

Fixed interest



Fixed interest markets are the largest capital markets in the world and play an important role in the global financial system. The fixed interest asset class may also be referred to as fixed income and the terms are used interchangeably. It is so called due to their structure of paying fixed cash flows to investors.

Fixed interest securities

Fixed interest securities trade on the debt markets also known as the interest rate markets and their value is determined primarily by interest rates. Fixed interest securities are comprised of long-term debt such as government and investment grade bonds and short-term debt such as bank bills. The interest rate markets, which include the primary and secondary markets, have developed so governments and companies can issue debt securities to raise money to fund their operations or finance large projects.

Fixed interest at AustralianSuper

At AustralianSuper we actively invest in a range of Australian and international fixed interest securities issued by governments, companies and other organisations.

Fixed interest investments offer stable returns, steady income and capital security, while also providing portfolio diversification, downside protection and lower volatility. It is for these reasons fixed interest is considered a defensive asset class and an important component of the AustralianSuper portfolio.

What is fixed interest?

Fixed interest securities are the engine room of financial systems across the world. The issuer of a fixed income security that needs money is the borrower and the investor lends money by investing in the fixed income security. The price they agree is determined by the interest rate at which the investor will lend money to the borrower. Fixed interest securities are issued for a range of maturities, including short-term money market instruments (one year or less) and longer-term securities that are typically issued for a time between one and 30 years. Fixed income, fixed interest and bonds are terms that are often used interchangeably.

Features and examples of fixed interest securities

A fixed interest security has three important features:

- › **Coupons** – regular interest payments the bondholder (investor) will receive over the life of the bond or period of the loan.
- › **Face value** – the nominal amount or cost of the initial investment by the investor, which is repaid on maturity. This may also be called the principal or par value.
- › **Maturity date** – the date at which the security matures and the issuer returns the face value plus the final coupon to the investor.

Some examples of fixed interest instruments:

- › **Australian government bonds** are issued by the Federal Government to finance federal government needs such as the budget deficit or to refinance maturing debt. They are the safest type of bonds and currently have the highest credit rating possible of AAA, which means that the issuer has the strongest capacity to repay lenders. They have various maturities such as three and 10 years and can be issued for fixed rates or rates linked to inflation.
- › **Semi-government bonds** are very similar to Australian government bonds except they are issued by the state and territory governments. They carry different credit ratings according to the creditworthiness of each state government.
- › **Corporate bonds** are issued by a corporation in order to raise funds for the financing of ongoing operations, M&A (merging with or acquiring another company) or to expand the business.

- › **Asset-backed securities** are securities that derive their value from a specified pool of underlying assets. Pooling securities into an asset-backed security is called securitisation. These products gained notoriety during the Global Financial Crisis as securitisation of mortgage debt into bond like investments occurred.
- › **Floating rate notes** provide regular variable payments based on a benchmark such as the bank bill rate which will move over time, hence the term 'floating'.
- › **Indexed securities** link the return paid to investors with an indexed rate of interest, ensuring investors receive a real rate of return, adjusted for inflation. The most common index for price inflation is the Consumer Price Index (CPI), which is a measure of the changes in the prices of goods and services. The CPI is added to a nominal coupon rate to give a total or 'real' rate of return. These bonds are typically issued by governments for maturities of approximately 20–30 years.

Money market securities

Money market instruments are also known as discount (non-coupon) securities as they are issued at a discount to their face value on the assumption the buyer will receive the face value on maturity. They are typically issued for a period of days up to one year.

Example cash flow of a bond



Time value of money

The time value of money is an important concept relating to fixed interest. It states that money held today is worth more than the identical amount at some time in the future due to the interest it could earn over time. This is the basis of valuation for all fixed interest securities. The interest rate is the reward investors receive to sacrifice current consumption in exchange for future consumption.

Like any other price, interest rates are determined by market forces. The level of the interest rate for a fixed interest security is based on the issuer, level of risk and the term to maturity. These factors will determine the yield (investment return) you would expect to receive as compensation for the risk taken to invest in the security.

Bond yields and pricing

The yield to maturity of a bond is the investment return, which is the total value of the coupon payments, over the lifetime of the bond, incorporating the price paid for the bond and the face value an investor will receive at maturity. It is expressed as a percentage per annum.

Pricing of bonds is based on calculating the value of the cash flows which are made of the two components: the coupon payments and the right to receive the face value on maturity. Changes to the current market level of interest rates, compared to the coupon rate, affects the current price of the bond.

If you buy a bond at issuance and hold it through to maturity, the return of the investment will not be affected by changes to interest rates, as the coupon remains the same for the life of the bond until maturity. However, if you sell the bond on the secondary market before maturity, the relationship between the bond's price and yield becomes important. This is because the bond yield and the bond price have an inverse relationship. For example, when the level of market interest rates decrease, the price of the bond would increase, because investors will pay more for the bond based on its coupon amount.

