Fixed Interest

MORE THAN TERM DEPOSITS

NEED GREATER PORTFOLIO STABILITY AND RELIABLE INCOME?

Fixed interest products often play an important role in our clients' investment strategies. In times of extended market volatility, they can provide a stabilising influence while still attracting reliable returns.

Fixed interest investments can offer more 'capital stability', regular income, a range of maturities, and diversification from higher risk asset classes, and some protection against loss in a cyclical downturn. Figure 1 below provides a snapshot of fixed interest products-, which one is right for you?

Cash Management

A Cash Management Account refers to a type of account offered by brokers and other financial institutions. They enable investors to buy and sell stock, options, bonds and commodities, while at the same time allowing them to earn money market interest on cash balances.

Most of our clients open an account with DDH Graham Limited with a link to Burrell, which will facilitate automatic settlement of buy and sell transactions, and enable quick and easy payment of dividends.

An account with DDH Graham provides bank security (accounts opened with DDH Graham are covered by the Australian Government Guarantee of $250,000 per person per institution), higher interest rates paid monthly, and features that most cash management trusts do not provide like a low $500 minimum balance requirement.

DDH Graham has a strong history in servicing the investor market, and we find it offers an efficient and competitive service that will save you time and money and ensures that your funds are always working with you.

By depositing money in a DDH Graham Money Market Deposit Account, you are making a direct deposit with the

Bank of Queensland. We can provide you with a copy of their Product Disclosure Statement.

Term Deposits

A term deposit is a cash deposit, for a fixed term, at a fixed rate, at a financial institution of your choice. They are simple and easy to understand and offer a secure, low-risk investment option for all investors including Self Managed Super Funds (SMSFs) within their fixed interest asset allocation, and Not-for-Profit organisations looking to match their cash flow within term deposit maturity dates.

Term deposits offer:

- higher interest rates than a standard call account
- a fixed interest rate, which is particularly attractive when interest rates are falling
- a choice of investment terms from one month to five years

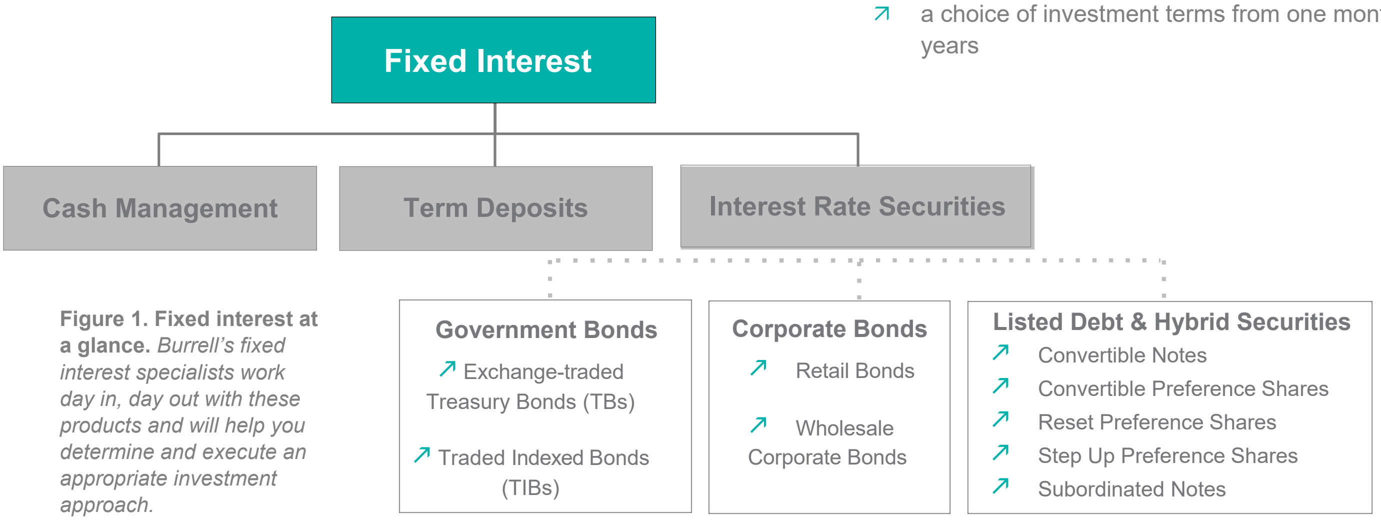

Figure 1. Fixed interest at a glance. *Burrell's fixed interest specialists work day in, day out with these products and will help you determine and execute an appropriate investment approach.*

