Affluence
FUNDS MANAGEMENT

Guide to Fixed Income

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INVEST
DIFFERENTLY

01 Purpose of this Guide

Thank you for your interest in the Affluence Guide to Fixed Income.

Fixed Income is a vast and complex asset class. While this guide is not intended to be a comprehensive resource, we hope it will help you gain an understanding of Fixed Income as an investment, the different investment options and why it can be a useful addition to investor portfolios.

02 Introduction

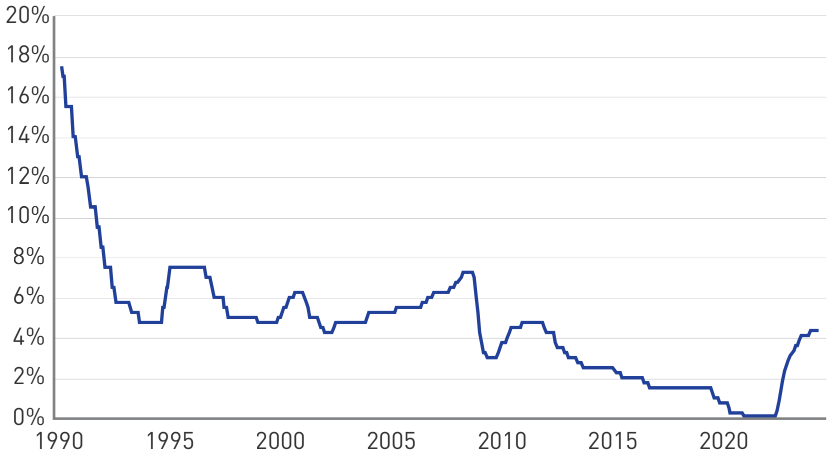
Fixed Income is back. After years of low and near zero interest rates (and even negative interest rates in parts of the world), in 2022 central banks around the world dramatically increased interest rates as part of their fight against inflation. While this initially had a negative impact on many asset classes, it has had the positive outcome of making the entire Fixed Income sector much more attractive to investors.

Investors can now achieve returns from 4% per annum from cash in the bank and term deposits, to well over 10% per annum from some private credit and higher risk Fixed Income assets.

While still not high by historical standards, the current 4.35% RBA cash rate is the tide that has lifted all boats. The majority of Australian Fixed Income investments are referenced to the RBA cash rate plus a premium for risk. Therefore the 4.25% increase in the cash rate since early 2022 has increased the available returns by a similar margin.

Investors can now put together a very attractive portfolio of diversified Fixed Income assets that have the potential to deliver equity like returns with much lower risk and volatility.

RBA Cash Rate



Source: RBA

03 What is Fixed Income

The Fixed Income asset class includes bonds, loans and other types of debt securities, where a borrower is advanced funds by one or more investors for a fixed term. Returns from Fixed Income (usually interest) are contractually obligated, as is the repayment of the loan amount. For this reason, Fixed Income investments are generally considered to offer lower risk returns than equity investments.

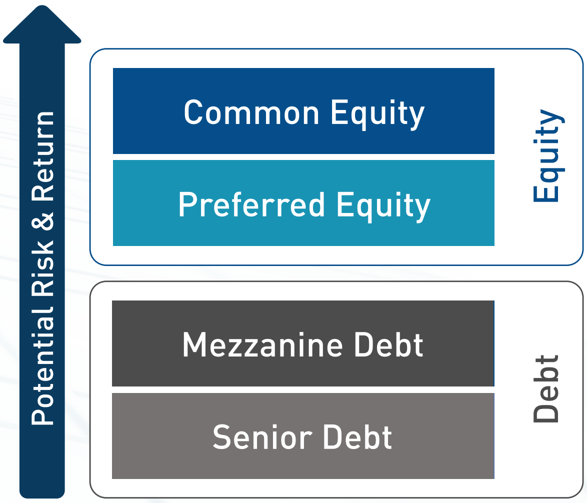
The common characteristics of Fixed Income investments include:

