



Predictable.

ASX Interest Rate Securities for a regular income stream.





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The ASX Interest Rate Market

The ASX Interest Rate Market is a market where you can buy and sell debt securities, such as bonds, as easily as equity securities, such as shares. Just as you can instruct your broker to buy shares in a company for you, you can now instruct your broker to buy corporate bonds.

The market was established in 1999 and operates on the same trading and settlement systems as the sharemarket. The minimum amount you can invest is \$500 but the usual transaction value recommended by brokers is \$5,000+.

Currently, over 100 issues of corporate bonds, floating rate notes, convertible notes and hybrid securities such as convertible preference shares are available for trading.

This booklet will help you understand why ASX Interest Rate Securities may be a worthwhile addition to your portfolio and how to go about investing in them. In addition to this booklet, there is more information and a free online course at asx.com.au. Alternatively, please feel free to call your contact at Westpac, details of which appear on the inside back cover of this booklet.

Why invest in Interest Rate Securities?

Interest Rate Securities are sometimes referred to as bonds, however there are a variety of reasons investors chose to invest in Interest Rate Securities including:

- receive a steady and predictable income stream
- improve the return on your capital typically held as cash
- diversify your portfolio and reduce your risk
- profit from expected movements in interest rates
- hedge the interest rate exposure on your own debt
- preserve the value of your capital while you wait for new investment opportunities.

Differences between Interest Rate Securities and shares

When you subscribe to a new issue of Interest Rate Securities such as corporate bonds, the company issuing the bonds effectively borrows money from you. The amount you lent will be returned to you at maturity. In comparison, when you subscribe to a new issue of shares, you become a part owner of the company. The company has no obligation to repay your investment.

When you buy or sell bonds or shares on ASX, the relationship as creditor or part owner of the company is simply transferred between you and the other investor.

Bondholders usually carry a lower risk (despite being subject to some volatility), than shareholders in a company and therefore may expect a lower return for a number of reasons:

- Bondholders have a priority claim on the company's assets relative to shareholders, making bonds a lower risk investment compared to shares in the same company
- Your return on a bond is largely predictable if you hold it until maturity. It will usually include a fixed or floating rate of interest paid regularly until the bond is repaid at maturity (perpetual notes are an exception) in addition to any difference between the face value of the bond and the amount you paid for it
- Shares have no fixed maturity and your return will fluctuate in line with the profitability of the company and other factors. It will include any dividends from the company plus any capital gain or loss when you later sell the shares

Using Interest Rate Securities to diversify your portfolio

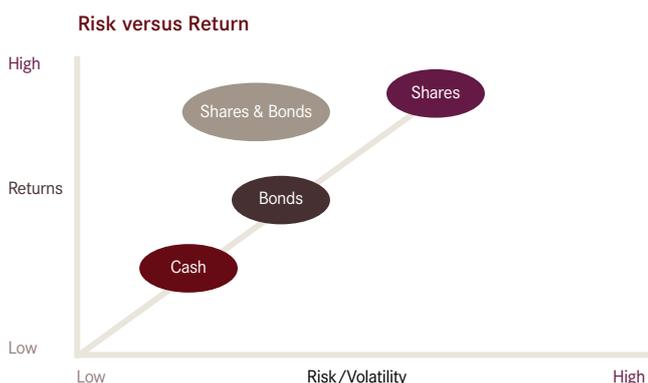
Diversifying your portfolio can help to minimise your risk and protect your returns over the longer term. Diversifying involves:

- Spreading your investments across a mix of assets such as Interest Rate Securities, shares, cash and property
- Spreading your investments within each asset type
- Spreading your investments across assets that have low correlation with each other.

The aim is to minimise the effects of shifts in market conditions. An investor whose entire portfolio is invested in one or two types of industries is subject to cycles in that industry. For example, an investor whose entire share portfolio was in technology companies would have felt somewhat vulnerable in April 2000 when the technology industry suffered a major downturn.

Just as it is generally suggested that a share portfolio be spread across industries, it is also usually wise for a bond portfolio to include a spread of issuers and maturity dates.

By combining different assets in a portfolio, it is possible to maximise your return relative to your risk. The following graph shows estimates of bond and share market returns, which demonstrate this theory of an optimal portfolio, showing how a balance of shares and interest rate securities can have a significantly lower risk profile, but with only slightly lower returns.



Source: *Bonds & Hybrids, ASX, 2003.*

Risk and return – the trade off

It is important to understand the degree of risk associated with different types of investments. Generally speaking there is a trade off between the returns of different investments and the risks associated with those investments. The risk level of a portfolio can be decreased by spreading your money across several different types of investments or 'asset classes'.

Interest Rate Securities listed on ASX

Interest Rate Securities in Australia have traditionally been traded in the over-the-counter market by institutional investors. However, ASX has made it easier for these products to be traded on its exchange. Brokers can use their ITS screens to buy and sell Interest Rate Securities and to compare the return offered with those of other products such as term deposits, finance company debentures and cash management accounts.

As a result, more companies are now listing their Interest Rate Securities on ASX in order to gain access to the retail investor market. Companies seeking to raise funds by issuing Interest Rate Securities publish a prospectus outlining the offer to investors. A recent example was the launch of Westpac Stapled Preferred Securities II in March 2009.

