FIXED INCOME.

Fixed Income in Australia - An Investor's Guide

BELL POTTER

CONTENTS.

1.0 ABOUT BELL POTTER

As one of Australia's largest, independent stockbroking firms, Bell Potter provides a full range of services to institutional, corporate and private clients.

Our organisation's objective is to offer a complete range of financial products and services, including: stockbroking, research, financial planning, interest rate products and superannuation.

Bell Potter is part of the Bell Financial Group of companies (ASX code: BFG).

Access to primary corporate bond issues

As one of Australia's largest full service, private client stockbroking firms with 14 offices around the country we enjoy access to a significant range of corporate new issues from our own corporate team as well as our syndication unit.

In-house capability

Bell Potter's Corporate Finance team has significant experience as lead managers, underwriters and coordinators of Initial Public Offerings, placements, rights issues and other capital market activities in small to mid-cap companies across all sectors.

Syndication

Bell Potter also has a major syndication business, which places third-party transactions into the firm's retail and high net worth client base. As a result, Bell Potter is involved in many of the major capital raisings, including some of the largest corporate bond and hybrid issues released to the Australian market, as well as the syndication of:

- Placements
- Rights issues
- Share buy-backs
- Hybrid and debt Issues

Highly regarded research and experienced professionals

Whether it is equities, fixed interest, or hybrids, access to quality research is imperative. Bell Potter advisers have the benefit of being able to access research that covers the full spectrum.

On a daily basis, Bell Potter research and deal in a range of interest rate product investments including:

- bank accepted bills and other discounted securities;
- government and semi-government bonds;
- corporate bonds;
- ASX listed hybrid securities; and
- ASX listed corporate debt securities.

Our advisers are fully qualified to provide interest rate product advice. Just as you would instruct your adviser to buy or sell shares, you can instruct them to purchase bank bills, bonds, or interest rate securities listed on the ASX.

2.0 OVERVIEW

- A BALANCED INVESTMENT PORTFOLIO
- KEY REASONS FOR INVESTING IN INTEREST RATE PRODUCTS
- TYPES OF INTEREST RATE PRODUCTS
- RISK AND RETURN
- DIFFERENCE BETWEEN SHARES AND INTEREST RATE PRODUCTS

2.1 A BALANCED INVESTMENT PORTFOLIO

A balanced or diversified investment portfolio should contain a broad range of assets including cash, fixed income, shares and property. Within each asset class there should also be diversification to minimise the risk of capital loss.

Often referred to as the 'defensive' or conservative portion of an investment portfolio, interest rate securities are generally predictable in terms of their return on capital.

The defensive characteristics of interest rate securities provide a balance to a diversified investment portfolio.

2.2 KEY REASONS FOR INVESTING IN INTEREST RATE PRODUCTS

Key reasons for investing in fixed income securities include:

- An attractive and relatively safe investment;
- A regular and predictable income stream;
- Investors can improve the return on capital over a cash account;
- Capital preservation;

Table 1: Types of Fixed Interest Products

ASSET ALLOCATION	Investing Timeframe	Type of Cash or Fixed Interest Product	
Cash and Fixed Interest		Cash	
	< 6 months	Bank Bills	
		Treasury Notes	
	< 12 months	Bank Term Deposits	
		Short-Dated Bonds	
		Short-Dated ASX listed Debt	
	> 12 months	Government Bonds	• Commonwealth Bonds • State and Semi Government
		Corporate Bonds	• ASX listed Debt Securities • Wholesale Corporate Bonds
		Hybrid Securities	• ASX listed Hybrid Securities

- Diversification in volatile markets to reduce risk;
- Discount entry to ordinary shares;
- Franking credits and other tax advantages; and
- The hedging of interest rate risk.

2.3 TYPES OF INTEREST RATE PRODUCTS

The term interest rate security is a broad term that can refer to any type of investment that provides a regular (or fixed) income return.

Interest rate products include, but are not limited to:

- Bank bills
- Treasury notes
- Bank term deposits
- Government bonds
- Corporate bonds, and
- Hybrid securities.

2.4 RISK AND RETURN

Understanding Fixed Income Assets and Risk

The relationship between risk and return is a fundamental financial relationship that affects expected rates of return on every investment asset. If an investor considers a particular asset to have higher levels of risk associated with it, then they will require a greater level of return to compensate them for that higher expected risk.

Alternatively, if an investment has relatively lower levels of expected risk then investors are satisfied with relatively lower returns.

Government Bonds are considered essentially risk free bonds, given the perception that Governments have a very low probability of default.

The table below shows some longer-term financial products and how they compare from a 'risk' or security perspective.