- **Loan or principal amount –** The amount which has been lent to the borrower.
- **Loan term –** The period of the loan. Usually, the borrower is required to repay the loan at the end of the loan term.
- **Interest rate –** The compensation paid to the lender by the borrower for the use of the funds. This may be a floating or fixed rate. There may also be additional amounts payable during the term of the loan.
- **Loan covenants –** These are key terms and conditions that the borrower must abide by during the term of the loan. Failure to do so may result in additional costs, early repayment or other penalties.
- **Secured vs unsecured** – Secured loans have specific rights to certain assets of the borrower, for example property. Unsecured loans do not have specific security, but are usually still repayable in priority to other debts and equity of the borrower.

Common types of Fixed Income assets include Government and semi-Government bonds, bank bonds and hybrids, corporate bonds and loans, private credit (loans), asset backed securities, commercial real estate debt, and residential real estate debt.

One of the key elements that reduces the risk of fixed interest investments compared to equity investments is that repayment of loan principal and interest has a higher priority in the capital structure.

In cases where more than one loan is advanced to a borrower, the level of seniority will be agreed between borrowers. Senior debt holders are eligible to be repaid first, so senior debt is regarded as the lowest risk tranche in the capital stack, and usually has the lowest returns. Equity, which is ranked last, has the highest risk and the highest potential returns.



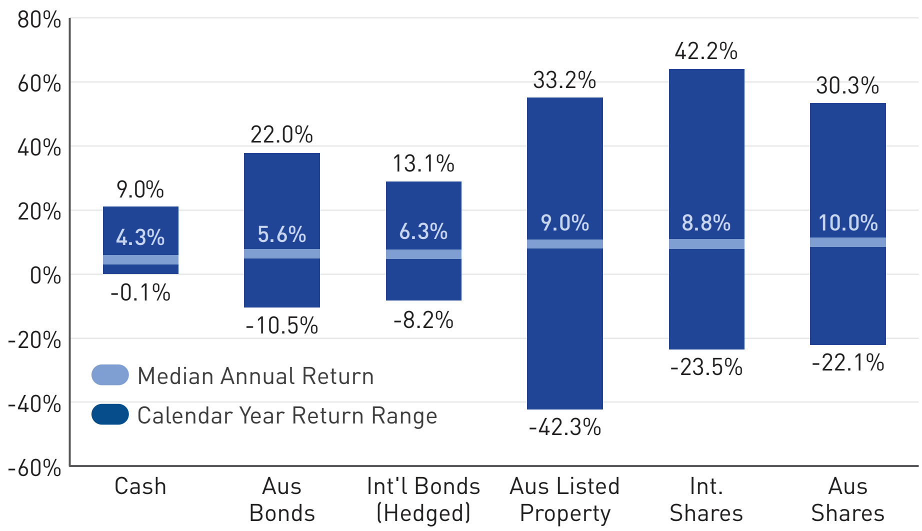
04 Why Invest in Fixed Income

Most investors from individuals and SMSFs, high net worth families, right through to the largest pension and superannuation funds have significant allocations to Fixed Income in their portfolios.

