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Fixed Income Specialists

Demand is fixed for new investment options



Latent demand revealed among investors for more fixed-income opportunities is a warning to financial planners to broaden the range and scope of the investment solutions they offer. Simon Hoyle reports.

Research released by Goldman Sachs Asset Management (GSAM) in January grabbed headlines because it purported to show an “alarming” fall in the proportion of investors who rely on financial advisers to make investment decisions.

But the 600 investors surveyed came from a group of 2000 direct share investors – so the lack of reliance on investment advisers wasn’t as disturbing as it first looked.

But the research also uncovered strong latent demand among share investors to learn more about other asset classes – particularly fixed interest and bonds.

The head of third-party distribution for GSAM, Jessica Jones, says the research revealed very low levels of investment in fixed income, which was “a great concern to us at GSAM, because we believe fixed income should be a core part of people’s portfolios”.

“It acts as a natural counterbalance to the volatility that we see in equities, and it has a huge range of diversification benefits,” she says.

“To not have any, or very little...intention

to allocate to fixed income is worrying.”

“But on a positive note...many investors are keen to learn more about fixed-income investment – 45 per cent of investors said they are keen to learn about fixed income,” Jones says.

“This shows a great opportunity for advisers here in Australia to provide more investment solutions or more education in this field.”

45 PER CENT OF INVESTORS SAID THEY ARE KEEN TO LEARN ABOUT FIXED INCOME

The director of education and fixed income research for FIIG, Elizabeth Moran, says many investors are already familiar with holding direct investments, principally equities.

As more investors, including self-managed super funds (SMSFs), seek to develop or maintain the defensive component of their portfolios, a direct holding in bonds inevitably will come onto

trustees’ radars.

Financial planners need to be ready to address investors’ questions.

Moran says a common misconception about bonds is that “there’s only one type of bond, being a fixed-rate bond, and it’s only good in certain types of markets”.

“But there are other types of bonds – floating-rate notes and inflation-linked bonds – and they work differently in different markets, so I think that’s one of the big ones,” she says.

“And a lot of that misconception comes from talking about US Treasuries. They’re typically fixed-rate, and a lot of the misconceptions come from reporting along those lines.”

Moran says an issue that commonly arises with financial planners is the investment mandate, which prevents them from investing in bonds rated below a certain credit rating.

“Demand for bonds is quite high at the moment, so sometimes we can’t always fill orders for bonds when they come through,” she says.

“There’s high demand from investors

The “security ladder”

The security of a fixed-income security varies, depending on where it ranks in the issuer’s capital structure. In the event of a failure by an issuer, investors rank in order when it comes to having their capital returned.

Senior secured debt

FIIG’s director of education and fixed income research, Elizabeth Moran, says senior secured bonds are at the top of the security ladder. These bonds are also called “covered bonds”, where a specific asset – for example, a portion of a bank’s loan portfolio – is set aside as security for the bond. Moran says major banks’ covered bonds are rated AAA.

Term deposits

Moran says term deposits are not explicitly secured within a bank’s capital structure, but they do benefit from the security of the government’s capital guarantee.

Senior unsecured debt

Widely regarded as low-risk, Moran says it’s these bonds that are generally subject to credit agencies’ ratings. They are typically

issued for terms of five years, so investors know when initial capital will be returned. Investors also know the exact dates of interest payments. Moran says fixed-rate bonds typically pay interest half-yearly; floating-rate and inflation-linked bonds typically pay quarterly.

Subordinated debt

Less secure than other types of bonds, subordinated debt often features a “call option” – the option for the issuer to repay the debt, typically after five years. Moran says the issuer has the option, but not the obligation, so the precise term of the bond can be uncertain.

Hybrids

The least secure of the fixed-interest family of securities. Moran says income from hybrids can be uncertain because in some cases the issuer can miss an income payment and not be required to make it up. She says hybrids come with a range of features and options and can be complicated – for example, maturity

dates can be extended, and the securities can be converted to equity in the company that issued them.