To invest in the primary issue phase, investors typically first evaluate the issuer's offer in the prospectus and then subscribe through a broker for a number of securities. Once the securities are issued and listed on ASX, you can then buy and sell them on the exchange.

Types of ASX Interest Rate Securities

Corporate Bonds

Bonds issued by companies that can be either secured or unsecured. They have a fixed maturity and coupon rate meaning that cashflows are known throughout the life of the bond and the face value is repaid at a fixed date in the future.

Floating Rate Notes (FRNs)

Bonds that can be either secured or unsecured FRNs pay a variable coupon amount, generally quarterly or semi-annually, which is referenced to a short-term benchmark rate such as the 90-day bank bill swap rate. Many FRNs are perpetual and therefore you have to sell them to recoup your investment.

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.

Hybrid Debt Securities

Securities that have both debt and equity characteristics including those Convertible Preference Shares that convert into a dollar amount of the ordinary shares of a company at a future date and at a set discount to the ordinary share price at that time.

The ASX Interest Rate Market offers four key benefits:

Transparency

Ready access to information about the price, yield and other characteristics of different Interest Rate Securities helps you and your adviser make comparisons with other interest rate products and select securities with the return which best suits your chosen level of risk.

Ease of entry and exit

Interest Rate Securities are traded on ITS and settled in CHES so your adviser can easily place buy and sell orders for you and help you manage asset allocation for your overall portfolio.

Liquidity

The ASX Interest Rate Market gives you access to a broader range of potential buyers when you wish to sell, which creates price tension and potentially improves the price. Previously, investors often had to accept the price that was offered by the issuer to buy back the securities.

Transferability

Unlike other interest rate products such as term deposits and cash management accounts, ASX Interest Rate Securities are negotiable instruments. Just as you can buy and sell shares, you can trade Interest Rate Securities and the change in ownership is recorded automatically on a register in exactly the same manner as shares.

A list of Interest Rate Securities available for trading is provided on the ASX website at asx.com.au or in a number of publications including the Australian Financial Review or can be obtained from a stockbroker or financial adviser.

To find a broker visit asx.com.au/broker or asx.com.au/planner for an adviser.

Risks associated with Interest Rate Securities

Each Interest Rate Security is unique and carries some risks that investors should be aware of and should therefore obtain independent advice from a professional adviser prior to making any financial decision. Specific risks include;

- **Default**
- **Liquidity** – refers to the ability to buy and sell the Interest Rate Security
- **Income** – past income payment may not be guaranteed in the future and may vary over time
- **Pricing** – the prices of the Interest Rate Security can fall as well as rise

Characteristics of Interest Rate Securities

The three most defining characteristics of an Interest Rate Security are usually the amount of interest (coupon) you will receive over the life of the security (maturity) from the company (issuer) that borrowed the funds in the first place. The coupon payments and face value repaid at maturity are the two cashflows that determine the return on your investment, while default by the issuer is a potential risk.

However, like most investment markets, there are other characteristics and related jargon you should understand before you invest:

Call provision

Some Interest Rate Securities, notably perpetual securities, have a call provision attached. This gives the issuer the right, but not the obligation, to buy back the securities from you at a particular point in time at a certain price.

Convertible

A security that is convertible gives the holder the option to convert the security into ordinary shares at specified times (usually reset or maturity dates). If the holder decides not to convert there are generally two other choices: receive the face value back, or continue for a new set term (These terms are set out in the prospectus to the issue).

Converting

A converting security does not give the holder a choice at maturity; the security must convert into the underlying shares at a specified date.

Coupon

A coupon is interest paid at regular intervals by the issuer to investors, normally expressed as a percentage per annum. Coupons can be fixed or floating, that is a fixed rate for the life of the security or a floating rate that varies in line with a benchmark rate, usually at a margin above the bank bill rate.

Coupon frequency

Coupon payments are made at regular intervals throughout the life of the Interest Rate Security and are usually quarterly, semi-annual or annual payments.

Creditor status

It must be understood that in the event of winding up a company the repayment of capital of a hybrid (if in the form of a convertible preference share) ranks ahead of ordinary shareholders but behind all creditors. Convertible preference share holders do not have full shareholder voting rights. Convertible notes on the other hand generally rank above convertible preference shares.

Cumulative & Non-cumulative

This refers to what happens in the event of missed dividend or interest payments.

- **Cumulative:** missed payments are added to the next payment
- **Non-cumulative:** missed payments are forgone.

Discount at Conversion date

This generally applies to hybrids that do not have fixed conversion terms. At conversion the allotment of ordinary shares (to the holder of the hybrid) is calculated on the current market share price. The holder of the hybrid usually receives a discount off the current market share price, (typically around 5%), therefore the allotted number of shares increases per hybrid.

Face Value

The issue price or underlying value of the security is usually \$100. This is the base value used to calculate dividend or interest payments e.g. 8% return is not calculated on the market price of \$102.50, it is calculated from the \$100 face value, therefore you receive \$8 p.a. per security.

Market price

The market price of an Interest Rate Security is stated as a percentage of its face value. For example, a price of \$100 means 100% of face value; a price of \$99.90 is 99.9% of face value; a price of \$102.45 is 102.45% of face value.