Table 2: Security(Risk) Ranking of Investment Products

Security	Category	Product	Common name
Lowest Risk	Debt	Commonwealth and State Government Bonds	Treasury Fixed Coupon Bonds and Treasury Capital Indexed Bonds
	Debt	Corporate Bonds	Senior debt-secured Unsecured debt
	Lower Tier 2	Corporate Bonds	Subordinated debt
	Upper Tier 2	Hybrid Securities	Perpetual step-up securities (cumulative)
	Innovative Tier 1	Hybrid Securities	Perpetual step-up securities (non-cumulative)
	Non-Innovative Residual Tier 1	Hybrid Securities	Converting preference shares Perpetual preference shares
Highest Risk	Fundamental Tier 1	Ordinary shares	Ordinary shares

Asset Class Returns

Investment markets move in cycles, as such, investors can benefit from taking a long term perspective of the performance of asset classes. Although there have been short term periods in history when cash has outperformed other asset classes, over the long run, history has shown that sharemarkets have delivered superior returns.

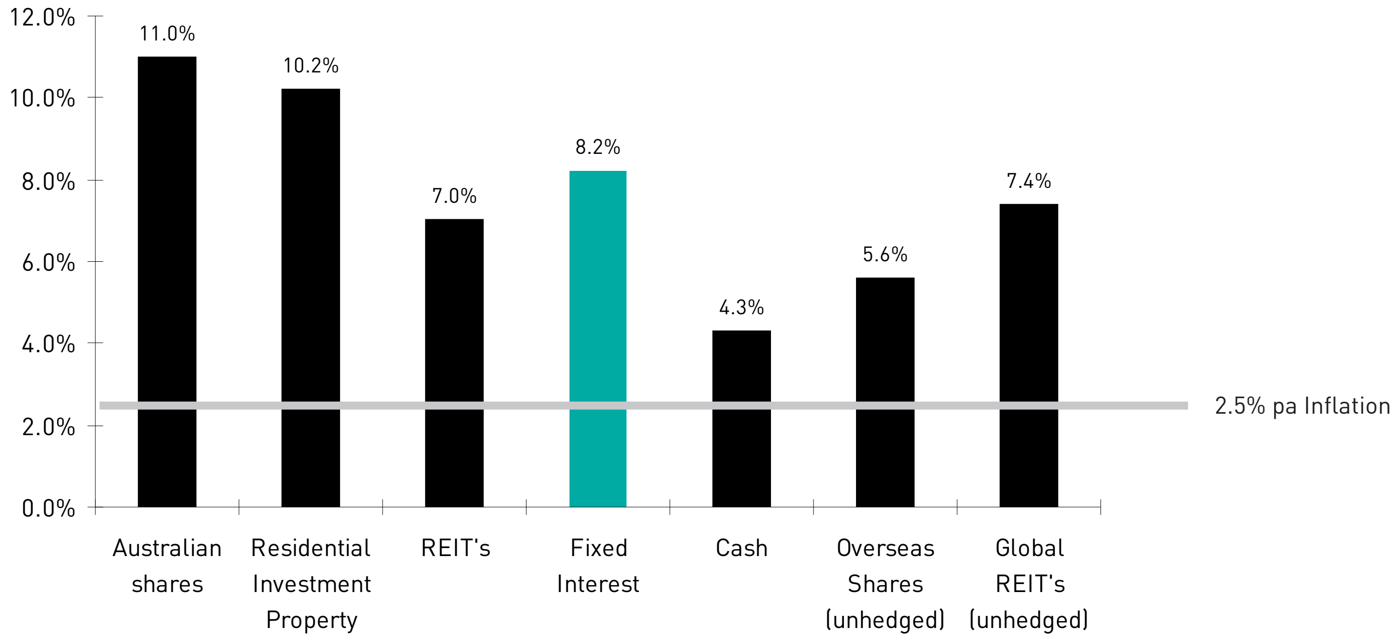
In the past twenty years Australian shares (11.0%) have outperformed all other investment sectors before taxation but after costs. Residential property (10.2%) and Australian bonds (8.2%) were also strong performers over the period. All investments performed well above average inflation (2.5%)*.

Tax Implications for Investors

It is important to note that tax implications for investors will make a significant difference to the end outcome for various investments. The way returns are distributed to investors can also affect outcomes.

Interest rate securities, along with shares and property, comprise one of the three major asset classes available to investors in Australia.

Figure 1: Investment returns for the twenty years to December 2010



**Source: Long Term Investing - ASX and Russell Investments June 2011*
Please note: Past performance is no indication of future performance.

