Corporate Bonds Explained

XTB

FACT SHEET

Fixed income investments generally provide investors with more secure and stable investments than equity, property and other growth orientated and therefore more risky investments.

A very common form of fixed income investment is a bond. The Australian government, state governments and many of Australia's largest companies borrow money by issuing bonds.

Exchange Traded Bond units (XTBs) are securities that relate to individual corporate bonds. There are 17 XTBs available giving investors 100% of the coupons and principal from 17 different corporate bonds. This Fact Sheet looks at the nature of the corporate bonds underlying XTBs.

Let's start by looking at what corporate bonds are. If a company wants to borrow money for a number of years it can do so in one of two ways. It may borrow from a bank (or a group of banks). The risks of lending to the company are borne by the bank(s), those risks are not easily transferable to other parties.

Alternatively, the company can issue corporate bonds. The bonds are basically IOUs: they are typically bought by a number of investors, who may then trade them with other investors.

The returns to investors from bonds are determined by two factors.

1. The face value that is paid when the bond matures.
2. The steady stream of income that is defined by the coupon.

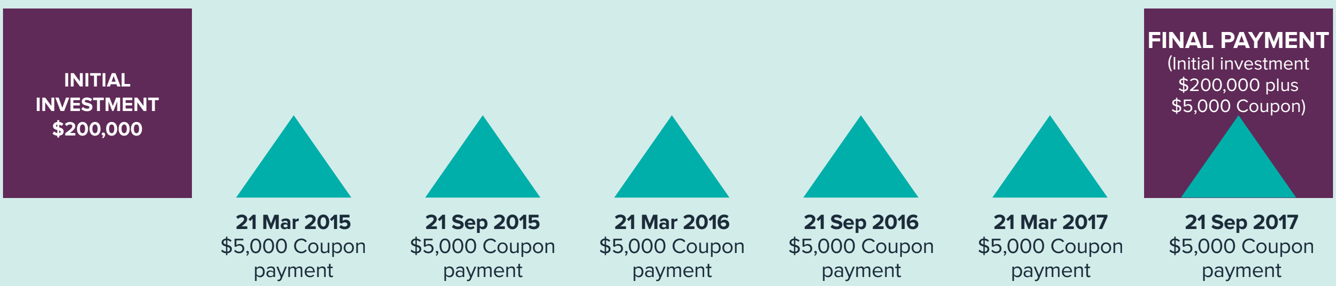
Key features

Corporate bonds are not all alike. The key features, which can differ from one bond to another, include:

- **Issuer** – Companies vary quite markedly in their financial strength. Depending on the businesses that they are in, and how much money they have already borrowed. Two companies that are broadly similar by some measures, can be very different in terms of financial risk. The bond issued by a riskier company is not necessarily a less attractive investment – if it offers a suitably attractive return.
- **Face value** – This is the nominal value of the bond, which the company promises to pay when it matures. The market value (bond price) of the bond can be higher (premium) or lower (discount), once trading begins. Face values of $10,000 or $100,000 per bond are typical.
- **Coupon** – This is the annual income that is paid to investors, expressed as a percentage of the face value. The word coupon reflects the fact that, when bonds first existed in physical paper form, they would normally have coupons attached. To be paid, the investor detached the coupon for a particular payment and took it to the company's bank.

  Income is usually paid semi-annually or quarterly, on specified dates. If a bond with a face value of $100 has a coupon of 5%, paid semi-annually, there will be two payments of $2.50 each year, as demonstrated in the diagram below. In general, a riskier company will issue bonds that have a higher coupon than a less risky company.

CORPORATE BONDS: EXAMPLE OF COUPON PAYMENTS OVER TIME



Corporate Bonds Explained

- **Fixed or floating** – Professional investors describe the asset class that includes bonds as ‘fixed income’. It is true that many bonds have a coupon that is fixed. However, some corporate bonds have a coupon which is ‘floating’, meaning it is pegged (or tracks) an industry benchmark with a fixed margin (e.g., 0.75%) above the benchmark (e.g., the Bank Bill Swap Rate or BBSW) or is linked to inflation.
- **Term to maturity (or tenor)** – This is the length of time from the issue of the bond to its maturity, when the face value and the final coupon are paid to investors. In Australia, maturities of corporate bonds are typically from one to about 10 years, with longer dated bond being more uncommon. Of course, an investor does not have to hold a bond to maturity, as they may sell it in the market, subject to liquidity.

CAPITAL STRUCTURE OF A BANK

LOWEST RISK

- **SENIOR SECURED DEBT** (covered bonds)
- **TERM DEPOSITS**
- **CORPORATE BONDS**
- **SUBORDINATED DEBT**
- **HYBRIDS - DEBT LIKE - EQUITY LIKE**
- **EQUITY**

HIGHEST RISK

PRIORITY OF PAYMENT IN LIQUIDATION

- **Ranking in the company’s capital structure** – In the event that a company gets into financial trouble, some bonds (senior unsecured or secured) will be paid out before others such as sub-ordinated bonds, which rank below senior bonds. Hybrid securities often rank below subordinated bonds and just above equity securities, which rank last in the capital structure. The lower the ranking in the capital structure a security is, the higher the risk and potential reward associated with that security.