The market price includes two components:

- **Capital amount** – the value of the security estimated by the market. It is based on a number of variables including current market interest rates relative to the coupon rate, time to maturity, ranking and credit quality. This value may remain stable from one day to the next, unless general 'market' interest rates move
- **Accrued interest** – the amount of interest accumulated on a security since the last coupon payment. A security price increases daily by the amount of interest accrued, for example, a security with a \$100 face value and 6.5% coupon rate accrues interest at \$6.50 per annum or 1.78 cents per day. The price should adjust immediately after a coupon payment.

Maturity

Maturity is the date the agreement or contract between the issuer and investors holding the securities ends. On this date the final coupon and the face value is paid to investors. The time to maturity can vary greatly from short term (up to four years) to medium term (five to 10 years) or long term (10 or more years). Convertible or hybrid securities are converted into shares in the issuing company on maturity rather than paying you the face value. Perpetual Interest Rate Securities have no maturity date but you can recoup your investment by selling them on the ASX.

Redeemable & Non-redeemable

- **Redeemable:** at certain times the holder may have the option to hand the securities back to the company in return for the face value issue price. Similarly, the issue terms may give the company the ability to redeem in certain circumstances
- **Non-redeemable:** The securities cannot be redeemed under any circumstances.

Reset & Resettable

A resettable security means that after a certain period (usually 3-5 years) the current terms and rates are reviewed i.e. a new interest or dividend rate is set over a new term and reset by the issuer. At this reset date the holder may have several options available to them, but generally the holder can either accept the new terms, redeem, or in relation to hybrid securities, convert into ordinary shares.

Returns

Like bonds convertible notes pay a coupon, i.e. interest. Convertible preference shares pay dividends in a similar way to coupons, i.e. a set return on set dates. This dividend is often franked and therefore offers possible tax advantages to the holder. Unlike ordinary shares the dividend on hybrids is known and predictable. The dividend rate may be fixed or floating.

Yield

The yield is the expected return on your investment. It can be described as:

- **Nominal yield:** the return based on the annual coupon payments as a percentage of the face value of the security. Also referred to as the coupon rate, it does not change throughout the life of the security
- **Current yield:** the return based on the annual coupon payments as a percentage of the amount you paid for the security or any given price

- **Yield to maturity:** the annualised total return based on all the coupon payments plus the face value you would receive if you held the security to maturity. It includes any gain or loss if your purchase price was below or above the face value. Therefore it is the most useful indicator of the value because it enables comparisons between different securities and other interest rate based products.

Example: Buying corporate bonds

On 10 May 2009, you buy 50 corporate bonds of a fixed-rate issue by WBC of '6.50% 11 February 2011 bonds' at a price of \$103.50 with a yield of 5.39%

Issuer	Westpac Banking Corporation
Coupon	6.50%
Coupon Frequency	Semi-annual: 11 February & 11 August
Maturity Date	11 February 2011
Face Value	\$100
Purchase Price	\$103.50
Yield to Maturity	5.39%

The 5.39% yield to maturity on your investment is based on the following:

Accrued interest and capital amount

You bought the bonds on the date of 10 May 2009 this is 88 days after the last coupon was paid on the 11 February 2009 therefore there is accrued interest incorporated into the securities price:

- The accrued interest amount is the coupon of \$6.50 per \$100 face value per year. This coupon accumulates per day for a calculation of $\$6.50/365 \text{ days} = 1.78 \text{ cents per day}$
- Therefore the accrued interest is for 88 days = $\$0.0178 \times 88 = \1.57
- Leaving the capital amount of = $\$103.50 - \$1.57 = \$101.93$
- The total investment amount is $\$103.50 \times 50 = \$5,175.00$

Income stream

The coupon is 6.50%. The coupon is paid semi-annually so the amount you will receive twice a year:

- = (number of bonds x face value) x (coupon rate/coupon frequency)
- = $(50 \times \$100) \times (6.50\%/2)$
- = \$162.50

Payment at maturity

The maturity date is 11 February 2011, at which point you will receive the face value of the bonds as well as the final coupon
Maturity payment:

- = $(50 \times \$100) + (50 \times \$100 \times (6.50\%/2)) = \$5,162.50$

Yield

The nominal yield (coupon rate) of this bond is 6.50%. The nominal yield will remain at 6.50% throughout the life of this bond.

Given the above cashflows, the yield to maturity on the purchase price is 5.39%. This yield will fluctuate during the life of a bond, reflecting the changing level of interest rates generally, in addition to other factors.

Hybrid Securities

The term hybrid is given to a class of securities that have the characteristics of both an interest bearing security and equity i.e. both bonds and shares. This classification covers securities such as convertible notes and convertible preference shares. These securities pay a fixed return (like a bond) but also have an option to convert into equity (i.e. shares) of the issuing company.

Here we explain how these hybrid securities behave and demonstrate the major features and terms that investors should understand.

What do hybrid securities offer?



Investor buys the hybrid: Issuer of the hybrid security pays the investor a known regular return (usually every 6 months):

At maturity the investor gets the \$100 back in the form of shares (or cash in some instances):



Why would investors buy them?

- Regular income stream
- Security or lack of volatility
- Some have fully franked returns
- Discount on the share price when converting from the hybrid into shares.