2.5 DIFFERENCE BETWEEN SHARES AND INTEREST RATE SECURITIES

When companies wish to raise capital for expansion or to fund their operations, they can either raise equity capital or debt capital. Equity capital is usually raised through the issue of shares often from existing shareholders through a rights issue. Debt capital, on the other hand, can be secured through loans from a bank, issuing debt into the wholesale debt (over-the-counter) markets and more recently, by issuing interest rate securities that are listed and trade on the ASX.

The essential differences between an interest rate security and ordinary shares can be broadly characterised along the following lines:

- The cash flows paid by the security;
- The term or life of the security; and
- The right to claim against the assets of the company in case of insolvency.

A fixed income security often represents the debt of the issuing company. (This is why fixed income securities are also referred to as bonds and the holder as a bondholder.) In return for lending money to the company, the company agrees to pay a contractually defined interest rate for the life of the security and the return of capital on a specified date. In other words, these securities are simply an IOU issued between the company and the investor.

This is in contrast to a dividend paid by a company, which is at the discretion of the company in terms of the timing and amount. (A company has no obligation to pay a dividend.)

Secondly, fixed income securities represent the borrowing of funds for a specified period of time as the Issuer agrees to repay the debt at an agreed maturity date. With shares on the other hand, once issued, they are perpetual with no obligation to repay the initial capital.

Finally, in the event of insolvency and liquidation of an Issuer, bondholders have first claim against the assets of the company. Equity holders, or shareholders rank below the debt holders of the borrowing company, and have a right to the residual cash from the sale of the company's assets only after all other creditors have been repaid the money owed.

Equity holders are the owners of a company and therefore as owners have additional rights including voting rights that can be exercised on various company decisions, including the appointment of directors. The value of the equity can increase or decrease, depending on the prospects for the company, decisions made by the management of the company and general economic conditions in the markets in which they operate.

In summary, debt holders tend to carry less risk than shareholders, and will therefore generally expect a lower return given:

- Debt holders have a priority claim on the company's assets;
- Debt holders returns are more predictable and the repayment of capital is likely at a specified maturity date; and
- Shares are a perpetual security and the price will fluctuate in line with the general markets and the overall profitability of the company.

Figure 2: Characteristics of Fixed Income and Equity Securities

	Fixed Income	Equity
Return	Fixed	Variable
Life	Fixed	Indefinite
Security	First	Residual

3.0 SHORT-TERM INVESTING

- CASH
- BANK BILLS
- TREASURY NOTES
- BANK TERM DEPOSITS
- ASX DEBT SECURITIES
- SHORT-DATED BONDS

CASH

At a practical level, investors own cash investments to pay for their daily or monthly expenses. Cash is also a relatively safe investment - investors won't make money - it has a zero expected return, but they won't lose it either - it has near certainty around the expected return.

SHORT-TERM MONEY MARKET

The short-term money market involves investing and borrowing of money and trading of securities that mature from within one day through to 6 months (some types of deposits can have a maturity of up to 1 year).

The common characteristics of these securities are:

- They mature at par at a fixed future date, known as the maturity date;
- Only one payment is made to investors at maturity;
- Their price is determined by prevailing interest rates;
- The maturity term ranges from one day to one year.

Investors purchase short-term money market instruments for four major reasons:

- To earn the highest possible return on the cash component for their portfolio;
- To invest funds where cyclical timing differences exist between the receipt of funds and the use of funds;
- To employ cash in the most profitable way, pending longer term investment strategies;
- To keep low risk liquid reserves on hand in case of unexpected payment requirements.

BANK BILLS AND TREASURY NOTES

A bank accepted bill of exchange (bank bill) is a negotiable instrument that is issued at a discount to its face value. A bank's name appears as the acceptor on the bill which means the bank is liable to pay the amount of money due on the bill's maturity to the holder of the bill.

The market views these securities as first class credit, so they trade at the lowest yields. The 90-day bank bill rate is the primary benchmark rate for the Australian money market.

The Federal Government, through the Reserve Bank of Australia (RBA), issues treasury notes. They have terms of maturity of 5, 13 and 26 weeks on issuance. Treasury notes are also sold on a discount to face value basis.

How to buy bank bills or treasury notes

Bell Potter can purchase bank bill and treasury notes on the client's behalf in the wholesale secondary market. Minimum amounts are typically in the order of $25,000.

BANK TERM DEPOSITS

Investors looking to receive a steady stream of income often consider bank term deposits. Purchased over the counter from authorised deposit-taking institutions (ADI's) term deposits offer a guaranteed* rate of return for a nominated term. The money can only be withdrawn after the term has ended or by giving a predetermined number of days notice. Term deposits can be subject to bank fees and other charges especially if the investment is accessed prior to the end of term.