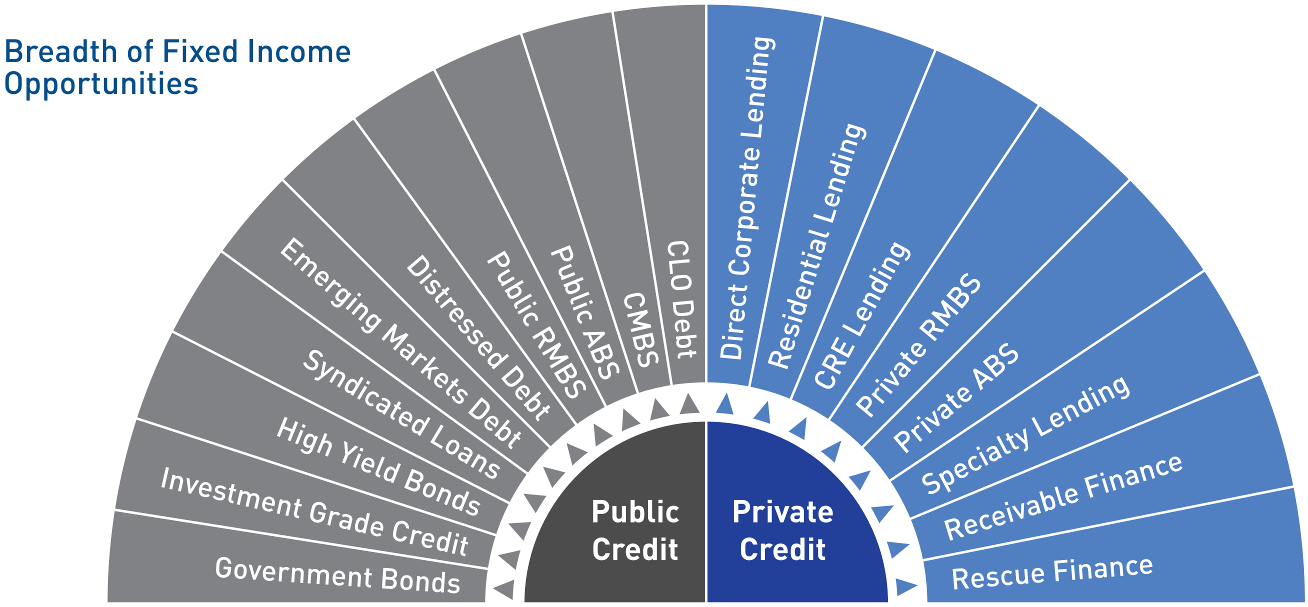
Benefits of investing in Fixed Income include:

- **Capital stability –** While the value of an equity investment or property can vary, a Fixed Income investment is contractually obligated to be repaid. Therefore, except in the event of a loan default by the borrower, an investor knows the value of the investment.
- **Regular income –** Unlike equity investments where dividends/distributions are dependent on profits, Fixed Income has contractual obligations expressing when interest payments must be paid – leading to a much more reliable income stream.
- **Higher in the capital structure –** In the event of a default or other difficulties, a lender ranks ahead of equity investors in the capital structure. Therefore, they should receive the proceeds of any recovery of funds before equity investors. This makes Fixed Income a lower risk alternative to an investment in equities.
- **Lower volatility –** The majority of Fixed Income investments have significantly lower volatility of returns compared to equity investments.
- **Uncorrelated returns –** Investing in Fixed Income, particularly high quality securities with fixed rates, may provide uncorrelated returns compared to other major asset classes. This can be very beneficial if the Fixed Income allocation of a portfolio can provide positive returns when other asset classes provide negative returns.
- **Lower risk and drawdowns –** In times of market stress, when equity and property markets fall in value, it is likely that Fixed Income investments will fall by a much smaller amount, and may even increase in value.

Historical Returns Across Asset Class (FY1992 to FY2023)



05 Types of Fixed Income Investments



Bank accounts and Term Deposits

Deposits held in bank accounts are one of the major funding sources for Australian and global banks. Cash held by investors in their bank accounts and term deposits are essentially short term loans to the bank/ credit union where they are deposited. This is why banks pay interest on cash held in these accounts.

Cash held in bank accounts is considered to be one of the lowest risk investment options. The cash is easily accessible, can be withdrawn at any time, and in Australia the Government guarantees bank deposits up to $250,000. Commensurately, due to the low-risk nature of bank accounts the returns are also amongst the lowest.

Term deposits are similar to cash in the bank except they are usually invested for a minimum term. As the funds are locked away for a period, term deposits usually pay a higher interest rate than a normal cash account. However, if the term deposit needs to be accessed earlier, break fees can be incurred.

Like all Fixed Income investments, interest rates on bank accounts and term deposits in Australia are heavily influenced by the Cash Rate set by the Reserve Bank of Australia.