Why bond prices and yield are inversely related

A bond is issued with a specific coupon which is paid regularly. If market interest rates fall the price of a bond would adjust, so that an investor would receive the current level of interest rates as the total return on the investment, or yield to maturity. A bond that has already been issued will continue to pay the same coupon, set when interest rates were higher. The bond offering a higher coupon, after market interest rates decrease, becomes more valuable and will trade at a premium i.e a higher price.

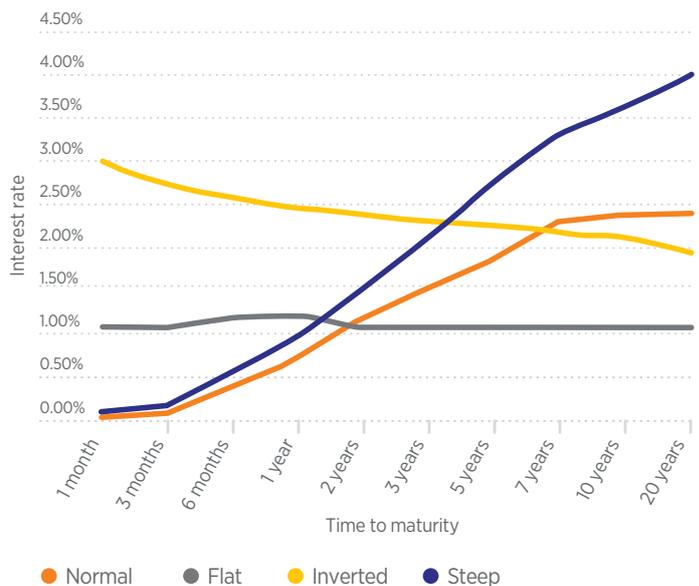
When the opposite occurs and interest rates rise, newly issued term deposits and bonds will pay higher rates of interest with a higher yield. Therefore, the price of existing bonds already issued will fall, due to the other more attractive yielding investments available.

The yield curve

The yield curve describes the relationship between term to maturity and interest rates and may be used as a guide to predict longer term rates. It also shows the going rate for fixed interest securities with different maturities. The yield curve is fluid and adjusts as prices change.

Normally, short-term rates are usually lower than long-term rates acknowledging investors require a higher rate of interest for the uncertainty of locking in an investment for a longer period of time.

Yield curve examples



A normal or positive yield curve occurs when short-term interest rates are lower than long-term interest rates, reflecting expectations that interest rates will rise in future. An inverse or negative yield curve occurs when short-term rates are higher than longer term rates reflecting expectations interest rates are going to fall in future.

Fixed interest in real life

The fixed interest asset class involves the flow of money through our society redistributing capital to where it is needed. It is for this reason that bond markets exist. Any person who has bought a house and has a mortgage has benefitted from the bond market. When capital is needed for a longer term investment or to fund a liability, governments and corporations issue debt securities and investors, usually institutions or pension funds such as AustralianSuper, lend them the money. In return AustralianSuper's members receive the returns for investing in fixed interest assets.

Benefits of investing in fixed interest

The benefits of investing in fixed interest are a result of the structure of fixed interest assets. These benefits may include:

- › **Compensation for risk** based on the credit quality of the lender. Premium rated issuers, such as sovereign governments rated AAA, generally have lower yields, while lower rated issuers provide higher yields based on the risk of the issuer. This enables investors to select investments that meet their risk and return objectives. Credit risk is assessed using the credit rating system to determine the risk quality of a bond. These ratings are issued by credit ratings agencies such as Moody's or Standard & Poors to determine credit quality of a bond. The ratings system assigns ratings from AAA, the highest level, down to C or D, the lowest levels. These categories are often described as either Investment Grade (BBB and higher) or High Yield (BB and lower) denoting the capacity for the borrower to repay the loan, and subsequently the risk of loss to the lender.
- › **Stable income** due to the coupon interest payments paid over the life of the security providing regular steady income.
- › **Liquid markets** due to deep secondary markets providing liquidity with multiple buyers and sellers allowing the ability to rebalance the portfolio and adjust holdings more easily if necessary.
- › **Low correlation to equities** which means when equity markets rally, bond markets tend to be lower or more subdued. However when equity markets tumble fixed interest can provide the stability of returns and downside protection.
- › **Low volatility** due to the stable nature of fixed interest returns and a lower variability of returns compared to other asset classes.

Diversification of the fixed interest portfolio

AustralianSuper invests in fixed interest providing diversification in the portfolio across several levels.