Benefits of corporate bonds and XTBs

Corporate bonds and XTBs over them bring a number of advantages to a properly balanced portfolio of investments:

- **Steady and predictable income** – Corporate bonds pay a coupon regularly, which is passed on 100% by XTBs tracking them. This means that they offer the prospects of a predictable and steady income flow – which makes forward-looking cash flow planning easier.
- **Superior income** – The yield from a corporate bond (i.e. the return on your investment including the coupons and the final payment, in relation to the price paid) may be superior to the yield from a similar maturity government bond, cash in bank term deposit or cash management account.
- **Portfolio diversification** – True asset class diversification of portfolios across fixed income, equities and property is important for investors. As corporate bonds are generally negatively correlated to equities, most advisers recommend fixed income investments, like corporate bonds, in a balanced portfolio.
- **Liquidity** – Unlike, for instance, property, there may be an active market for corporate bonds. They can normally be bought or sold relatively quickly, subject to liquidity. XTBs on ASX have a Market Maker who provides buying and selling opportunities for investors, subject to the liquidity in the underlying wholesale bond market.
- **Capital stability** – Corporate bonds are generally less volatile than all the securities below them in the issuer’s capital structure. But corporate bonds can lose value if the risk of the issuer increases. In such a situation, the market price falls and the yield rises. (NB the price and the yield always move in different directions, as shown below). In general, corporate bonds are more stable investments than securities ranked below them in corporate capital structures.

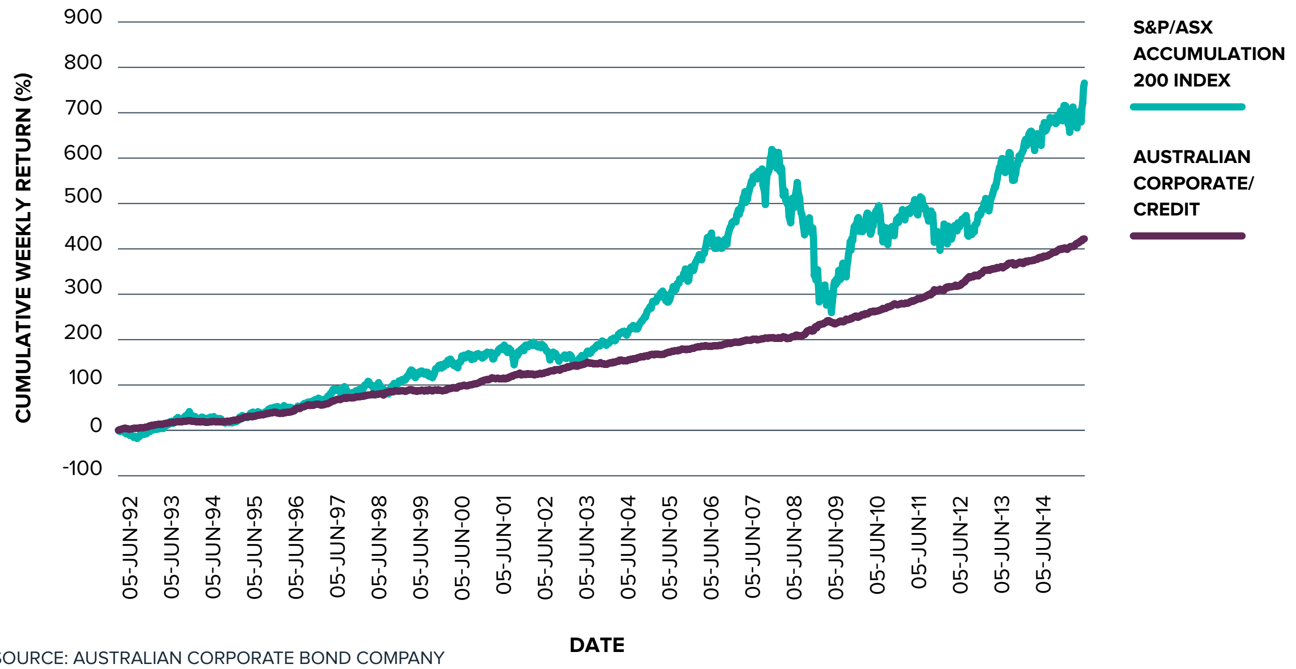
THE RELATIONSHIP BETWEEN PRICE AND YIELD

MARKET MOVEMENT	BOND PRICE MOVEMENT	BOND YIELD MOVEMENT	EFFECT ON XTB PRICES ON ASX
↑ INTEREST RATES RISE	↓ PRICES FALL	↑ YIELDS RISE	↓ XTB PRICES FALL
↓ INTEREST RATES FALL	↑ PRICES RISE	↓ YIELDS FALL	↑ XTB PRICES RISE