Hybrids: a simple graphical explanation

As an example, consider XYZ Ltd which is a listed company on the ASX. In January 2009 the Company issued hybrid securities – convertible preference share (expressed graphically below), which pays a semi annual, fully franked dividend of 6% p.a. for 5 years. If an investor invested \$10,000 they would receive \$600 p.a. (\$300 every six months until the maturity date). At maturity, according to the terms set by the company in the prospectus, the investor could choose to:

1. Convert the \$10,000 into ordinary shares (convertible); or
2. Rollover or reset the investment (resettable); or
3. Under certain circumstances, have capital in the form of cash returned (redeemable).



Coupon or Dividend

Hybrid securities returns

There is a decision to make when investing in a hybrid security based on returns. This decision is whether to invest in a security that pays interest or one that pays a fully franked dividend. One aspect to consider when making this decision is whether the investor can utilise the franking credits.

There are two types of hybrid securities:

1. The convertible preference share paying a dividend from after tax profits and which is often fully franked; or
2. The convertible note paying a coupon, which is regarded as interest and is an operating expense of the company.

Another point to consider is the ranking of returns paid on these two securities by an issuer. Generally, the coupon on convertible notes is paid out before all dividends because it is an expense of the company (and therefore the securities are regarded as a debt obligation). The dividends on convertible preference shares are paid out of after tax profits and before the ordinary share dividends. It must be remembered that in practice companies who issue these securities only ensure, but not actually guarantee that payments are made.

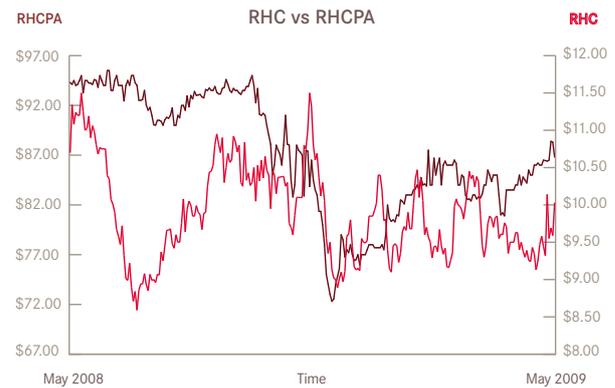
Hybrids structure

Economic shocks

Unfortunate and sometimes tragic world events affect the financial markets instantaneously, as the September 11th disaster demonstrated. Depending on their terms, hybrid securities and Interest Rate Securities as a class of investments, generally speaking, are not as affected by this sort of economic change as some other classes of investment (evidenced in the graphs below). It is this factor that shows why diversification across different classes of securities, (i.e. equities, Interest Rate Securities and property etc.), is important to ensure your portfolio is not seriously effected by one single event.

Example Ramsay Healthcare

Which is more stable? – Shares (RHC) vs Fixed Interest (RHCPA)



Example Woolworths

Which is more stable – Shares (WOW) vs Fixed Interest (WOWHB)

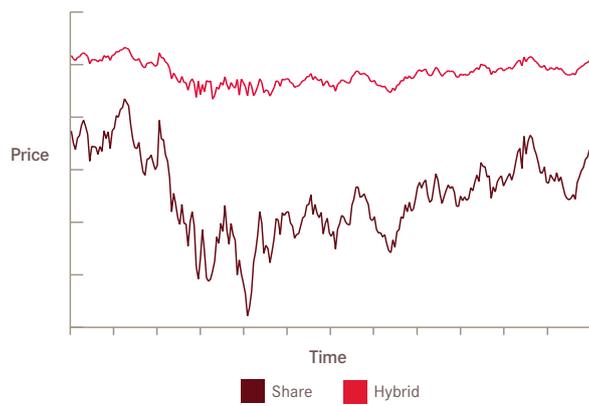


Conversion

Dollar value conversion

This is the latest style of hybrid where the conversion (or number of shares you receive) is determined at the maturity date, not at issue. The face value, usually \$100, effectively buys you shares at the market price on the date of conversion, thereby reducing the correlation between share price and hybrid price. Therefore the characteristics of this type of security are very 'bond like'.

Hypothetical graphical example below:



Each security with this type of conversion has individual characteristics, typically:

- They have a set dividend rate over a fixed period ('reset' period), which at the end of that period can be reset for a new dividend rate and new fixed period
- They are issued at \$100
- The holder has the ability to take the new 'reset' terms, convert or on rare occasions, redeem the face value
- The holder can convert into shares at a discount to the current ordinary share price e.g. 5%
- The conversion ratio is into a dollar amount of shares e.g. \$100 worth of the underlying equity

Note: This 'variable' conversion ratio means the price of these hybrids generally do not react to the movement in the share price and they therefore behave in a similar way to Fixed Interest Securities i.e. a bond.

Case Study – Westpac Stapled Preference Securities II (WBCPB)

In March 2009, Westpac issued hybrid securities called Westpac Stapled Preferred Securities II. The prospectus for this hybrid security did not state exactly how many shares the investor would receive on conversion, rather it stated that the face value (issue price) of \$100.00 will convert into \$101.01 worth of shares on the conversion date.

So the number of shares received is confirmed at the maturity or conversion date. Let's take the WBCPB example a little further.