Firstly, diversification is achieved at a portfolio level due to fixed interest being generally uncorrelated to equities.

Within fixed interest we have exposure to different types of securities such as government bonds or investment grade credit. These securities have differing times to maturity and levels of credit risk providing further diversification within the asset class.

Finally, across all the levels mentioned, further diversification is achieved with exposure to bonds and other fixed interest securities in different countries including developed market economies and emerging market economies. Bonds are issued by governments and corporations around the world so in addition to investing in Australian government, semi-government and corporate bonds, the Fund also invests internationally. This means that when there are differing economic trends across countries, the portfolio is able to invest in return generating opportunities around the world.

AustralianSuper seeks to add value to the fixed interest portfolio through active management that diversifies sources of return and effectively manages risk. Both internal and external managers are used, with about 50% of the fixed interest portfolio being managed internally. The range of managers are chosen for their specific expertise in Australia and internationally.

How does AustralianSuper invest in fixed interest?

It is the role of fixed interest at AustralianSuper to add value, by generating investment returns that flow through to member returns by identifying what interest rates are expected to do.

AustralianSuper actively manages the fixed interest portfolio considering all the factors that can affect interest rates, including all the risks to determine which fixed interest securities should be in the portfolio and at what price. In aiming to generate superior returns from investing in bonds, AustralianSuper seeks to identify when and in which direction interest rates are likely to move.

Risks – factors which affect fixed interest securities

Measuring risk in bonds

Duration is a measure of the price sensitivity of a fixed interest security for a given change in interest rates. It is tied to both the coupon rate and bond maturity and is measured in years. Short duration bonds are less sensitive to market interest rate movements than long duration bonds. A bond with long duration would be subject to larger increases and decreases in value with changing interest rates. It is a useful measure for comparison to other bonds and it provides a measure to help determine the risk of owning a particular bond.

For example, if interest rates go up by 1%, the value of a bond with a duration of 5 years would be expected to go down by 5%. If interest rates went down by 1%, the value of the bond would go up by 5%. The higher the duration, the larger the sensitivity in value of the bond you own.

Risks affecting fixed interest securities

Credit risk

Credit risk is the likelihood of not receiving the periodic coupon payments together with principal from the issuer. It assesses the capital stability of the asset. The higher the credit rating the more secure the investment. Credit risk is typically lower when the issuer is a government or state, however it can be higher if the government or state doesn't have a good track record and there is a higher possibility of default. Assessment of risk is important when considering the generation of investment returns as a higher credit risk can offer a higher yield giving a better investment return as reward for the increased risk.

Inflation risk

Inflation risk is the risk that a rise in inflation will undermine the value of the cashflows. When inflation increases it decreases the value of the fixed interest security.

Interest rate risk

Interest rate risk is viewed as the most significant risk for this asset class. It is the potential for changes in bond values resulting from an adverse change in interest rates.

Liquidity risk

Liquidity describes the ease at which a security can be bought or sold and how quickly it can be converted to cash. With a fixed interest security, ideally an investment would match the maturity of the bond and therefore no risk or uncertainty of return, however this is rarely the case. Government bonds are often more liquid than corporate bonds. Less liquid bonds provide compensation for the additional risk by providing a liquidity premium or higher yield.

Maturity risk

Maturity risk refers to the extra risk taken by an investor and the compensation required when investing in a long-term security with a longer term to maturity.

The impact of government policy on interest rates

Government fiscal policy

Fiscal policy describes government policy towards taxation and spending in order to achieve its economic objectives, usually a low level of unemployment and a high level of economic growth. Fiscal policy can be used to either increase or reduce the level of spending in the economy, with increased government spending potentially leading to economic expansion and reduced government spending potentially leading to economic contraction, all else being equal. Therefore, expansionary fiscal policy can put upward pressure on the level of interest rates in a country.

Monetary policy

Monetary policy involves the measures taken by government central banks to influence the supply of 'cash' and the level of interest rates in the economy. In Australia, the RBA has the ability to alter the cash rate and in doing so effect changes in the level of production, prices, employment and incomes (although sometimes with a time lag). Lower interest rates lower the cost to borrow money encouraging investment such as the borrowing of money to buy a house or expand a business. Monetary policy aims to contribute to the achievement of sustainable growth.

Summary

Fixed interest plays an important role in a balanced portfolio. When diversifying across types of issuers, maturities and countries, fixed interest assets can provide stable returns and steady income, as well as downside protection and lower volatility in a portfolio.

AustralianSuper takes an active role in managing the fixed interest assets in the portfolio for the benefit of members. Using years of investing experience within the team and a deep understanding of the factors that affect the returns of bonds, the fixed interest portfolio is invested to improve performance for members.

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