nabtrade

An introduction to

FIXED INCOME

Fixed income investments provide the opportunity to generate returns typically above the cash rate, with considerably lower volatility than shares.

With interest rates on cash at an all-time low, many investors are looking for alternative ways to generate income for their portfolio.

Fixed income investments provide the opportunity to generate returns typically above the cash rate, with considerably lower volatility than shares.

A balanced portfolio is more resilient to market turbulence. Many Australian investors are heavily concentrated in growth assets such as equities and property. Bonds – often considered to be defensive assets – can be used to even out the risk of concentrating your portfolio in growth assets.

The asset allocation between growth and defensive can then be altered over time depending on market conditions and your investment objectives. This whitepaper has been developed to help you understand the risks and opportunities in fixed income. It doesn't take into account your specific objectives and needs, and we recommend you consider whether it's relevant to your circumstances. As with any investment decision, we encourage you take into account relevant product information such as the Product Disclosure Statement before deciding to invest.

How do fixed income investments work?

When investing in fixed income, you're effectively lending money to a business or government for a pre-determined length of time. The issuer agrees to pay you interest on a regular basis and repay the face value of your security/securities on the maturity date.

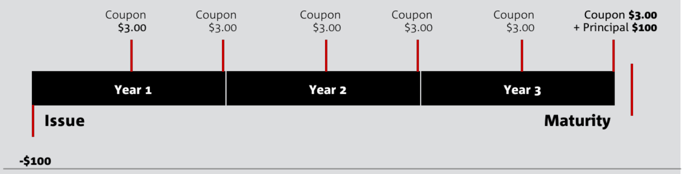
There are many forms of fixed income these include interest rate securities, bonds and floating rate notes. Hybrid securities combine elements of fixed income with shares. Different types of fixed income investments provide different returns and risk profiles.

Fixed versus floating rate

The interest rate or coupon on a fixed income investment can be fixed or floating. With a fixed rate coupon the interest is agreed at the time of issue, this allows you to protect your portfolio from future falls in the cash rate. A floating rate coupon allows applies a margin on top of a cash rate index, allowing you to take advantage of any future rate rises.

Fixed rate bond example:

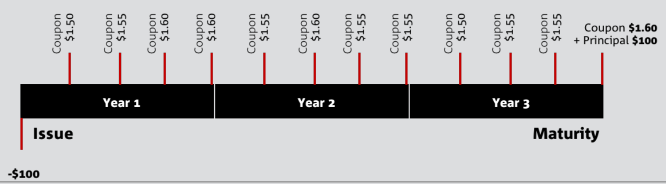
For instance a 3 year bond with a fixed coupon rate of 6% will pay investors $3.00 semi-annually over the term of the investment.



Floating Rate Note example:

The coupon payments on floating rate notes are equal to an interest rate benchmark, such as the three month Bank Bill Swap Rate (BBSW), plus a fixed margin (set at issue). For example:
2.40% BBSW + Margin 3.60%

This coupon is adjusted and reset quarterly at each reset date. Coupon payments received by the investor will vary depending on the changes in the underlying interest rate benchmark.



What are the benefits?

