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Bonding with Bonds

Fixed interest is an important asset class that typically provides a diversified portfolio with consistent and stable returns for relatively low risk. Also referred to as bonds, they are an essential component of pre-retiree and retiree portfolios. This is because a bond has a known income stream and this offers a certainty of return that is greater than shares. This article explains the basics of bonds, the rationale for investing in a portfolio of bonds, and the key features of the SSFS Fixed Interest Fund.

What is a bond?

A bond is essentially debt issued by an entity that needs to borrow. Think of a bond as a loan, where the borrower/issuer must make regular interest payments to the lender/bond holder for the term of the bond. These regular interest payments are called coupons and effectively provide an income stream to a bond holder. At maturity, the bond issuer must repay the principal or face value of the bond.

Coupon payments provide investors with a certainty of return that is greater than for shares. In the case of shares, a company can choose to reduce or not make a dividend payment at all, but in the case of bonds, a company is legally obligated to make their interest (coupon) payment. The coupon rate can be fixed or floating.

Who issues bonds?

There are five major categories of bond issuers, or borrowers, in the Australian bond market:

1. The Australian Commonwealth government and state governments
2. Australian financial institutions
3. Australian corporates
4. Asset-backed bonds issued by an Australian-domiciled entity

5. Entities from outside of Australia who issue Australian dollar bonds. These bonds are called Kangaroo bonds.

Bonds issued by categories 2-5 (above) are non-government bonds, and are usually referred to as credit securities or simply, credit.

Are government bonds still considered the safest type of bond?

Within the Australian market, Commonwealth government bonds are still the safest type of bond to invest in because payments are explicitly guaranteed by the government. Therefore, the risk of default is negligible. Reflecting this, Australian government debt has the highest credit rating of AAA, which has become an increasingly elite club. We have seen in Europe how governments can be considered vulnerable to a ratings downgrade if they run unsustainably high levels of spending and debt.

Are non-government bonds riskier than government bonds?

Non-government bonds will typically have a higher risk of default. As the possibility of default increases, investors are compensated for taking additional risk by being offered a higher return.

In Australia, the credit quality for non-government bonds is quite high, with around 50% of issuance rated AAA, and almost 40% being rated AA.

Why invest in bonds?

The main benefits of investing in bonds are:

- **Defensive characteristics:** Bonds tend to perform well during periods of uncertainty, risk aversion, and during economic downturns.



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- **Diversification:** Traditionally, bonds have had a low correlation to equities. This means that bonds perform differently to equities under varying market conditions. Of course, there are times when bond market correlations to equities can increase. This will typically impact the non-government segment of the bond market more than the government bond segment, as government bond correlations to equities tend to be consistently lower. As a result, bonds perform an important role in smoothing out the returns of a diversified portfolio of assets.
- **Return composition:** The regular income stream from bonds provides investors with greater certainty of returns relative to other asset classes, while also offering the potential for capital growth.
- **Less risky:** In the event that a company goes into liquidation, bond holders will be paid before equity holders.
- **Good liquidity:** Government bonds are considered highly liquid and can be sold quickly if required. Liquidity for non-government bonds can be mixed: some enjoy high liquidity while others may be less liquid.

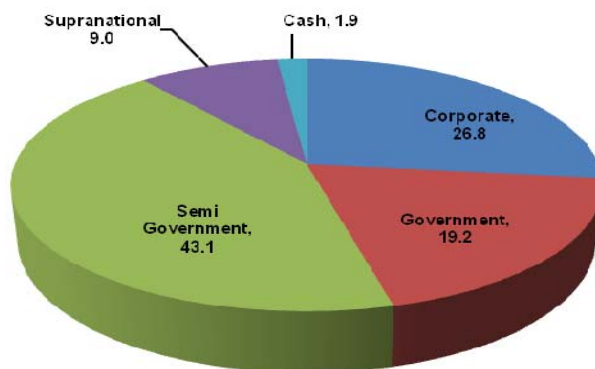
If I invest in a fixed interest portfolio does this mean that my monthly returns are fixed?

Despite the label for this asset class, your investment in bonds will not deliver a fixed periodic return. This is because bond returns are comprised of regular coupon income plus the change in capital value. Bond markets do fluctuate, and changes in capital value will impact the value of your bond portfolio. This means that an investment in bonds is capable of offering income as well as the potential for capital gain (or loss).

What is the composition of the SSFS Fixed Interest Fund?

The SSFS Fixed Interest Fund has a 70% allocation to Australian bonds and 30% allocation to international bonds.

Within the Australian bond component of the portfolio, the portfolio is well-diversified across sectors. The chart below depicts the Australian sector exposure as at 31 December 2011. The overall credit rating of the Australian bond portfolio is high.



The international bond component of the portfolio is also well-diversified across a range of securities. The international bond component is fully hedged to the Australian Dollar, which eliminates the impact of currency fluctuations on returns. The SSFS Fixed Interest portfolio is actively managed, which enables our fund managers to select bonds based on their risk and return characteristics. As a result, our portfolio has no exposure to bonds in Greece, Portugal, Ireland, Spain or Italy at present.

Why would I increase my allocation to fixed interest if I already have an exposure through my diversified portfolio?

Every person has unique circumstances and financial planning requirements. You should speak to your financial planner if you are interested in increasing the defensive attributes of your portfolio.

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