- an Australian Government Guarantee of $250,000 per person per institution
- no set up fees
- low brokerage

There are some downsides to term deposits:

- you cannot access funds for an agreed period until the term deposit has matured
- if you do seek to withdraw all or some of the funds in an emergency situation, penalties apply
- the interest rate return can be lower than other Interest Rate Securities like corporate bonds and hybrid securities
- a lower dollar investment amount typically attracts lower interest rates

Once your Burrell account is established, we do all the paperwork and legwork for you. For the term you require, we identify the most competitive interest rate offered by banking and deposit-taking institutions in Australia. We then take ongoing transactional instructions and follow up at the term deposit maturity date. A simple instruction to rollover, mature or change institution is all you need to do.

This service becomes even more valuable when you are juggling a range of portfolio maturities and multiple bank dealings.

It is our business to monitor the fixed interest market each day. Burrell produces a *Fixed Interest Market* report specifying a range of banks, interest rates, minimum amounts and maturities available. This report is included in our *Burrell Bourse*. We also communicate any special rates that become available from time to time.

Interest Rate Securities (IRS)

Debt securities traded on the ASX are also called Interest Rate Securities (IRS). With IRS, capital is raised by an entity (corporate or government) to assist in the running of their operations. There are three types:

1. Government bonds
2. Corporate bonds
3. Listed debt and hybrid investments

IRS have a higher face value than many shares i.e. $100, and when you buy them through the ASX, your relationship with the issuer is one of creditor rather than part owner.

IRS provide many benefits of fixed interest investing, however they are not without risk:

- **Credit risk.** The risk that the issuer may not be able to pay its obligations (distributions or capital) at the due date. Generally, the higher the credit quality of issuer, the lower the risk and the yield associated with the security, and vice versa.
- **Market price volatility.** Like company shares, the market price of IRS may fall below the price the investor originally paid, especially if the company suspends or defers interest payments, or if its performance or prospects decline.
- **Interest rate risk.** A fixed interest rate security will typically depreciate in value in a rising interest rate environment (and appreciate in value if interest rates fall).
- **Liquidity risk.** The risk you may not be able to sell your securities on the ASX when you want, at the price you want, as there may not be sufficient buyers.
- **Long timeframes.** The longer the term the greater the exposure to risk that market conditions or the issuer's credit quality might change.
- **Ranking.** Ranking refers to the order in which liabilities will be paid should the issuer be wound up. The higher the ranking of a security the safer the investment.

1. Government bonds

A bond is a security that pay a specific amount of interest for a given period of time and repays the face value of the security on the maturity date. Government bonds are medium to long-term debt securities issued by the Australian Government, or state governments.

There are two types of Australian Government bonds (AGBs) trading on the Australian Stock Exchange (ASX):

- **Exchange-traded Treasury Bonds (TBs):** debt securities with a fixed face value. They carry the same annual rate of interest over the life of the security, payable every six months.

- **Exchange-traded Treasury Indexed Bonds (TIBs):** debt securities that hedge against inflation. Their face value is adjusted for movements in the Consumer Price Index (CPI). Coupon interest payments are paid quarterly at a fixed rate, on the CPI-adjusted capital value. At maturity, investors receive the face value of the security adjusted for CPI movement over the bonds.

The face value of one TB is $100 plus CPI adjustment. The minimum parcel size is one AGB traded at the price quoted, with the usual parcel size between $30,000 and $50,000. TIBs typically trade in large parcels, putting them beyond the reach of many retail investors.

