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Fixed income for your portfolio

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Defence

Fixed income investments such as bonds are widely used in portfolios to enhance income and compliment low risk interest paying investments such as cash and term deposits.

Bonds usually deliver a reliable income stream and for that reason they form a valuable part of a portfolio. Bonds are often referred to as defensive or low risk assets because they usually deliver more stable returns than equities and their prices are less volatile.

Bonds are like loans

A bond is essentially a loan by the investor to the entity issuing the bond. In return for the loan, the entity makes a promise, that is, it "gives its bond", that it will repay the loan on a specified date (the maturity date) and will make interest payments at regular intervals during the term of the loan.

At issue, bonds have a face value or principal amount per bond, with a specified interest rate, called the coupon. Like ordinary bank loans, the coupons can be fixed or variable. Most bonds have a fixed coupon from the time the bond is issued through to its maturity. For example, a bond with \$100 face value and a 5% fixed coupon will pay investors a \$5 coupon per annum over the life of the bond.

Like a loan, a bond is issued for a specific term or maturity. This generally ranges from 12 months to 30 years. In the example above, the issuer has an obligation to repay the \$100 principal plus the final \$5 coupon to the bond holder (at the maturity date).

A bond's coupon is a reflection of:

1. The bond's maturity;
2. The prevailing market interest rates at the time the bond is issued; and
3. The issuer's creditworthiness.

The return on bonds

Generally the higher risk you take with your capital the higher return you will reap over time. Bonds, which have a higher risk than cash, carry a higher interest rate than cash investments such as cash management trusts (CMTs) and term deposits.

A bond's price, or capital value, may go up or down, whereas with cash, your principal is held by a bank and virtually insulated from external market risk factors.

Bonds produce both a capital and an income return for investors. Some bonds have higher returns than others. There are many factors that impact the value of a bond and the return it produces. These include:

- economic factors such as inflation;
- remaining time to maturity of the bond;
- sensitivity of the bond to interest rate movements (duration); and
- credit rating of the issuer.

Inflation

Inflation erodes the current value of money. Therefore, the higher the expected future rates of inflation, the less the future coupon and principal payments due under a bond are worth in today's dollars. An increase in future expected inflation will generally push down the price of a bond.

Interest rates and duration

As interest rates rise, the values of existing bonds go down because demand for those bonds falls in favour of newer bonds paying a higher coupon. This brings us to a concept called duration. Duration measures the sensitivity of a bond to changes in interest rate movements. For example, if the duration of a bond is 4.00, it means that with a 1% interest rate rise, the value of the bond would fall 4.00%. For fixed rate bonds, the longer the time to maturity the higher the duration.

It's important to note when interest rates rise, while the value of the bond price falls, its yield rises. A bond's yield always moves in the opposite direction of its price. So if interest rates fall, existing bonds become more valuable because their coupons are relatively high. However, the yield of these bonds would fall, moving in the opposite direction of the price of the bond.

Yields on bonds are often expressed by yield to maturity, which is the annual rate of return expected on a bond if you purchased the bond at the current market price and held it until the maturity date. The yield to maturity will vary with the price of the bond. As the bond price goes up, yield to maturity goes down and vice versa.

The yield to maturity is different to the coupon described above, as unlike the coupon, for fixed rate bonds the yield to maturity changes throughout the life of the bond.

As the bond nears maturity date its price becomes closer to, then equal to, its face value plus the final coupon.

Credit ratings

A bond and its issuer usually carry a credit rating determined by independent rating agencies which gives an indication of how risky the issuer and therefore its bond is. If a bond has a low rating, the company or government issuing it is considered to have a high risk of default. Conversely, if a bond has a high rating, it is considered to be safer. The yields on low rated bonds are therefore higher than the yields on safer, higher rated bonds. A table on page four lists the different ratings of Australian Bonds.

Types of bonds

Bonds can be issued by governments or companies. Different bonds have different levels of risk. For example, Australian Government Bonds are the safest bond investments for Australian investors, while corporate bonds will vary in risk levels depending on the credit worthiness of the company issuing the bond.