Firstly, a price of the ordinary shares is needed to work out how many shares the \$100 face value will buy. The conversion price is calculated by obtaining the average of the volume weighted average share price over the last 20 days of trading up to the conversion date (VWAP), to get a fair figure. As in most cases with hybrid securities a discount is applied to the conversion price, 1% in this case, effectively delivering more shares.

For example, you purchase 50 WBCPB at the issue date for \$5,000. If the VWAP was \$25.00, then you would receive at conversion:

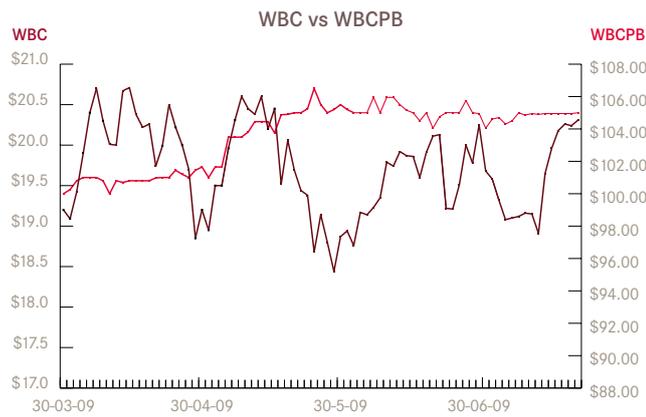
$$\begin{aligned} \frac{\text{Face Value}}{\text{VWAP} \times (1 - \text{Discount})} &= \frac{100}{\$25.00 \times (0.99)} \\ &= \mathbf{4.04 \text{ shares per security}} \end{aligned}$$

Thus you would receive 202 WBC shares at the conversion date.

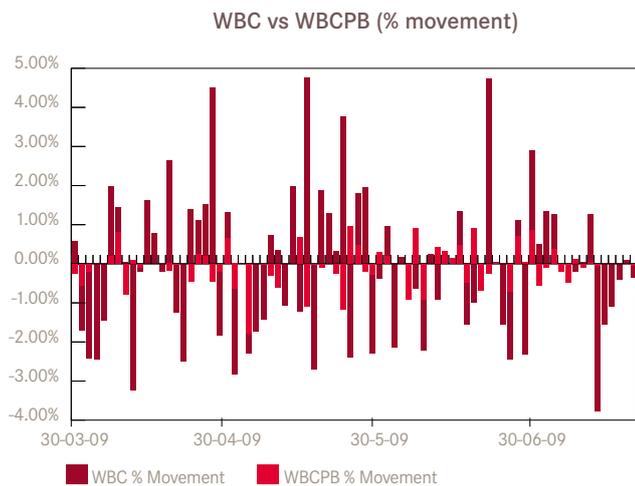
Correlation

Correlation is the measure of how closely the movement in the price of a hybrid security and the movement in the price of the underlying share mimic each other. Why is this important?

A highly correlated hybrid security will track or follow the price of the underlying share. If an investor didn't want to invest in a hybrid security that falls when the share price falls or vice versa, then a hybrid security that has a low correlation is more suitable.



The above graph portrays that WBCPB (fixed interest security) has a more stable price line than WBC (shares). However, the graph below highlights the correlation more effectively because it expresses the daily hybrid price movements and the daily share price as a percentage.



The above graphs highlight the steady nature of a hybrid with a dollar value conversion. As indicated by the graph above, (Percentage Movements) the WBCPB is generally more stable than the WBC price and although this type of hybrid cannot benefit from upward capital price movements as much as a fixed conversion hybrid, it can limit the down side.

Resettable

Most of the recently issued hybrid securities are resettable. Resettable refers to the option the current hybrid security offers at maturity. The choices are to either convert into ordinary shares or roll over into a new set of terms offered by the issuer. As an example consider this hypothetical position:

Old Terms	
Swap Rate	3.16%
Margin over swap	2.00%
Coupon / dividend	5.16%
Issued	6 Feb 2009
1st reset / conversion date	6 Feb 2014
Term	5 years
Convert into ordinary shares or Reset for a new 5 year term	
New Terms	
Swap Rate	4.75%
Margin over swap	2.00%
Coupon / dividend	6.75%
Issued	6 Feb 2014
1st reset / conversion date	6 Feb 2019
Term	5 years

Valuation

Considering that each hybrid is constructed differently, comparing them is no easy task. There are many formulas and formats to measure value, two of the most popular are explained below.

Running Yield

Running yield is calculated as the dividend or returns divided by the purchase price. It is a simple measure of the return the holder can receive at current market prices, excluding any discount or optionality value.

Yield To Maturity (YTM)

One method of comparison is to use a common indicator of value like YTM. The YTM is the return you will receive if you buy the security today and hold it until maturity. The YTM takes into account all future coupon or dividend payments due to the holder, current price if purchased today and the face value returned to the holder at maturity. YTM enables comparisons to be made between hybrid securities but only on its bond content.

To get a true indication of value, three additional aspects to be considered are: firstly, the value of remaining dividend payments grossed up so they represent the extra value from franking credits; secondly, the added value of a discount available to the share price at conversion; and thirdly, the value of the options tied in to the conversion terms of the hybrid.

To find these indications of value on hybrids (or any interest rate security) contact your broker or financial adviser for advice or analysts' reports.

