

# VanEck<sup>®</sup>

Access the opportunities.

**Fixed income  
for your portfolio**

2023

# Fixed income for your portfolio

## Defence

Fixed income investments such as bonds are widely used in portfolios to enhance income and complement 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, generally 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 can produce both a capital and an income return for investors. 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, it’s 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, (YTM) 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 YTM will vary with the price of the bond. As the bond price goes up, YTM goes down and vice versa.

The YTM is different to the coupon described above, as unlike the coupon, for fixed rate bonds the YTM changes throughout the life of the bond. A yield curve is formed by

plotting the YTM across different maturity periods. 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 five 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.

## 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.

Because the states have different ratings, yields on semi-government bonds vary and they can be slightly higher than AGBs, reflecting different 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.

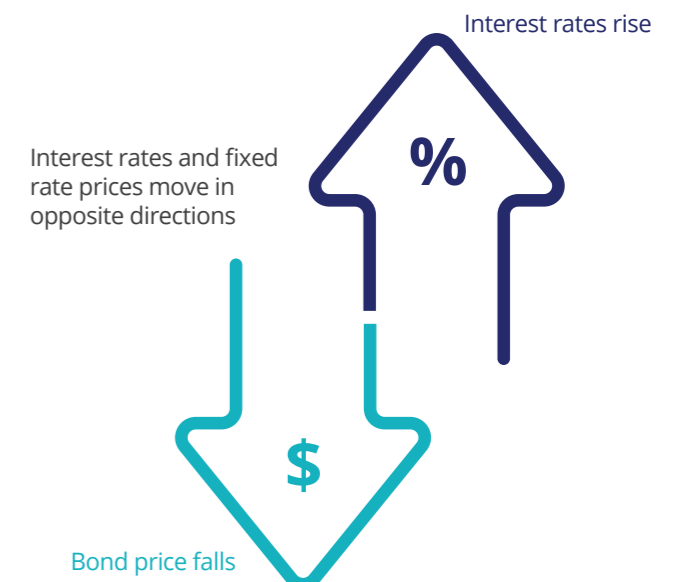
## Factors affecting a bond’s price

The market price of a bond will vary over time depending on what’s happening with interest rates and the economy 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



*The yield curve and changes in the economy*

A yield curve is a line that plots the yields of AGBs with differing maturity dates. The slope of the yield curve can predict economic activity and future interest rate changes.

To graph the yield curve, the yield is calculated for AGBs at each term to maturity remaining. For example, the yield on AGBs with one year remaining until maturity is calculated. This value is then plotted on the y-axis against the one-year term on the x-axis. Similarly, the yield on AGBs with

five years remaining until maturity is calculated and plotted on the y-axis, against five years on the x-axis, and so on. The RBA's cash rate target forms the beginning of the AGB yield curve, because it is the interest rate with the shortest term in the economy (overnight).

**There are three main yield curve shapes: normal upward-sloping curve, flat and inverted downward-sloping curve.**

**Normal (upward sloping)**

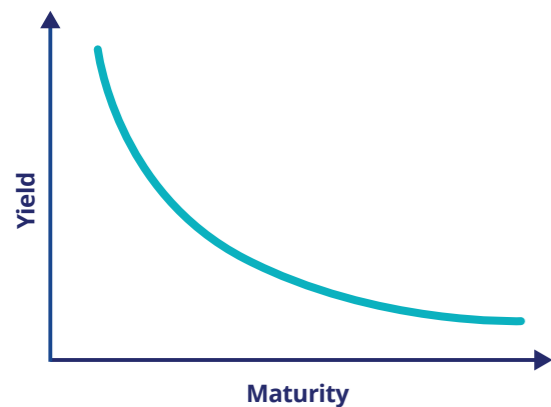
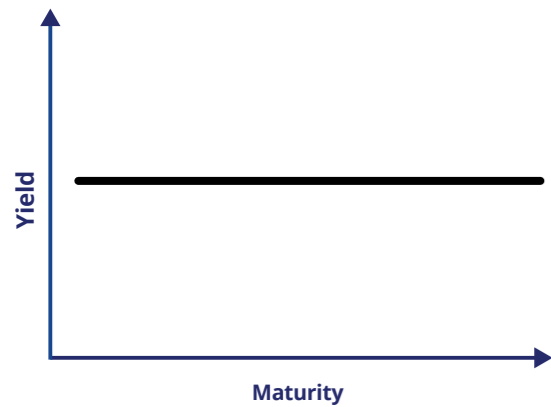
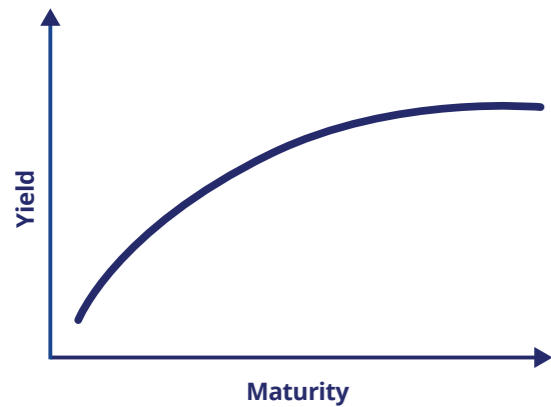
- The shape of the yield curve is upward sloping, from left to right. This type of yield curve indicates that bond yields are higher on longer-maturity bonds.
- Typically, this type of yield curve is seen during periods of economic expansion when the economy is growing. In an expansion, there is an expectation that future interest rates will be higher than current interest rates because investors expect the RBA to raise its policy interest rate in response to higher inflation.
- In this environment, investors demand higher yields on longer-term bonds as compensation for inflation and future rate rises.