Government bonds

To fund its spending, the Government of the Commonwealth of Australia issues bonds called Australian Government Bonds (AGBs), which range in maturity from two to 30 years and carry fixed coupons, with coupon payments made every six months. AGBs come with the same rating as the Australian Government, being 'AAA', the highest credit rating available. Most governments around the world don't enjoy such a high credit rating and that's why most AGBs are owned by foreign investors.

Semi-government bonds

Semi-government bonds are similar to AGBs except they are issued by government entities apart from the Commonwealth, such as Australian state and territory governments. Like other bonds, semi-government bonds come in a variety of maturities and pay different coupons, reflecting the creditworthiness of each state government.

Currently, New South Wales, Victoria and the Australian Capital Territory have AAA ratings; Queensland, Western Australia and Tasmania have a AA+ rating; while South Australia has a AA rating. As a result, yields on some semi-government bonds can be slightly higher than AGBs, reflecting some additional credit risk.

Corporate bonds

Companies have three ways to raise cash to finance operations: they can issue equity in the form of shares; they can obtain a loan; or they can issue debt in the form of corporate bonds.

Corporate bonds are considered less risky than shares as the bond issuer promises to repay the principal at the end of the term and if the issuer becomes insolvent bond holders are repaid in priority to shareholders. Corporate bonds carry a higher risk than AGBs as repayment of investors' principal by a company isn't as certain as it is by the government, so corporate bonds generally offer higher coupons than government bonds of the same maturity to attract investors.

Floating rate notes (FRNs)

A key characteristic of FRNs is that the coupon, instead of being a fixed amount, is variable or 'floating,' calculated as a set margin above a recognised short-term market interest rate. For example, the coupon on FRNs is often stated as "the 3 month bank bill swap rate + 1%" or "3mth BBSW + 1%". FRN coupons are typically reset against the benchmark every 3 months. This means coupon payments will increase if market interest rates rise and vice versa.

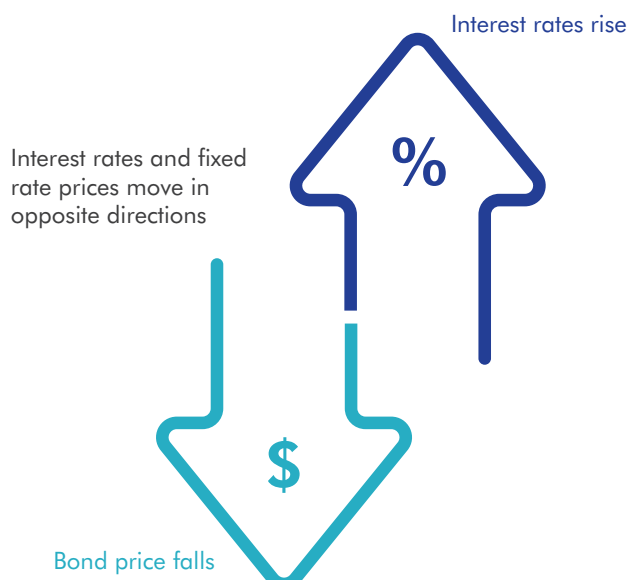
Factors affecting a bond's price

The market price of a bond will vary over time depending on what's happening in the economy and with interest rates, as well as any changes in the creditworthiness of the issuer.

Interest rates

The value of fixed-rate bonds will fall with a rise in interest rates. The longer the time to maturity of a bond, the greater the interest rate risk, that is, the more the bond's price will fall if there is a rise in interest rates. This is known as duration risk. Due to their quarterly resets FRNs have significantly lower duration risk than fixed rate bonds.

Relationship of fixed rate bond prices to interest rates and vice versa



Credit worthiness of the issuer

If a bond issuer's credit rating goes down, or there is a perceived deterioration in its creditworthiness, then the price of its bonds will also fall and the yield will rise. The table below lists the different credit ratings of Australian Bonds.