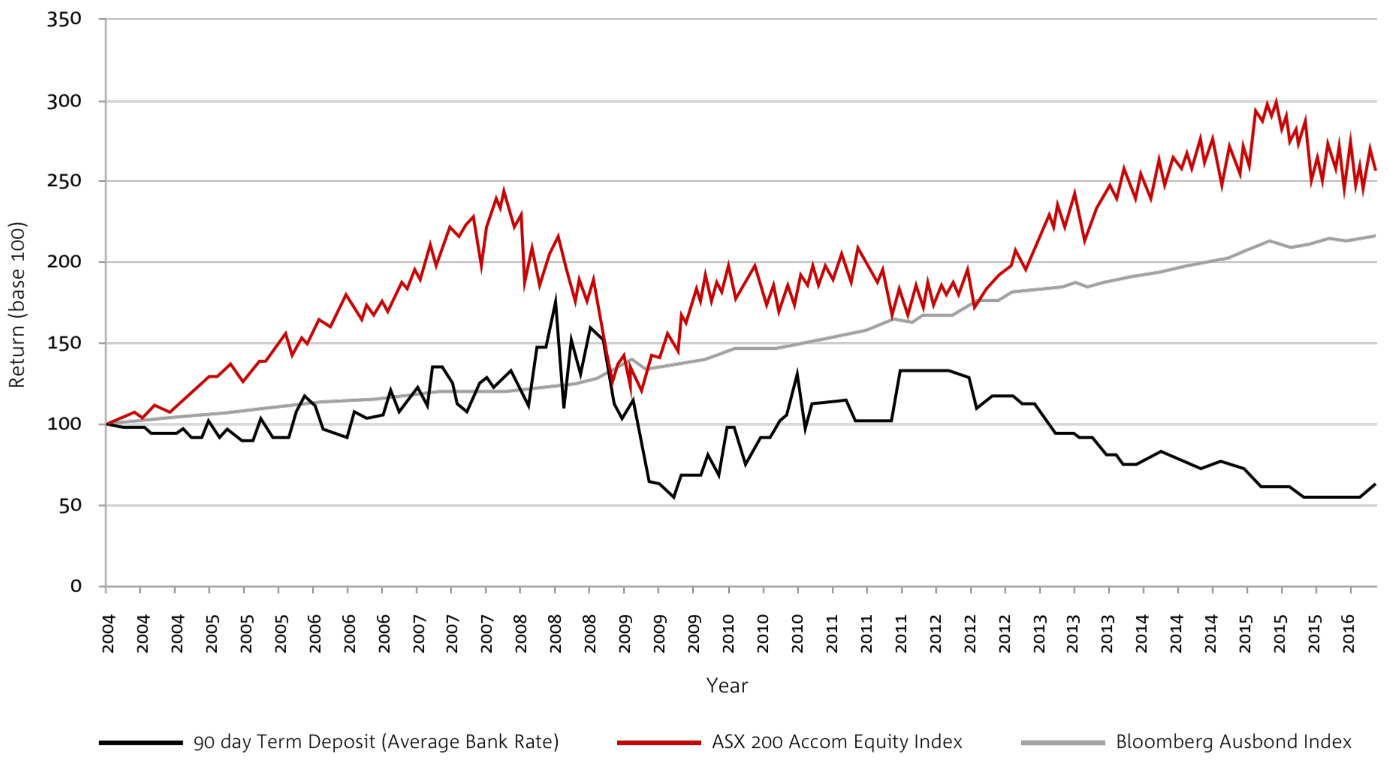
Diversification:

Diversification reduces the concentration risk of your portfolio, and can help you generate more stable returns with less volatility.

The chart below compares the performance since 2004 of a diversified basket of bonds as measured by the Bloomberg Ausbond Index, the S&P/ASX 200 Accumulation Index and 90-day term deposit rates as measured by the Average Bank Rate.

While shares (red line) have clearly delivered the strongest returns over this period, they have experienced a higher level of volatility. The bond index (grey line), meanwhile, has doubled in value at a steadier rate over the same timeframe. Whilst the 90 Day Term deposit (the black line) has failed to keep up with inflation and has lost value in real terms. It can be seen from below there are different risk and return profiles of each, and through a combination of asset classes you can manage your own individual investment objectives.

Chart 1 – Performance comparison



Source: NAB Income & Investment Solutions

Reliable income and cash flow

The majority of investment returns for bonds is from coupon payments and repayment of principal at maturity. For a broad portfolio of bonds, these payments can constitute a reliable stream of income.

Fixed income investments typically pay a higher return than cash or term deposits, which in 2017 are not delivering the same returns of past years. Additionally dividends from shares are discretionary, and subject to valuation uncertainty which has helped drive demand for fixed income amongst many retirees.

Hybrid securities are combination of debt and equity giving you the certainty of fixed income with the growth opportunity from the equity.