Why consider government bonds:

- AGBs have the lowest possible credit risk and they provide absolute security when held to maturity.
- You buy or sell them on the ASX the same way you buy or sell shares.
- There is typically a high level of stock availability and liquidity.
- Unlike other interest earning investments, your money is not locked away for the term of the investment.
- AGBs can help diversify your portfolio, offsetting the risk of other investments.
- Regular coupon interest payments provide a secure and reliable cash flow.
- Generally, if interest rates decrease the price of a TIB is likely to rise.

Look out for:

- Yields will generally be lower than most other (higher risk) interest rate investments.
- AGB prices will fluctuate. The Australian Government does not guarantee investment performance and will not compensate investors

  for investments losses.
- If you purchase TIBs for a price greater than the nominal value, sell the TIBs prior to their maturity date or there is a decline in the CPI, you could incur capital losses (note there is a floor on coupon interest payments, which may protect TIB holders in an environment of deflation).
- Generally, if interest rates increase, the price of a TIB is likely to fall.
- The Australian Government may, with three months' notice, convert holdings of TIBs to the underlying Treasury Indexed Bonds directly registered in the Commonwealth Stock Registry.

Investors would continue to receive their entitlements, but would not be able to sell their TIB investments on the ASX, rather through bond traders who deal in bigger parcels.

2. Corporate bonds

A corporate bond is one way for a company to raise money from investors to finance its business activities. In return for your money, the company issuing the bonds promises to pay you regular interest payments, and at a specified maturity date, pay back the money you originally invested.

Corporate bonds typically carry higher risk than government bonds and therefore a higher yield. The issuing company can pay interest at a fixed rate for the life of each bond, or at a floating rate where the rate floats in line with movements in a benchmark interest rate, usually the variable interest rate for a bank bill for a three or six month term. A fixed margin is generally added to get the floating rate.

So, your coupon interest payments could vary: you could get higher returns if the benchmark interest rate goes up or lower returns if the benchmark interest goes down.

You can buy corporate bonds through a public offer. The company makes a public offer and issues a prospectus and investors apply directly to buy bonds, at the face value of the bond, which is usually $100 each. You can also buy some corporate bonds on the ASX after they have already been issued in the primary market, however you will pay the market price that may be higher or lower than the face value of the bond.

There are a number of corporate bonds available in the unlisted bond market, issued by companies operating across a diverse range of industries like retail, energy and resources, property and infrastructure. As an example, corporate bond issuers include National Australia Bank, Westpac, Telstra and Suncorp.

Retail bonds are a special class of corporate bond with an initial minimum trading parcel as low as $5,000 making investment accessible to retail investors. Larger investors can also access the wholesale corporate bond market. Minimum parcels are typically $500,000, although smaller parcels can be available.

Why consider corporate bonds:

- Usually provides a higher interest rate than a term deposit or other cash-based product.
- Regular interest payments (normally each quarter).
- Fixed-term investment (unless you decide to sell early).
- Some security with your bonds generally ranking higher than shares if the company cannot pay all its debts.
- Generally less risky than shares.

Look out for:

- If the company becomes insolvent, you may not get your interest payments or capital back. There are two factors that determine how likely you are to get your money back:
- Your ranking in the list of creditors.
- Are the bonds secured against company property or unsecured? Unsecured creditors generally rank above shares but lower than a secured creditor.
- Corporate bonds are not generally designed to give you capital growth: the bonds you buy are unlikely to increase in value during the time you have the investment.
- Early redemption by the issuer whereby they can buy back the corporate bonds before the maturity date. They will usually pay you the face value of the bond with any accrued interest to date.

3. Listed debt and hybrid investments

Hybrids are a broad classification for a group of securities that have the characteristics of both an interest bearing security and equity i.e. both bonds and shares. They may incorporate a more debt-like bias or have more equity-like features, depending on the needs of the issuing company.

Hybrid securities pay a predetermined (fixed or floating interest) rate of return or dividend until a certain maturity date, at which point the holder has a number of options including being repaid in cash or converting the security into shares (sometimes at a discount) of the issuing company, which may pay fully franked returns.

The interest rate is determined by a margin over the market rate, usually the Bank Bill Swap Reference Rate (BBSW).