	Moody's	S&P	Fitch	Meaning	Highest Rating
Investment Grade	Aaa	AAA	AAA	Prime	↑ ↓
	Aa1	AA+	AA+	High grade	
	Aa2	AA	AA		
	Aa3	AA-	AA-		
	A1	A+	A+	Upper medium grade	
	A2	A	A		
	A3	A-	A-		
	Baa1	BBB+	BBB+	Lower medium grade	
	Baa2	BBB	BBB		
	Baa3	BBB-	BBB-		
Junk	Ba1	BB+	BB+	Non investment grade	
	Ba2	BB	BB		
	Ba3	BB-	BB-		
	B1	B+	B+	Highly speculative	
	B2	B	B		
	B3	B-	B-		
	Caa1	CCC+	CCC+	Extremely speculative	
	Caa2	CCC	CCC		
	Caa3	CCC-	CCC-		
	Ca	CC	CC+	In default with little prospect for recovery	
		C	CC		
			CC-	In default	
	D	D	DDD		
			Lowest Rating		

Source: VanEck

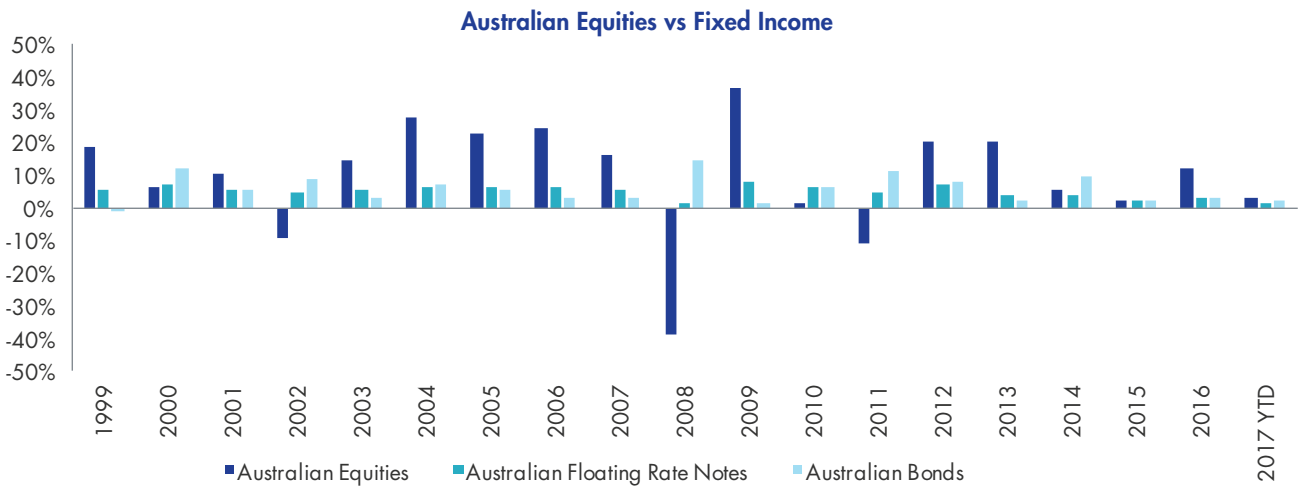
Performance of equity markets

Demand for bonds is also linked to the performance of other financial markets. For example, demand for bonds often rises when equity markets are falling as they are deemed safer investments than equities. An increase in demand will result in an increase in the price of bonds. Conversely, when equity markets are performing strongly demand for bonds may fall resulting in bond prices falling.

Why bonds are so important

Bonds are defensive investments which means they tend to do well when the economy slows down or equity markets sell off. Over the last 10 years, some high quality fixed-rate corporate bonds have provided comparable and in some cases better returns than Australian and international equities. Along with less volatility, corporate bonds have posted fewer years of negative performance than equities.

The graph below shows the strong outperformance of Australian bonds during the global financial crisis (GFC) compared to equities. Benchmark indices for FRNs and a composite index of corporate and government bonds easily outperformed Australian equities during 2008 when the GFC hit and in 2011 which was marked by high levels of equity market volatility.