Each of these rungs on the “security ladder” is higher than the ordinary shares issued by a company.

“As we come down this ladder, investors should be being paid more,” Moran says. “Because bonds can be issued at three levels – senior bonds, senior unsecured bonds and the subordinated bonds – they offer different risks and returns.”

A credit rating on a bond gives investors “a very good indicator of the risk” – which for bondholders is the likelihood of the issuer defaulting and being unable to make interest payments or to return capital, where that’s applicable.

“But analysts do not always get it right,” Moran says.

“We try to add value because we can make other assessments, or our assessment can be different from theirs. Where an assessment is different, that can often be an opportunity for an investor.”

Issuers of Australian dollar bonds

Domestic	Commonwealth and state governments	Queensland Treasury Corporation	The largest issuer of the Australian states and territories.
	Banks	National Australia Bank	Issues across the capital structure – senior secured, senior unsecured, subordinated bonds and hybrids.
		Bendigo and Adelaide Bank	First to issue new Basel III compliant subordinated debt in the over-the-counter market in January 2014.
	Insurers	Vero	Vero is the insurance arm of the Suncorp Group.
	Corporations	Sydney Airport	Sydney Airport has much of its revenue linked to inflation, so issues inflation-linked bonds (debt) to match revenue.
		Telstra	Cash cow following NBN payout. Low-risk bond.
		Cash Converters	Cash Converters placed its first bond last year. The debt diversifies its funding sources, reduces reliance on banks and extends the maturity profile, providing certainty for the company.
Public private partnerships	Australian National University	ANU, a not-for-profit located in Canberra, derives much of its revenue from the Commonwealth government. It issued an inflation-linked annuity bond that pays principal and interest.	
	Praeco	Public private partnership (PPP) to build and maintain the defence headquarters outside of Canberra. It has issued both a fixed-rate bond and an inflation-linked bond.	
International	Banks	Morgan Stanley	International organisations issue \$A bonds to diversify funding sources.
	Insurers	Swiss RE	The second largest global re-insurer with significant investments.
	Corporations	General Electric	Very large international conglomerate; active issuer in many currencies.

Note: ANU, Praeco, Morgan Stanley, Swiss Re and General Electric are not listed on the ASX, so provide good diversification. Many Australian dollar bond issuers also issue in foreign currencies. Source: FIIG

and from planners for corporate bonds, and you will have seen just [recently] when Bendigo and Adelaide Bank came to the market with a \$250 million floating-rate [issue], that was two-and-a-half times oversubscribed, so they ended up upsizing the issue by \$50 million – but still there’s unsatisfied demand there. That just goes for the whole market at the moment.”

Moran says FIIG expects other corporate issuers, particularly the banks, to tap the wholesale market in coming months, issuing subordinated debt.

“Bendigo and Adelaide was an issue under new Basel III rules [on bank capital structures] in that market, so it was a bit of a test case; but I think the demand is proven and I think there will be other issuers to come,” she says.

Moran says there’s a growing realisation among financial planners that investing directly in bonds is as straightforward as investing directly in equities. She says it’s common for financial planners to be “tied into certain platforms, and if they belong to certain groups they have different requirements.”

“But typically what we’re seeing is the more independent financial planners are the ones that are coming to us or who we’re dealing with.”

Moran says that just as with investing directly in shares, investing directly in fixed income gives investors a wide range of choice and flexibility.

“They get to choose the [security] they want to invest in,” she says.

“They get to choose the maturity date for the senior and unsecured bonds – that’s really important, because if you go into a managed option, there’s no natural maturity date. You again have to make that decision to sell, and you lose one of the major benefits.

“It’s also liquidity to a degree, and there’s arguments around liquidity, but by holding individual bonds, you can just sell into the market.

“With some of the managed funds, they have had instances where they’ve been frozen and you haven’t been able to access your [capital], because there’s been a run on the fund.