Corporate Bonds Explained

- **International exposure, if you want it** – Some foreign companies issue corporate bonds that are denominated in Australian dollars. Some Australian companies also issue corporate bonds that are denominated in other currencies.
- **Equities vs Corporate Bonds** – The chart below tells much about how Australian corporate bonds may work in a portfolio, and how they compare with shares over the 22 years from June 1992 to June 2014. Over that period, there were a number of episodes where an investment in Australian shares would have lost a lot of value – and particularly during the Global Financial Crisis. Annualised volatility of Australian shares during the period was 14.38%. Annualised volatility of Australian corporate bonds was just 2.64%.*

CUMULATIVE RETURNS SINCE JUNE 1992 FOR EQUITIES VS CORPORATE BONDS



SOURCE: AUSTRALIAN CORPORATE BOND COMPANY

* Past performance is no guarantee of future performance, all historical figures are provided for information purposes only and are not intended to be a prediction of future performance or in any way to be a forward looking statement. Australian Corporate / Credit performance represents the Bloomberg AusBond Credit 0+ Yr Index, which is an accumulation index.

CUMULATIVE RETURN SINCE 1992

	ANNUALISED VOLATILITY	ANNUALISED RETURNS
S&P/ASX ACCUMULATION 200 INDEX	14.38%	9.93%
AUSTRALIAN CORPORATE / CREDIT*	2.64%	7.52%

The difference in annualised returns from Australian shares and from Australian corporate bonds since 1992 was a lot less than the difference in volatility. The annualised returns from Australian shares were 9.93% per annum. Meanwhile, the annualised returns from Australian corporate bonds were 7.52%. Over the period, $10,000 invested in Australian shares would have turned into an investment of over $80,000. The same $10,000 invested in corporate bonds would have turned into an investment of over $50,000, but the bond portfolio was far less volatile than the equities. In short, a properly constructed and diversified portfolio across the asset classes is likely to provide solid and more stable returns over the long-term as opposed to concentrating on a single asset class.*

Corporate Bonds Explained

Key risks

Like all investments, corporate bonds have risks. The main ones are:

- **Credit risk** – The risk the corporate may not pay back the loan and/or default on coupon payments. If perceptions of the financial risk of the issuer increases, the market yield of the corporate bond may rise, and the market price may experience a corresponding fall. If the issuer defaults or goes into liquidation, you may lose a large portion of the money that you have invested. Although recovery rates globally for senior investment grade bonds is better than 70% or 70c in the dollar.
- **Liquidity risk** – Senior corporate bonds from well-known issuers are generally liquid investments because there is a secondary market where investors buy and sell the bonds. However, particular corporate bonds may, from time to time, be difficult to sell except at a significant discount to the current market price or the face value.
- **Inflation risk** – If inflation is expected to rise, bond investors will normally demand a higher return to compensate. In this situation, the market yields of bonds are generally expected to rise and the market prices of bonds are generally expected to fall.
- **Currency risk** – If you hold an investment that is denominated in a foreign currency, the value of that investment in Australian dollar terms is likely to fall if the currency rises.

How to invest in corporate bonds

Various challenges have constrained the development of Australia's corporate bond market in the past. One is that the senior bonds issued by major ASX Listed companies are not available to be traded on ASX. These major issuers have often been able to raise funds more easily from banks or from the local and offshore wholesale bond markets. Selling bonds to retail investors via an ASX listing can be much more expensive and time consuming, so senior bonds have rarely been available for trading on ASX.

As a result, in contrast to shares, corporate bonds in this country are generally not traded on a regulated and formally constituted exchange like the ASX. Instead, they are traded 'over-the-counter' – which means directly between banks, brokers and other wholesale market participants. The issuing company does not produce a Prospectus for these issues, which restricts the issue to "sophisticated" investors and the typical parcel of bonds that is traded is normally $500,000 or more – which may be too much for most individual investors.

Investors can access the returns from individual corporate bonds through XTBs. XTBs are quoted on the ASX and can be purchased for as little as $100 (or the minimum purchase a broker will allow, which is often $500). Each XTB provides access to the returns of a particular underlying corporate bond (after fees and expenses). If a corporate bond has 5 years to maturity, the XTB over it will also mature once the bond does, 100% of coupons and principal repayments are passed through to XTB investors. It is easy to find out what are the key features of each of the underlying bonds. You can combine XTBs to build a portfolio of corporate bond exposures that meet your own requirements. You can trade XTBs through your broker.

Because they are quoted, they are subject to the stringent requirements of the ASX, as well as those of ASIC, including the lodgement with ASIC and ASX of the Product Disclosure Statement the XTBs were issued under, giving you a level of comfort and security and providing access to the price of your investment at any time.

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