Government Debt

Both in Australia and globally, most state and federal Governments issue bonds to pay for expenditure and/ or fund infrastructure projects. These bonds can be short term (less than one year) or long term (up to 30 years or more in some countries). Government bonds are generally issued as fixed rate securities, which means they pay a fixed return for the term of the loan. For example, a 10 year Government bond issued at 3.5% per annum would pay that fixed rate of interest on the loan amount, generally six monthly, with the face value paid back after the 10 year term.

In AAA credit rated countries such as Australia, the Government bond yields are regarded as the risk-free rate. This is because it is considered that there is effectively zero risk that the Australian Government will default on their debt obligations.

At the date of this guide the Australian 1 year bond yield was 4.0% per annum. For any other investment a rational investor would demand a return premium above this level to compensate for the additional risk.

Governments issue new bonds into the public debt market. They are mostly purchased by major financial institutions and other large investors. The new securities are issued at par (the repayable amount) and the fixed rate return is calculated off the par value. An investor could purchase a Government bond directly from the Government, collect the coupon (interest) payments, and be repaid when the bond expires. For example, if an investor purchased a 10 year bond with fixed coupon payments of 3.5% and held the bond until maturity, they would receive an annualised return of 3.5% per annum.

Because Government bonds are an extremely liquid investment they are often traded on an exchange after being issued. The traded value of a bond is constantly changing as investor expectations for interest rates constantly changes. It is common for securities to trade above or below their par value. For example, a 5 year Australian Government bond issued last year would today be trading at a discount to its issue price because market interest rates have increased since the issue date. This is referred to the security trading at a discount. Likewise, if a debt security is trading above its par value (which usually occurs when prevailing interest rates are lower than the bond rates) it is known as trading at a premium.

Bank and Corporate Bonds

Major banks and larger corporations issue both senior and subordinated debt securities for their capital requirements. These debt securities are issued in large volumes, and once issued, can be traded on a public debt market in a similar way that shares are traded on ASX. These traded markets allow investors to access a wide range of different industry sectors, geographies, credit ratings and risks.

Corporate bond markets, both in Australia and globally are highly liquid. Whereas equity markets such as ASX are easily accessible by retail investors, it is much more difficult for retail investors to access corporate bonds directly. However, there are now ways for investors to access these markets via intermediaries such as specialist bond brokers.

Regardless of whether a particular security has a fixed or floating interest rate (more on this below), the total interest rate can be broken down into a base rate and a credit spread. By breaking each interest rate down into these two components, investors can assess the risk and return attributes of each security by the level of credit spread on offer. In general terms, the higher the perceived risk, the higher the required credit spread.

The returns available from bank and corporate bonds are partly dependent on the security's credit rating, which impacts the credit spread. Credit ratings are assigned by independent rating specialists and can change over time, depending on the rating agencies' assessment of the borrower.