Higher ranking in the capital structure

Bonds rank higher in an issuer's capital structure than an issuer's ordinary shares. This means that in the event of default or insolvency of an issuer, bond investors are prioritised above equity investors in claims.

Ranking	Class	Example	Risk/Returns
Higher	Secured Debt	Liabilities preferred by law including employee antitlements and secured creditors (loan and senior secured liabilities)	Lower
	Senior Unsecured Debt	Bonds and notes, trade and general creditors	
	Subordinated Unsecured Debt	Subordinated unsecured debt obligations	
	Hybrid Securities Preferred Equity	Preference shares and convertible preference shares	
Lower	Equity	Ordinary shares	Higher

Source: ThreeSixty National Australian Bank

What are the risks?

Interest rate risk

The risk that the price of bonds will fluctuate in response to movements in market interest rates.

Inflation risk

Higher levels of inflation can negatively impact the returns on bonds.

Issuer credit risk

There is a risk the issuer will be unable to meet its interest payments and principal repayments. NAB does not guarantee bonds available via the NAB Access Bond Service.

Market price risk

Movements in market interest rates and credit spreads may impact the secondary market value of the bond.

Liquidity risk

Market conditions or economic events may impact the ability of investors to sell their bonds - during adverse market conditions, investors may be forced to sell their bonds at a steep discount if there is an absence of sufficient buyers in the market.

Extension risk

Some bonds have uncertain maturity profiles. This may impact the expected returns and the market price of the bond.

QANTAS case study

Below we're looking at an example of fixed income versus equity investments over time in a single company. This example focuses on Qantas, which works in a highly competitive environment, both domestically and internationally.

Equity investors are owners in a company and there are a number of major factors that influence the success of the company. Some of these factors Qantas is in control of, such as quality of service, brand awareness and the ticket price.

However there are also a number of external factors, which have a more significant impact on their profitability, which they can manage but do not have full control over, such as currency fluctuations and oil prices.

Therefore when looking to invest in a company such as Qantas there are a broader number of factors to consider than might be the case for a fixed income investor.

Fixed income investors are lenders to the company, their focus is return on funds as well as return of funds.

The Shareholder Experience

Qantas shareholders had a turbulent ride between September 2013 and September 2017, traded between a range of $1.07 and $6.02. As a result shareholders experienced large swings over the period.

The share price was partly driven by the price of oil and the AUD.

During these periods of volatility Qantas did not pay any dividends.

The Bondholder Experience

During the same period the Qantas 2020 6.50% Bond price traded at a much narrower range of between $95.48 to $109.2.