There is a decision to make when investing in a hybrid security based on returns, i.e. whether to invest in a security that pays interest, or one that pays a fully franked dividend. Consider whether you can utilise the franking credits or whether the cash timing benefits of unfranked distributions is a better option for you.

Retail investors can purchase hybrid issues through IPOs from the issuing company. Investors also have the option to purchase through the ASX on the secondary market.

There are different classes of hybrids and the conditions, timeframe, risks and interest rates of each hybrid differ:

- **Convertible notes**. Securities that pay a fixed coupon rate and can be converted into ordinary shares at a particular date or period of time in the future.
- **Convertible preference shares.** Securities that convert into a dollar amount of the ordinary shares of a company at a future date at a set dollar amount, or at a discount to the ordinary share price at that time.
- **Reset preference shares.** Securities that typically pay a fixed rate where the coupon is set for a defined term. At the end of the defined term, the securities are paid out and the investor is invited to re-invest from the current prospectus detailing the latest terms and conditions and a new fixed coupon rate. They are typically perpetual in nature i.e. no set maturity date.
- **Step up preference shares.** These securities normally pay a floating rate coupon and have a call date after a set period. If these securities are not called at the first call date then the coupon 'steps-up' to a higher rate to compensate investors for non-redemption. They are typically perpetual in nature i.e. no set maturity date.
- **Subordinated debt.** These securities are usually unfranked and are paid out in cash at maturity. They are generally ranked behind senior secured debt and senior unsecured debt although they rank above hybrid securities and ordinary equity.

Every ASX-listed hybrid has its own unique characteristics and you should refer to the original company prospectus for details.

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Why consider listed debt and hybrid investments:

- Generally offers higher returns than more senior securities of the issuing company, reflecting their higher associated risk and their position in the company's capital structure.
- Offers a yield premium for their credit rating
- Provides potential tax benefits through fully franked distributions.
- May provide the opportunity to participate in the company through the share conversion option.
- Ranks ahead of ordinary shareholders.
- Offers a wide range of issuers, maturities, structures and varying liquidity, ensuring that investors are able to construct a diversified portfolio.
- ASX listing provides liquidity, full company reporting and disclosures.

Look out for:

- Like company shares, the market price of listed hybrid securities may fall below the price the investor originally paid, especially if the company suspends or defers interest payments, or if its performance or prospects decline. This means you can incur a capital loss.
- Hybrid securities are generally unsecured, meaning that repayment is not secured by a mortgage or security over any asset. If a company fails, hybrid investors have to line up behind these creditors and bondholders for their money. Hybrid investors do rank ahead of ordinary shareholders.
- Changes in the company's share price and in other interest rates may also be reflected in the price of the hybrid-listed security.
- Some offers allow the company to suspend interest payments for a number of years. While the interest owing may be cumulative, this could leave investors temporarily out of pocket.
- Some hybrid structures can effectively become a 'perpetual' instrument, which means the security does not have a fixed maturity date. And some hybrids have investment terms lasting several decades. As a result, investors may be required to bear the financial liquidity and interest rate risks associated with an investment in long-term security on a secondary market such as the ASX, but only if there is demand.

Hybrid securities can be complex. As an investor, it is important you understand the specific terms, the structure of the instrument and its pricing, the risks involved, and also how it fits within your portfolio.

Burrell has access to a range of corporate new issues through an Initial Public Offer, or just as you would ask your advisor to buy or sell shares, you can direct your Burrell advisor to purchase hybrid securities listed on the ASX.

Get started

If you want to know more about how fixed interest securities can complement your portfolio, call our Burrell Fixed Interest Desk on 1300 4 BURRELL, or email the team leader Wayne Matthews.

Burrell's Fixed Interest team: (Left to Right anti-clockwise): Wayne Matthews, Chris Burrell, Shanny Lai, Dylan Katzer and Michael Burrell. *Wayne is known as the 'go to' for anything to do with fixed interest. He guides large not-for-profit organisations, SMSFs and clients seeking cash and fixed interest advice.*

Contact us

P 1300 4 BURRELL/ 1300 4 2877 355
W www.burrell.com.au
E clientcare@burrell.com.au
B www.burrell.com.au/news-and-events/the-burrell-blog