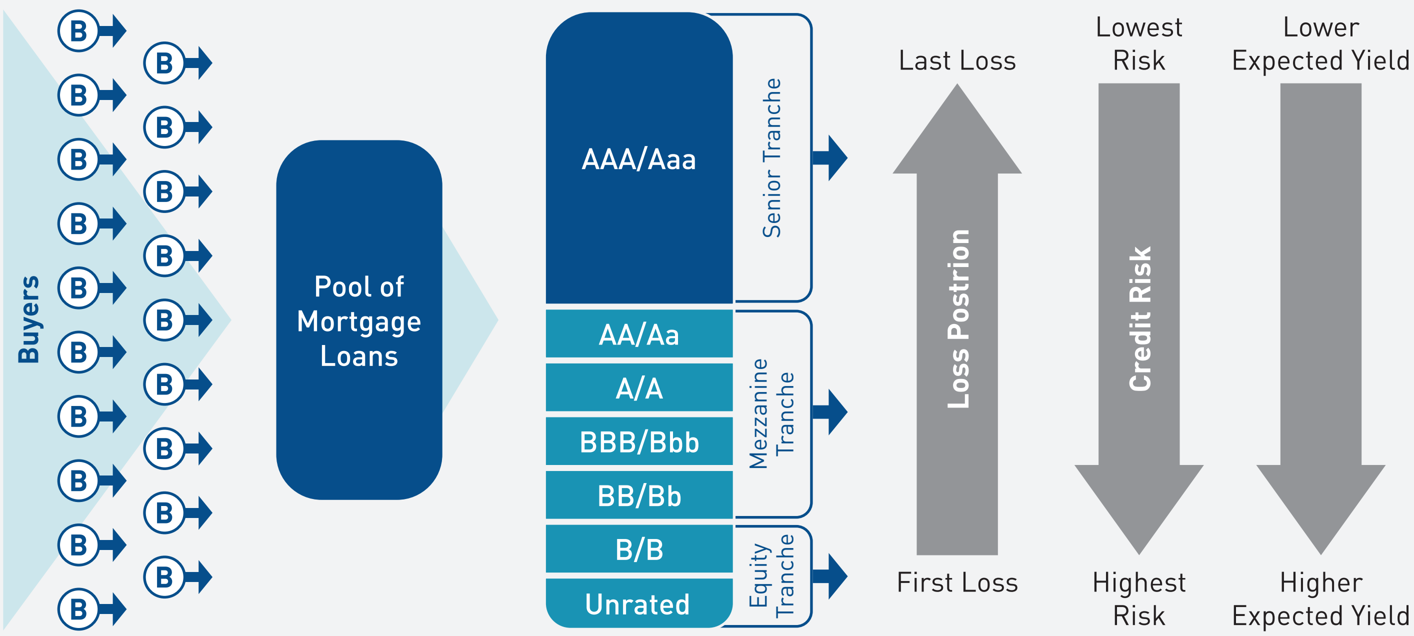
Private Credit

Private credit is the supply of debt capital to corporate and small and medium sized enterprises (SMEs) through loans. They are referred to as private because these loans are not traded or issued in public markets.

Private credit is a direct loan agreement between a lender and borrower. Private credit loans are likely to be smaller than those of the securitised credit market. Often, they are held by one or only a few investors, and they can be individually tailored for each specific loan. Private credit loans generally must be held by the investor/borrower until maturity, when the borrower repays the loan. Therefore they have no or very low liquidity. There is often an illiquidity premium attached to these loans. This results in higher investor returns than a comparable loan issued through public markets.

Securitisation Process

Different Risk and Return for Different Investors



Source: www.wallstreetmojo.com

Asset Backed Securities

Asset backed securities (ABS) and residential mortgage backed securities (RMBS) are structures where thousands of individual loans (e.g., car loans, home loans) are bundled into a securitisation structure (see diagram on page 6). These structures are then separated into tranches with diverse levels of risk and different credit ratings.

The highest rated tranche is the first to receive interest payments and the first to be repaid from loan repayments. Subsequent tranches receive both interest and principal repayments in order of seniority. The lowest rated tranche is the last to receive interest and principal, and therefore the first to take any losses.

Due to this structuring, the highest rate tranches receive the smallest risk premium, and the lower rated tranches receive the highest risk premium.

The lowest ranking tranche is quite often held by the loan originator, who must also put some equity at risk. This creates an alignment of interest between the originator and investors, with the originator highly motivated to ensure any loan losses are minimised.

Commercial Real Estate Debt

Commercial Real Estate Debt (CRE) are loans secured by a mortgage over real estate assets. There are three main types of CRE loans:

- **Land Loans –** The loans are secured by parcels of land for future development. These can be relatively high risk loans as development sites can lose value quickly and erode the security of the loan. These loans typically demand a higher interest rate.
- **Construction Loans –** These loans are used by developers to finance the construction of a new land estate or building. Additional risks such as builder insolvency, costs overruns, time delays and the inability to sell/lease the completed asset may impact the ability for the loan to be repaid. These loans typically demand a higher interest rate.
- **Asset Loans –** These are loans made against operating assets, such as office buildings, shopping centres, industrial sheds, pubs, hotels, and childcare centres.

In Australia, the vast majority of CRE loans used to be made by banks and credit unions. However, over the past 10-20 years, banks have vastly reduced their lending in this area. Non-bank financial institutions (private lenders) have entered the market to fill the void.