What to know before investing

The same relationship that generally holds true in other investment markets also applies to Interest Rate Securities: usually the greater the perceived risk, the higher the expected return required to compensate investors for that risk.

For example, you might be able to earn a 4% return on a term deposit. However, you might prefer to invest in a 10-year bond that, at the time of purchase, yields a 6.5% return. The yield is higher than the term deposit rate because you have to wait 10 years to get your investment back and in the meantime conditions may change or the issuer may default. Alternatively, you may sell the bond at the prevailing market price on ASX.

Over time, both the market interest rates, including term deposit rates, and the perceived risk may change, affecting the price of the bond if you do decide to sell it.

The effect of changing interest rates on yields and prices

When interest rates in general rise or fall, investors look for a correspondingly higher or lower yield from an Interest Rate Security.

If the coupon rate is floating, the yield on the security may stay in line with market interest rates without any significant impact on its price. However, if the coupon rate is fixed, the yield on the security can only keep pace with changing interest rates if the price of the security changes.

Interest rates*	Bond yields	Fixed-rate bond prices
Rise	Rise	Fall
Fall	Fall	Rise

*In this context, interest rates should be understood as a broad term describing the general level of interest rates in the market.

There is an inverse relationship between the capital price of a fixed-rate security and yield. A comparison can be made with what happens to the dividend yield on shares, that is, when the price of a share increases, the dividend yield falls (assuming the dividend amount stays the same).

The following table shows the effect of different yields on the capital price of one bond with a fixed 5% coupon and of another bond with a fixed 8% coupon.

Yield	5% fixed-rate Bond			8% fixed rate Bond		
	Time to maturity			Time to maturity		
	2 years	4 years	10 years	2 years	4 years	10 years
4.00%	\$101.904	\$103.663	\$108.176	\$107.615	\$114.651	\$132.703
6.00%	\$98.141	\$96.490	\$92.561	\$103.717	\$107.02	\$114.377
8.00%	\$94.555	\$89.901	\$79.615	\$100.00	\$100.00	\$100.00

*In this context, interest rates should be understood as a broad term describing the general level of interest rates in the market.

Other factors affecting the yield on Interest Rate Securities

In addition to the prevailing market interest rates, a range of factors can affect the yield that investors seek from any particular Interest Rate Security including:

- Credit quality of the issuer
- Ranking of the issue
- Time to maturity
- Coupon frequency
- Liquidity or marketability.

Credit quality

An important element of risk in Interest Rate Securities is potential default by the issuer. Generally the higher the credit quality of the issuer, the lower the risk associated with the security and therefore the lower the yield required by investors.

The three most prominent credit-rating agencies are Fitch, Moody’s Investors Service and Standard & Poor’s. The scales they use to rate the credit worthiness of issuers are:

Fitch	Standard & Poor’s	Moody’s	What the rating means
Investment Grade			
AAA	AAA	Aaa	Highest credit quality
AA	AA	Aa	Very high credit quality
A	A	A	High credit quality
BBB	BBB	Baa	Good credit quality
Non-investment Grade			
BB	BB	Ba	Speculative

An issuer’s credit rating can change over time. Any change in the rating will have a direct impact on the market price of its securities. If a company is unrated, it does not necessarily mean that its securities are high risk, but it does mean that you may want to turn to other means to evaluate its financial strength. Your broker may be able to help by providing company research data.

Ranking

Ranking or status 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 and the lower its yield.

The various ranks used include:

- **Secured:** a security backed by a charge over an asset of the borrower
- **Unsecured:** a security that is not backed by an asset or charge over an asset
- **Senior:** a security that ranks ahead of other debt and equity
- **Subordinated:** a security that ranks behind other debt but ahead of equity.

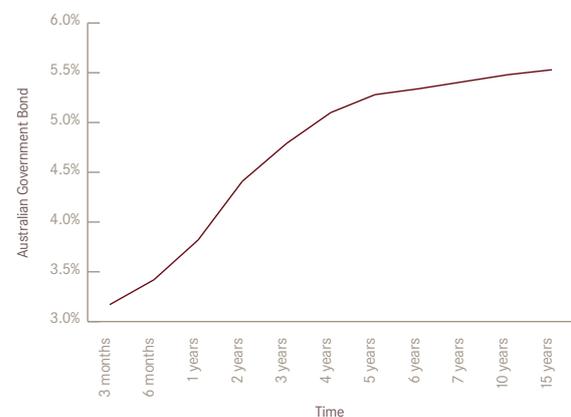
Time to maturity

The longer you are required to hold an Interest Rate Security, the greater your exposure to the risk that market conditions or the issuer’s credit rating might change and you should expect to receive a higher return as compensation for that additional risk (see yield curve chart below).

The relationship between yield and maturity is represented by what is known as a yield curve. Yield curves reflect investors’ view of the value of Interest Rate Securities of various maturities.

Yield Curve

The chart below shows the yield curve for Australian Government Bonds as of July 2009:



Source: Bloomberg L.P. July 2009.

Coupon frequency

The frequency of coupon payments is a key factor in the overall return of your investment. Consider which is the better investment: a 5.65% annual coupon or 5.57% semi-annual coupon?