**Flat**

- The shape is flat, indicating yields are the same on short and long-maturity bonds.
- Often a feature of when the economy is transitioning from expansion to slowdown, and vice versa.
- A flat yield curve is often seen when central banks raise interest rates to constrain a rapidly growing economy. In this instance, short-term rates rise to reflect rate hikes, while long-term rates fall as inflation expectations ease.

**Inverted (downward sloping)**

- Sometimes the yield curve inverts downward sloping, indicating that bond yields are lower on longer-maturity bonds.
- This shape is not common and is typically seen before recessions. In a slowdown, there is an expectation that future interest rates will be lower than current interest rates because investors expect the RBA to lower its policy interest rates in an effort to stimulate the economy.
- In the US, historically, the yield curve moves into an inverted position about 12 to 18 months before the recession starts.



Source: VanEck

The slope of the yield curve reflects the difference between yields on short-term bonds and long-term bonds. The yields on short and long-term bonds can be different because investors have expectations, which are uncertain, that the cash rate in the future might differ from the cash rate today. For example, the yield on a ten-year bond reflects investors' expectations for the cash rate over the next ten years, along with the uncertainty associated with this. Because longer-term yields are more difficult to predict, their yields tend to move more than shorter-term bonds.

The yield curve is an important economic indicator because it is a source of information about investors' expectations for future interest rates, economic growth and inflation.

It is possible for investors to take a view of the slope of the curve and position their portfolios as such. For example, if they believe interest rates will rise, they can cut or eliminate their position in longer-term bonds, while raising their position in shorter-term bonds.

*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  |            |  |                |

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.

## 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.

|  |  |
|--|--|
| <b>Inflation risk</b>                      | 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.   |
| <b>Interest rate risk or duration risk</b> | 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.  |
| <b>Credit risk</b>                         | 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. |

## 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 five fixed income ETFs which provide investors an opportunity to access different parts of Australia's bond market.

| ETF Name   | ASX ticker | Management fees (p.a.)* | Exposure  |
|--|------------|-------------------------|---|
| <b>VanEck Australian Floating Rate Note ETF</b>        | FLOT       | 0.22%                   | A portfolio of short-term investment grade bonds in a single trade on ASX.  |
| <b>VanEck Australian Corporate Bond Plus ETF</b>       | PLUS       | 0.32%                   | A diversified portfolio of Australian dollar-denominated bonds consisting predominantly of the highest yielding investment grade corporate bonds. |
| <b>VanEck 1-5 Year Australian Government Bond ETF</b>  | 1GOV       | 0.22%                   | A portfolio of Australian government bonds which have maturity dates between 1 and 5 years.   |
| <b>VanEck 5-10 Year Australian Government Bond ETF</b> | 5GOV       | 0.22%                   | A portfolio of Australian government bonds which have maturity dates between 5 and 10 years.  |
| <b>VanEck 10+ Year Australian Government Bond ETF</b>  | XGOV       | 0.22%                   | A portfolio of Australian government bonds which have maturity dates between 10 and 20 years.   |





\*Other fees and costs apply. Please see the PDS for more details.

## Glossary of key terms

|  |   |
|--|---|
| <b>Bond:</b>                                   | 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.           |
| <b>Coupon:</b>                                 | 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. |
| <b>Default:</b>                                | Failure by an issuer to pay coupon payments or repay principal when it is due.  |
| <b>Duration:</b>                               | A measure of the sensitivity of a bond's price to a change in interest rates.   |
| <b>Duration risk:</b>                          | The risk a bond's price will fall due to a rise in interest rates. The longer the duration, the higher the duration risk.   |
| <b>Face value:</b>                             | 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.   |
| <b>Maturity date:</b>                          | The date in the future when a bond's face value will be repaid.   |
| <b>Official cash rate:</b>                     | The level of interest rates set by the Reserve Bank of Australia at its monthly interest rate meetings.   |
| <b>Term:</b>                                   | The length of time, from issue date to maturity date.   |
| <b>Volatility:</b>                             | The degree of variation in the trading price of an asset over time.   |
| <b>Yield to maturity:</b>                      | 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.                              |
| <b>Convexity:</b>                              | The shape of the yield curve. A steeper curve points to a positive economic future.   |
| <b>Credit spreads:</b>                         | The difference between the yield of a risky bond (ie corporates) and a corresponding risk-free Government bond.   |
| <b>Widening and tightening credit spreads:</b> | Tightening is when investors require less compensation for credit risk and vice versa for widening.   |
| <b>Yield curve:</b>                            | A line that plots the yields of government bonds with differing maturity dates.   |
| <b>Yield spread:</b>                           | The difference between the short-term and long-term yield   |
| <b>Yield curve steepening and flattening:</b>  | Steepening is when the yield spread between long- and short-term interest rates increases and decreases for flattening.   |

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