CRE:
Commercial Real Estate Debt.

Construction Loans

Asset Loans   Land Loans

06 Other Considerations

Traded Debt vs Private Debt

With any investment, the availability of liquidity is an important consideration, and this is no different for Fixed Income. In general terms, an investment is referred to as 'private' if it is not actively traded on an exchange.

Government debt securities and many large corporate debt securities are highly liquid, and positions can be entered and exited on a daily basis. As these securities are traded so frequently through an exchange, the value of the securities are constantly changing, due to varying market conditions as well as borrower-specific issues. While the value of the security may vary on a daily basis, this does not change the contractual obligations for the borrower. Interest payments must be made, and the loan must be repaid in full at maturity of the loan.

Private credit is the supply of debt capital to corporate and small and medium sized enterprises (SMEs) through loans. They are referred to as private as these loans are not actively traded or issued in public markets.

As private credit is illiquid and not traded, it has lower volatility, and can be perceived as having lower risk. This is not necessarily the case, however it is a consideration for investors to be mindful of. In essence, increased volatility in publicly traded debt is the price of having liquidity.

Credit Ratings

One of the biggest considerations in corporate debt transactions is the credit rating of the issuer and loan. There are three main rating agencies in S&P, Moody's and Fitch. They all have their own methodologies and ratings scale, but have a range from AAA for the best and most secure issuers to D which reflects an issue already in default. As with any company assessment, there are a multitude of factors which impact a credit rating but some of the more important elements include the level of debt in the company, profitability, sustainability of the industry, level of competition and quality of management.

All else being equal, the better the rating the lower the credit spread the borrower must pay. A particularly important distinction is whether an issue/loan is investment grade or non-investment grade. A rating of BB- or better is generally considered to be investment grade. Ratings below this are classified as sub investment grade, and are also referred to as high yield bonds, or junk. Many large investors have strict rules around only investing in investment grade debt, which means there is a premium attached to these issuers.

Fixed vs Floating Rate

Despite the name, Fixed Income investments can have either a fixed or floating interest rate. For a fixed rate loan, the interest payments are fixed for the term of the loan. For a floating rate loan, interest rates are referenced to some underlying reference interest rate, such as the RBA Cash Rate, or more commonly to 30 or 90 day bank bill swap rate.

A floating rate loan is similar to the majority of Australian house loans, in that the interest rate is likely to move up and down, based on changes to the RBA cash rate.

A fixed rate loan has a fixed interest rate for the term of the loan, regardless of any movement in central bank cash rates.

There are advantages and disadvantages to both for investors, and it is not as simple as one being better than the other. In a rising interest rate environment (such as occurred in 2022) floating rate loans have had the advantage of the interest rate increasing in line with the increase in the cash rate. However, during a falling interest rate environment, it may be better to own fixed rate loans.

Duration and Risk

Duration is a measure of the period for which the interest rate of a loan or a portfolio of loans is fixed. Duration is usually measured in years. For example, a 10 year Government bond has a duration of 10 years when first issued, as the rate of interest is fixed for the full 10 year term.

Duration can result in positive or negative outcomes. In simple terms, fixed rate bonds increase in value if market interest rates for the fixed period fall, and decrease in value if market interest rates for the fixed period rise. The larger the duration of a bond, the larger the potential gain or loss.

The following is a hypothetical example showing the difference in duration risk on a Government bond between a 5 year duration term and a 10 year duration term. The example has been simplified.

	5 Year Bond	10 Year Bond
Par Value	$100 per bond	$100 per bond
Bond Fixed Rate	1.5%	1.5%
Bond Term	5 years	10 Years
Market Fixed Rate	3.5%	3.5%
Loss in value	Loss of 10%	Loss of 20%

As can be seen from the above a 10 year bond has twice the duration risk of a 5 year bond and therefore is subject to double the loss or gain.

So, while Government bonds are considered risk free from a credit perspective, they can have significant duration risk. These losses are not just hypothetical. In 2022 the Bloomberg AusBond Govt 0+ Yr Index, which has duration of a little over 5 years, returned -10.4%, as interest rates (including expectations of future increases), rose quite quickly.