“And because funds must be liquid, or fairly liquid, what they must do to ensure a certain level of liquidity is hold government bonds, which are the most liquid. At the moment, the prices on them are quite high. The price of government bonds may come down from here, and that would mean lower returns in the fund.”

“You get to choose the risk you want to take,” Moran says.

“Because there’s different levels of risk in that capital structure, you can choose the mix, if you like.

“There are some, like any asset class, higher-risk, higher-yielding bonds and you might want to allocate a small percentage to those, just to boost overall returns. But a fund may not allocate to them at all.” ■

The listed bond market

The growth and development of the listed bond market illustrates how new issuers have tapped into investor demand, and how investors’ appetite for fixed-income securities is evolving.

Michele Leung, associate director of fixed income indices, product management, for S&P Dow Jones Indices, says the bond market has more than tripled in size since S&P started tracking the market with its indices, nine years ago. As at the end of December 2013, the value of the market reflected in the S&P/ASX Australian Fixed Interest Index – that is, bonds traded on the ASX – was almost \$565 billion.

“While there is expansion recorded across three sectors, the growth of the supranational and sovereign bond sector outpaced the other two sectors, with its total market value rising 6.5 times,” Leung says.

She says the government bond market had a four-fold increase during the same period, but its weighting in the composite market remains steady at around 70 per cent.

“Investors continue to favour Australian government bonds, as it is one of the 11 countries that retain the AAA credit rating from both S&P Ratings and Moody’s,” Leung says.

“The corporate bond market size grew 1.8 times, yet the relative weighting in the whole bond market dropped from 21 per cent to, currently, 10 per cent.

“Traditionally, Australian corporates prefer issuing bonds in offshore markets as they want to diversify funding sources and minimise funding costs.”

However, there is solid and increasing interest in corporate bonds issued in the Australian market, as investors continue to search for attractive yields. Leung says the total return of the S&P/ASX Corporate Bond Index was 4.61 per cent in 2013 and it outperformed the other sector indices.

She says the S&P/ASX Corporate Bond BBB Rating Band Index had the largest gain, rising 5.72 per cent for the year and reflecting investors’ appetite for yield. She says this is likely to encourage more corporate issuers to tap into the Australian bond market.

Leung says the government inflation-linked bond market has expanded 1.6 times in the past two-and-a-half years.

“Australia sold \$2.1 billion of inflation-linked bonds due 2035 at the bottom-range yield last September,” she says.

“The strong issuance reflected a robust investor demand for inflation protection.”

The make-up of the bond market

The S&P/ASX Australian Fixed Interest Index Series is a broad benchmark index family that tracks the performance of the Australian bond market.

Index name	Index code	Market value (\$)	%
S&P/ASX Australian Fixed Interest Index	SPBDASXT	564,835,724,794	—
S&P/ASX Government Bond Index	SPBDAGVT	406,921,640,043	72%
S&P/ASX Corporate Bond Index	SPBDACPT	57,350,473,601	10%
S&P/ASX Supranational & Sovereign Bond Index	SPBDASAT	100,563,611,150	18%

As at December 31, 2013. Source: S&P Dow Jones Indices

Inflation protection

The S&P/ASX Government Inflation-Linked Bond Index measures the performance of the inflation-linked bonds issued by the Australian government or agency that meet specific eligibility criteria.

Index name	Index code	Market value (\$)	%
S&P/ASX Government Inflation-Linked Bond Index	SPBDAIBT	39,989,333,928	—

As at December 31, 2013. Source: S&P Dow Jones indices



Fixed Income Specialists

Fixed Income Education

TAILORED FOR PROFESSIONALS

FIIG's **education for professionals** provides support for financial advisors, accountants and their clients through our extensive range of **educational resources** and personalised **support services**

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Access a range of fixed income education resources developed specifically for professionals and delivered by FIIG's team of fixed income specialists.

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