Source: Morningstar Direct, You cannot invest in an index. Past performance is not a reliable indicator of future performance.

The chart below displays the greater capital stability of bonds compared to equities. Over 10 years to 30 June 2017, bonds easily outstripped the return on the S&P/ASX 200 Accumulation Index, which gained 3.30%. FRNs, using the benchmark Bloomberg AusBond Credit FRN 0+ Yr Index as a guide, returned 4.37% while corporate bonds did even better, with the Bloomberg AusBond Credit 0+ Yr Index, gaining 6.36%. This highlights the protective power of bonds. Bonds did a lot better than Australian equities, which dived during the GFC and took almost six years to recover. Bonds withstood the assault and came out post the GFC performing much better.



Source: Morningstar Direct, Results are calculated monthly and assume immediate reinvestment of all dividends. You cannot invest in an index. Past performance is not a reliable indicator of future performance. Indices used Australian Equities – S&P/ASX 200 Accumulation Index, International Equities – MSCI World ex Australia Index, Australian Bonds – Bloomberg AusBond Composite 0+ years, Australian Corporate Bonds – Bloomberg AusBond Corporate Bonds 0+ years, Australian Floating Rate Notes – Bloomberg AusBond Credit FRN 0+ Yr Index

Key risks to consider with fixed income

Depending on the fixed income investment you choose, there are different risks that you need to consider that may affect the value of your investment or your return. Some of the main risks are outlined below.

Inflation risk

This is the risk that the return on your investment will be lower than the inflation rate, resulting in the 'real' value of your investment falling.

Interest rate risk or duration risk

This is the risk that a rise in interest rates will erode the value of a bond. The longer the duration of a bond, for example, the greater the interest rate risk, that is, the more the bond's price would fall if there was a rise in interest rates.

Credit risk

This is the risk that an issuer defaults and cannot pay coupons or repay bondholders their capital. Typically, the higher an issuer's credit rating, the lower the risk they will default on payments. The coupon rate reflects a borrower's credit rating and is higher on bonds with lower credit ratings.

Glossary of key terms

Bond:	A debt security under which the issuer such as a government or company owes bond holders a debt and pays them interest (called a coupon) and repays the principal at the maturity date.
Coupon:	This is the interest payment on a bond, paid monthly, quarterly or semi-annually. Most bonds carry a fixed coupon which does not change from the time the bond is issued through to its maturity.
Default:	Failure by an issuer to pay coupon payments or repay principal when it is due.
Duration:	A measure of the sensitivity of a bond's price to a change in interest rates.
Duration risk:	The risk a bond's price will fall due to a rise in interest rates. The longer the duration, the higher the duration risk.
Face value:	Also called 'par value' this is a bond's original issue price before it is traded and the amount of money an investor will get back at the maturity date.
Maturity date:	The date in the future when a bond's face value will be repaid.
Official cash rate:	The level of interest rates set by the Reserve Bank of Australia at its monthly interest rate meetings.
Term:	The length of time, from issue date to maturity date.
Volatility:	The degree of variation in the trading price of an asset over time.
Yield to maturity:	This is the rate of return expected on a bond expressed as an annual rate if you purchased the bond at the current market price and held it until the maturity date.

VanEck Australian fixed income ETFs

An exposure to bonds via an ETF is a simple and cost effective way of gaining a defensive asset allocation in an investment portfolio. VanEck offers two fixed income ETFs which provide investors an opportunity to enhance their income.

ETF Name	ASX ticker	Management costs (p.a.)	Benefit
VanEck Vectors Australian Floating Rate ETF	FLOT	0.22%	FRNs offer enhanced yield above cash investments. Coupon payments will increase if market interest rates rise, or fall if interest rates go down.
VanEck Vectors Australian Corporate Bond Plus ETF	PLUS	0.32%	The yields from corporate bonds are generally higher than term deposits and government bonds. PLUS is a portfolio of higher yielding predominately investment grade Australian dollar corporate bonds.

Contact us

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