Credit Risk

Credit risk refers to the likelihood of the borrower complying with the obligations under the loan. Credit risk is usually reflected by the credit spread over a risk free rate. In Australia, the risk free rate is often referenced to the bank bill swap rate, which is usually similar to the RBA Cash Rate. The credit spread applied on top of the risk free rate is lower for the best regarded borrowers, and higher for weaker borrowers that are considered to have a higher probability of defaulting on their obligations.

Credit spreads range from less than 1% for the highly rated companies (such as Telstra) to over 10% for those with poor or deteriorating fundamentals.

Like all valuation metrics, credit spreads vary through the cycle based on investor demand and economic conditions. During periods of buoyant investor sentiment, credit spreads tighten (reduce) as investors are prepared to accept a smaller margin of safety over the cash rate. When investors are fearful the opposite occurs, and credit spreads widen (increase) as investors demand an additional premium to take on the risk of owning the bond.

The following graph shows the average credit spread for US High Yield (Junk Bond Yield). As can be seen below, credit spreads are highly variable and react to market movements.

The period of credit risk is referred to as modified duration. As opposed to measuring the interest rate risk period, this is a measure of the average credit duration.

For example, a modified duration of 3 years indicates that the credit spread is fixed for an average of 3 years. All else being equal, an investor would demand a higher credit spread for a longer loan period.

The effect on a bond from changes in credit spreads and the modified duration of the bond is another form of duration risk. The longer the modified duration, the larger the impact of a change in credit spreads.

Senior Secured versus Subordinated

Senior secured debt is usually the highest ranking security. It ranks above shareholder equity and any other debt or preferred equity. In the event of trouble, where a borrow is not complying with the terms of the loan, the senior lenders generally have the right to take action to recover their debt.

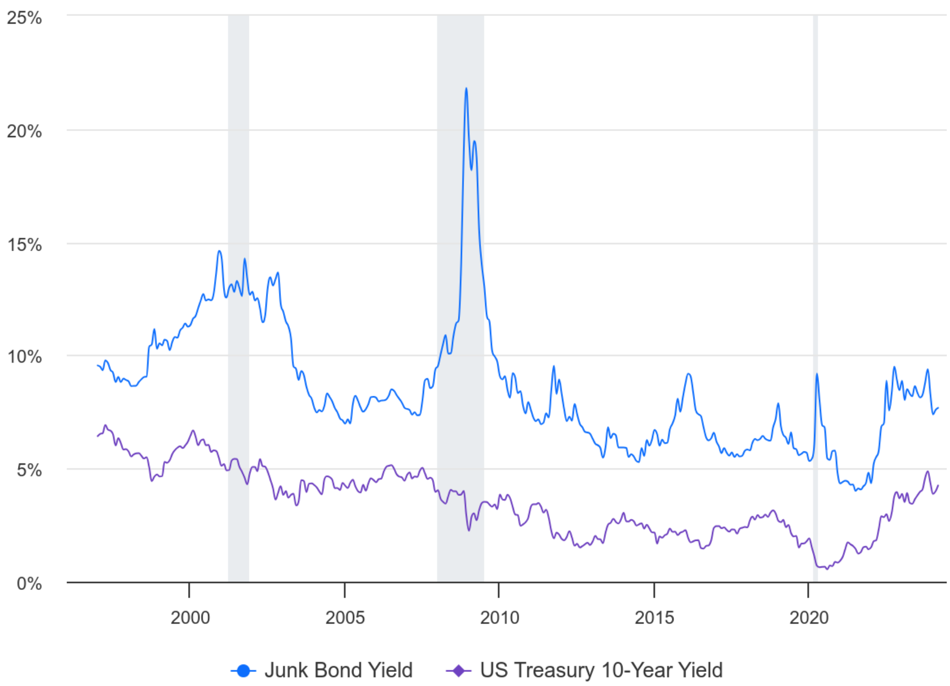
Subordinated debt, as the name suggests, ranks behind senior debt, but ahead of common and preferred equity.