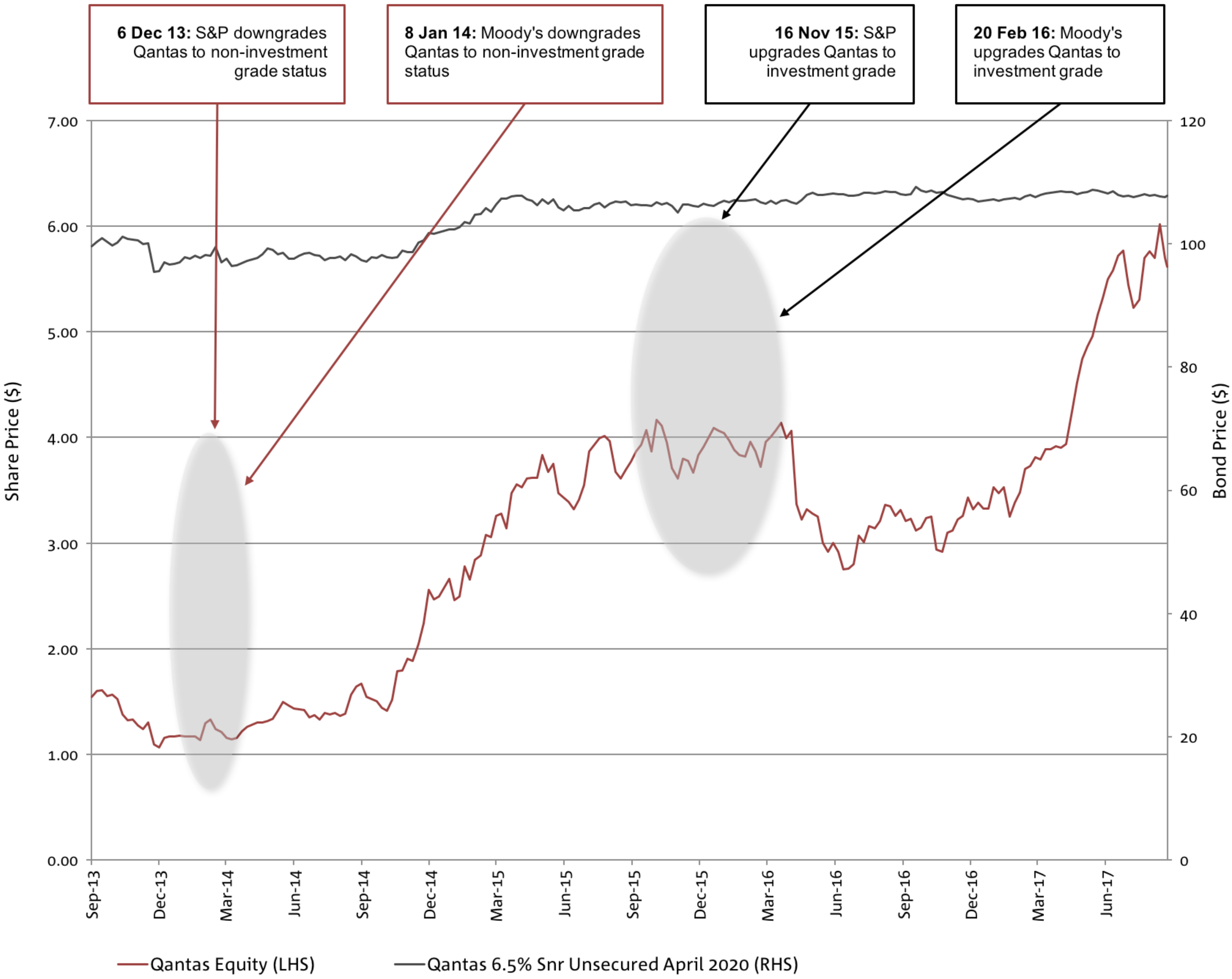
Driving the Bond price was Investment Rating and prevailing interest rates. Through the period the Bond paid a stable coupon of 6.5%.

Outcome

The equity price highlighted in red was volatile, the black line is the performance of the 6.50% 2020 Bond and it was more stable.

As you can see there are different benefits and risks between investing in fixed income or equities, even in the same company.

How you allocate your portfolio between the asset classes should depend on your individual investment objectives.



How to access Fixed Income

There are many different types of fixed income investments, and as a result you can access this asset class in a number of different ways. Some are readily available via your nabtrade account as ASX listed securities, ETFs and mfunds.

If you are a wholesale investor, you can also access unlisted fixed income through nabtrade via NAB Portfolio Access.

Listed fixed income

The listed fixed income market is available to all nabtrade clients. Securities are traded through the ASX in the same way as equities.
To take a look at available listed fixed income investments simply login and visit the fixed income page under insight centre on the top level navigation.

Here you'll find:
- Government and Corporate Bonds
- Floating Rate Notes
- Convertible Notes
- Hybrid Securities (Preference shares)

You can also access fixed income through nabtrade via managed investments like ETFs or mfunds.

Unlisted fixed income

The unlisted fixed income market is significantly larger than the listed market however investment is limited to Wholesale Clients as defined under the Corporations Act 2001.

NAB can give clients access to the unlisted fixed income market through the NAB Portfolio Access Service.

One of the benefits of this service is you can see your unlisted fixed income through nabtrade.

To find out more about the NAB Portfolio Access service visit *nabtrade.com.au/nabportfolioaccess* or call us on NIIS phone number to speak to a NAB fixed income specialist.