An annual coupon rate of 5.65% actually provides the same return as a semi-annual coupon rate of 5.57%. The interest rate is a little lower for the semi-annual coupon but you get half of the interest sooner.

Liquidity or marketability

Liquidity refers to the ease with which a security can be readily and with minimal loss, converted into cash. The characteristics of the security itself, including time to maturity, coupon rate and credit rating of the issuer, as well as the scarcity or abundance of substitute investments can all affect the level of demand for it in the market.

The ability to trade an Interest Rate Security on the ASX market usually reduces the costs of transacting while at the same time giving you access to a broader range of potential buyers.

Factors that influence general interest rates and yields

While you don't need to be an economist to invest in Interest Rate Securities, it is generally important that you understand the key economic factors that influence interest rates and, in particular, how the Reserve Bank of Australia decides to set official interest rates.

Inflation

Expectations about inflation are a powerful influence on interest rates as inflation affects the purchasing power of money and therefore the value of any investment assets. As the inflation rate (specifically, the expected inflation rate) rises, interest rates become under pressure to rise in order to maintain the value of assets in the economy. However, at the same time the Reserve Bank may be hesitant to raise official interest rates for fear of inflation getting out of control.

Gross domestic product (GDP)

GDP is a measure of the goods and services produced in an economy and whether that economy is growing or stagnant. Because the cost of supplying those goods and services is affected by shifts in interest rates; interest rates also can affect GDP.

Balance of payments (BOP)

BOP provides a record of Australia's economic transactions with the rest of the world. Generally a positive or improved balance of payments would reduce pressure on interest rates to increase. Conversely, a negative or deteriorating balance of payments normally intensifies pressure on interest rates to increase.

Borrowing and lending in Australia

Interest rates assist in achieving a balance between the total amount of borrowing and lending that occurs in Australia and therefore the level of overall economic activity. When the demand for borrowing exceeds plans to lend, interest rates will tend to rise and when the demand for borrowings fall short of plans to lend, then interest rates tend to fall.

International economics

Australian interest rates are influenced by a number of international factors including:

- **World growth:** high levels of activity in the major world economies can result in strong manufacturing demand for commodities. The resulting higher commodity prices can improve our BOP and therefore generally ease the pressure on interest rates
- **Overseas interest rates:** Australia has consistently run a BOP deficit, forcing it to borrow funds overseas. Therefore Australia may attempt to offer interest rates that are attractive relative to overseas rates in order to attract offshore investment funds to Australia. This means that, generally, if overseas interest rates rise then domestic interest rates also tend to rise
- **Currency movements:** the prices of Australian exports and imports are affected by the value of the Australian dollar (AUD) against the currencies of our trading partners and competitors. A strong AUD may result in our exports being more expensive, while at the same time reducing the cost of imported goods. This can have a negative effect on Australia's BOP and may put upward pressure on interest rates.

The Reserve Bank of Australia (RBA) meets monthly to consider amongst other things the above factors. The RBA Board sets the rate of interest that the RBA is prepared to pay the Australian banks for call deposits. This sets the 'Base Rate' for all other rates (including Interest Rate Securities coupon rates) that are benchmarked against it.

ASX codes and price information

Interest Rate Securities that trade on ASX are quoted and traded on the Stock Exchange Automated Trading System (ITS). Each security is identified by an ASX code that is four to five alpha-characters long.

The first three characters identify the issuer, for example, WBC for Westpac Banking Corporation.

The fourth character identifies the type of security, for example:

- H indicates an unsecured note
- G indicates a convertible note
- P indicates a preference share.

The fifth character, if any, is known as the sequence code. It indicates the number of that particular security within a series of securities on issue by the company. For example, WBCA indicates the first unsecured note on issue by Westpac Banking Corporation or CBAPB indicates the second preference share on issue by Commonwealth Bank of Australia.

Current price information

You can get information about current trading prices through a number of channels:

- A broker should be able to provide the current market price for any securities
- Price information is available at the ASX website at asx.com.au
- The financial press carries a comprehensive list of the previous day's closing prices.

Bid and offer price

The bid price is the price a buyer is willing to pay for a security. The offer price is the price a seller is willing to accept for a security. The bid price is usually lower than the offer price, so the bid yield is generally higher than the offer yield.

Other considerations:

Minimum investment

Some securities require you to make a minimum investment at the time of initial listing. You should check the prospectus or ask your broker to determine if this is so.

Settlement

Settlement of ASX Interest Rate Securities takes place in CHES (Clearing House Electronic Sub-registry System) in the same way as shares are settled. As with shares you may hold your Interest Rate Securities in CHES either as broker sponsored holdings or on the issuer's register as issuer sponsored holdings.

CHES settlements normally occur on a trade day plus three (T+3) basis and the quoted prices for Interest Rate Securities reflect this. However, by mutual agreement, settlement can be scheduled from T+1 onwards.

Where to from here?

This booklet has covered the major issues involved in understanding Interest Rate Securities. This exercise will help you decide whether investing in Interest Rate Securities is right for you. By completing the following questions, you will be able to use this information when contacting a financial adviser to include Interest Rate Securities in your investment portfolio.