Senior debt is the first to be repaid any proceeds in the event of a windup or default, including principal, interests and any other costs or penalties.

Subordinated debt only gets repaid once all the senior debt has been repaid.

All else being equal, senior debt has a lower risk than subordinated debt, and the credit spread would be smaller. Subordinated securities usually demand a higher credit spread to allow for the additional risk.

10 Year US Treasury Yields: 10 Year to 3 Month Spread



Source: www.currentmarketvaluation.com/models/junk-bond-spreads.php

07 How retail investors can access Fixed Income

Investing directly into Fixed Income for retail investors is not as simple as accessing the equity market. While there are some retail brokers who cater for retail investors to directly invest into a limited number of bonds and securities, the majority of retail investors access the asset class through pooled schemes.

The main investing structures include:

- Exchange Traded Funds
- Listed Investment Trusts
- Managed Funds

Exchange Traded Funds

Investing in Fixed Income through ETFs is a very established and popular method. Like all ETFs, Fixed Income ETFs have the following characteristics:

- Aim to track an established index.
- Liquidity provided by market makers at close to NAV.
- Very transparent investment strategy and holdings.
- Relatively low management fees.

There are a large number of ETFs available on the ASX across a number of different sub asset classes and strategies. Given that one of the requirements of an ETF is a high level of liquidity, this restricts Fixed Income ETFs to the more liquid investments such as cash at bank, term deposits, bank bonds and hybrids, corporate credit and Government bonds.

Listed Investment Trusts

There are current nine Listed Investment Trusts (LITs) listed on the ASX, investing in strategies from Australian investment grade corporate debt, global high yield credit and Australian private credit. Like most LICs/LITs, they have the following characteristics:

- Specific investment strategy that aims to provide the highest risk adjusted returns.
- Managed by asset managers with extensive investing experience.
- Underlying assets may be liquid or illiquid. Given the closed end nature of LITs this is the only way a listed investment can invest in illiquid assets.
- As the market sets the price, the trading price may be substantially higher or lower than the NAV.
- Relatively higher fees compared to an ETF.

For more information on how to access and evaluate Listed Investment Companies, we recommend reading the Affluence Guide to LICs.

Managed Funds

Managed funds continue to be a popular way for investors to access Fixed Income, both through retail and wholesale only funds. A vast range of investment strategies and asset classes that can be accessed through managed funds, and the terms and conditions range accordingly.

Investment strategies range from very low risk investments with cash like returns and high liquidity, to comparably high-risk strategies that aim to achieve at least equity style returns and may have no liquidity at all for periods of time.

For more information on how to access and evaluate Managed Funds, we recommend reading the Affluence Guide to Managed Funds.

08 Introducing the Affluence Income Trust

Let us choose a Fixed Income portfolio for you.

Fixed Income investments can play a very important role in investors portfolios. Their ability to pay regular income and provide capital stability are very attractive features, and can provide an important defensive role to other higher risk assets.

Fund Features

- Attractive Monthly Distributions*
- Highly Diversified Fixed Income Portfolio
- Access to Wholesale Funds

Investment Objective

The Fund aims to pay a minimum distribution equal to the RBA Cash Rate plus 3% per annum, paid monthly. The Fund also aims to preserve capital over rolling 3 year periods after payment of distributions.

Investment Strategy

The Fund invests predominantly in a highly diversified Fixed Income portfolio, with a focus on maximising returns with low volatility. The Fund has a flexible investment mandate. This allows us to take advantage of what we believe to be the best risk adjusted investment opportunities within the Fixed Income asset class at any given time.

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Key Statistics

Investment Class	Fixed Income	**Applications**	Monthly
Minimum Investment	$20,000	**Withdrawals**	Monthly
Suggested Timeframe	At least 1 year	**Management Fees**	Nil*
Target Returns	RBA Cash Rate +3%	**Performance Fee**	10% of positive performance*
Distribution Frequency	Monthly*	**Buy / Sell Spread**	0.10% / 0.10%

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