000 per bond for the first time.

Individuals can now access over 400 Corporate Bonds directly, including well known companies like Woolworths, Commonwealth Bank and Macquarie as well as other successful Australian companies. Wholesale qualified investors can also invest in foreign currency denominated bonds, including GBP, USD and Euro bonds.

With FIIG's DirectBonds Service , you're in control. Choose the Corporate Bonds to suit your investment goals with the support of one of FIIG's Relationship Managers, and view your holdings at any time online.

You'll need a minimum of $50,000 to invest through FIIG's DirectBonds.

MIPS

Managed Income Portfolio Service (MIPS)

If you want direct access to the bond market but don't have the time or expertise to make these decisions, MIPS combines the benefits of owning Corporate Bonds directly with the services of a professional portfolio management team.

You still directly own your Corporate Bonds, but FIIG constructs and manages the portfolio in compliance with your selected investment program. Choose from Conservative Income, Core Income, Income Plus or Inflation Linked Income investment programs to match your investment goals and risk appetite, and we'll take care of the rest.

You'll need to be a wholesale client with a minimum of $500,000 to invest through MIPS.
Contact Marcus Blake, Head of Investment Management: 0427 063 362

Transacting Corporate Bonds

The majority of Corporate Bonds FIIG manages are traded in the secondary market, giving it access to a large pool of potential buyers and sellers. This allows you to buy Corporate Bonds depending on your income and investment goals, and also sell them to provide a lump sum if you need it.

Transparent costs

Another advantage of Corporate Bonds is the relatively low cost of management.

Unlike managed funds, where you pay ongoing management, performance and entry or exit fees, the cost of investing in the Over-The-Counter bond market is built into the rates of return a broker shows you. It's similar to buying foreign currency, where the bank takes a margin between the buy and sell price.

If you come to us looking for a yield of 5% or 6%, for example, we can find a bond for you. We may buy it at 6.7% and sell it to you for 6.2%, so your yield is effectively 6.2%. FIIG publishes a daily bond rate sheet that lists the market prices of over 400 Corporate Bonds. This rate sheet is available via fiig.com.au.

Once you've set up your bond portfolio, you control any costs you incur. If you just hold your Corporate Bonds, and don't trade until maturity, those costs will be minimal. All fees, including a monthly Custody & Administration Fee for bonds held in custody with FIIG, are set out in FIIG's Financial Services Guide, available at www.fiig.com.au/fsg.

When comparing Corporate Bonds with managed funds, it's also important to consider how you'll be paid. By investing direct, you know when to expect your interest income unlike a managed fund where you have to wait for the fund manager to make a distribution. And when the Corporate Bonds mature you're repaid the face value of the bond and interest, rather than having to sell units in a managed fund and accept the fund's price at the time of sale.

Why FIIG?

400+
different bonds

7,000+
Australian investors

100+
employees

Melbourne, Perth, Sydney, Brisbane.
with offices in

1998
when FIIG was established

$billions
assets under advice

FIIG's fixed income expertise and market access provides over 400 different Corporate Bonds to more than 7,000 Australian investors. FIIG is privately owned and not owned by any financial institution.

Our clients appreciate the depth and quality of our research conducted by our highly experienced market research team and our recommendations are without corporate alignment bias.

With over 100 experts in Sydney, Melbourne, Brisbane and Perth, a dedicated FIIG Relationship Manager will provide guidance and support to help you invest with confidence.

Get started today

Ready to get more certainty over your investment income, and achieve more stability in a volatile market? FIIG can help you build a bond portfolio to suit your financial goals and cash requirements.

Please call 1800 01 01 81

Or visit fiig.com.au

FIIG | The fixed income experts

The fixed income experts

FIIG Securities Limited
ABN 68 085 661 632
AFS Licence No. 224659

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Office addresses

Sydney

Level 24, 60 Martin Place
Sydney NSW 2000

+61 2 9697 8700

Brisbane

Level 31, 1 Eagle Street
Brisbane QLD 4000

+61 7 3231 6666

Melbourne

Level 35, 120 Collins Street
Melbourne VIC 3000

+61 3 8668 8888

Perth

Level 1, 131 St Georges Terrace
Perth WA 6000

+61 8 9421 8500

1800 01 01 81

www.fiig.com.au

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