The importance of diversity

Interest Rate Securities provide an excellent way of diversifying your portfolio. However, many Australians have not yet taken advantage of Interest Rate Securities. Consider your current asset allocation percentages:

Investment Type	Your assets
Shares	%
Property	%
Interest Rate Securities	%
Cash	%
Other Investments	%

One of the reasons for the use of Interest Rate Securities is that they help offset risk. The graph on page 3 illustrates the changes in risk according to the relative allocation between Interest Rate Securities and shares.

Given the information above, and considering your existing asset allocation, what do you think would be an appropriate new asset allocation for you circumstances?

Investment Type	How your assets could look
Shares	%
Property	%
Interest Rate Securities	%
Cash	%
Other Investments	%

Steps to investing in Interest Rate Securities

Having considered the importance of diversifying your assets and the role that Interest Rate Securities can play in providing diversity, the following section provides a step-by-step guide to purchasing Interest Rate Securities.

Step 1: Check your understanding

To begin with, consider those areas of knowledge which you understand, or still need more information about:

Investment Type	Yes	In part	No
1 I understand how Interest Rate Securities can help diversify my investment portfolio.			
2 I understand that differences in coupon frequency affect coupon value (that is, the interest rate).			
3 I understand that different Interest Rate Securities have different risks, and that these risks are monitored by rating agencies.			
4 I understand how the value of Interest Rate Securities may go up and down with changing interest rates.			
5 I understand that to compare different Interest Rate Securities, a key measure to consider is the 'yield to maturity'.			
6 I understand the differences between the various types of Interest Rate Securities listed on the ASX.			

For those areas you are unsure about, we recommend you review this booklet further, or talk with a financial adviser. You should consult a licensed financial adviser before making any investment decision. Remember, lack of knowledge is one of the key barriers that stop people from taking advantage of Interest Rate Securities.

Step 2: Prepare to speak to your financial adviser

Before speaking to your financial adviser about purchasing Interest Rate Securities, you may wish to consider the following questions:

What sort of products do you wish to buy?

- Do you only want low risk securities, or are you interested in a range of products?
- What kind of spread of maturity dates would suit your needs?
- Are you interested in any Interest Rate Securities which may be convertible into shares at a later date?

You can add some of your questions below. Don't worry if you don't have all the answers to start with – your broker or financial adviser is there to help you!

Your Questions	Write your questions below
Question 1	
Question 2	
Question 3	

Step 3: Determine the funds you have to invest in Interest Rate Securities

Based on the asset allocation percentage you developed for Interest Rate Securities above, and considering your total investment portfolio value, how much will you now allocate to purchase Interest Rate Securities? \$ _____

Step 4: Call your financial adviser and purchase some Interest Rate Securities

With all the information prepared here, speak to your financial adviser about the possibility of including Interest Rate Securities in your investment portfolio.

To find a financial adviser, visit asx.com.au/planner.

Glossary

accrued interest

The amount of interest that has been accumulated from the last coupon date to the date when a bond is bought or sold.

annual coupon

A coupon that is paid once a year.

bid price

Price a buyer is offering.

capital price

Gross price less accrued interest.

corporate bonds

Bonds issued by a company.

convertible notes

A type of coupon-paying debt security that converts to the issuer's ordinary shares (equity) at maturity.

convertible preference shares

A type of dividend-paying preference share that converts to the issuer's shares (equity) at maturity.

coupon

The interest amount paid on the specified date to an investor in a bond. It is commonly expressed as the amount per \$100 as a percentage rate.

coupon date

The date on which the coupon interest is paid to an investor of a bond.

debenture

A type of fixed interest security issued by companies. It is usually backed by a specific or floating charge over the issuer's assets.

default

When an issuer cannot meet the payment obligations.

discount

When the capital price of a bond is less than its face value.

exchange traded

A security traded on an exchange.

face value

The amount that an investor will receive at maturity.

government bonds

Bonds issued by a government.

gross price

The price an investor pays to buy bonds is made up of capital price plus accrued interest.

hybrid debt securities

A term or classification encompassing securities that have both debt and equity characteristics.

ITS

ITS Integrated Trading System. The computer system used for trading shares and Interest Rate Securities listed on ASX.

maturity date

The date on which a bond matures.

offer price

Price a seller is asking.

over the counter

A security that is not traded on an exchange such as ASX but transacted over the phone between professional investors and brokers.

par

A bond at par is one whose capital price is the same as its face value.

premium

When a bond's capital price exceeds its face value. Face value is normally \$100.

purchase price

The dollar amount paid for bonds (gross price multiplied by number of bonds).

quarterly coupon

Coupon interest that is paid four times a year.

redemption yield

The yield earned on bonds held to maturity.

secured note

A note backed by a charge over an asset of the borrower.

senior note

A note (evidence of debt) that ranks ahead of other debt and equity.

semi-government bonds

Bonds issued by a state owned government authority.

semi-annual coupon

Coupon interest that is paid twice a year.

subordinated note

A note that ranks behind other debt but ahead of equity.

time to maturity

The number of days until a bond matures.

unsecured note

A bond (note) that is not backed by an asset or charge over an asset.

volume weighted average pricing (VWAP)

A measure of the price at which the majority of a given day's trading in a given security took place. Calculated by taking the weighted average of the prices of each trade.

yield

The annual return on an investment (bond, shares, property) expressed as a Percentage.

yield curve

Graph showing the relationship between yield to maturity and time to maturity.

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