* In October 2008, the Australian Government introduced a Guarantee Scheme under which all deposit balances under $1 million per customer per institution were

protected by the government. The Guarantee Scheme enhanced depositor protection and is intended to be a permanent feature of the Australian financial system. Deposits with an Australian ADI covered by the Guarantee Scheme can be considered as virtually risk free.

How to purchase a term-deposit

Visit your nearest bank or credit union to discuss applicable interest rates for nominated loan terms, or speak to your Bell Potter adviser to discuss your options.

ASX DEBT SECURITIES

Investors seeking to increase the earning potential on the fixed income portion of their portfolio may also consider ASX debt securities.

ASX debt securities are the result of an ASX listed company raising funds for its capital requirements. The company typically offers securities through an initial public offering (IPO) and these will then trade on the secondary market; the ASX.

ASX debt securities are similar to term deposits in that there are regular interest payments and a fixed term when the company is obligated to redeem the debt for cash, however, they can be bought or sold on the market at any time. This will affect potential capital gain or loss if sold prior to maturity.

Just as you would instruct your broker to buy shares, you can instruct them to buy or sell ASX debt securities.

Generally, as with buying a share on market, there is a minimum amount of $500 you can invest but the usual transaction value recommended by brokers is $5,000 or greater.

How to buy ASX debt securities

Your Bell Potter adviser can purchase or sell ASX debt securities for you.

More information about ASX debt securities is given in Section 4.0 Long Term Investing.

SHORT-DATED BONDS

Bonds or debt securities can be simply described as an IOU where the issuer - either government or non-government - guarantees to pay the holder a regular distribution (interest) at specific periods until maturity. On the maturity date the holder will receive the original face value of their capital investment. Short dated bonds will typically have a term of 5 years or less.

Bond transactions take place in exchanges, trading rooms, and electronic networks around the globe by firms, banks, and brokers - including Bell Potter Securities Limited.

How to buy short-dated bonds

Bell Potter can purchase bonds on a client's behalf in the wholesale secondary market. Minimum amounts are typically in the order of $25,000.

More information about bonds is given in Section 4.0 Long Term Investing.

Table 3: Comparing bank term deposits with ASX listed debt securities.

FEATURE	BANK TERM DEPOSITS	ASX DEBIT SECURITIES
Interest rate return	Typically lower than ASX debt security	Typically higher than term deposits
Access to funds	Typically locked in for the term of the deposit, with penalties for early withdrawal	Able to access at any time by selling on the ASX market
Size of investment and rate	A lower rate typically applies for smaller dollar amounts	The market sets a market price - no matter what the size of the investment

4.0 LONG-TERM INVESTING

- FIXED INCOME INVESTMENT IN AUSTRALIA

- GOVERNMENT BONDS
  - COMMONWEALTH BONDS
  - STATE AND SEMI GOVERNMENT BONDS

- CORPORATE BONDS
  - ASX LISTED DEBT SECURITIES
  - WHOLESALE CORPORATE BONDS

- HYBRID SECURITIES
  - ASX LISTED HYBRID SECURITIES

4.0 FIXED INCOME INVESTMENT IN AUSTRALIA

The Australian bond or debt market is a highly liquid, transparent market that allows borrowers to raise new capital and investors to receive a safe and reliable income distribution over the life of their investment.

The Australian fixed income market comprises a wide range of securities issued by various borrowers including: the Commonwealth Government, the central borrowing authorities of the State and Territory Governments and major Australian corporations.

Investors with a general timeframe of 12 months or more can choose from a range of investment options.

4.1 GOVERNMENT BONDS

4.1.1 COMMONWEALTH BONDS

The Commonwealth Government, through the Reserve Bank of Australia (RBA), offers a variety of fixed interest securities including vanilla bonds, inflation-indexed linked bonds *(see Appendix 5.0)* and short-term treasury notes. All bond issues are Australian Dollar-denominated securities and are unconditionally guaranteed by the Commonwealth therefore, have the highest possible sovereign credit ratings from the ratings agencies.

The Reserve Bank of Australia debt portfolio comprises over 85% fixed rate debt securities with the remainder evenly split between inflation-indexed bonds and shorter dated treasury notes.

The RBA's focus in recent years has been on issuing lines of benchmark bonds ensuring that the market has liquidity.

The amount of bonds issued in Australia is dependent upon the prevailing economic conditions. A decade of Federal Government surpluses during the late 1990s - mid 2000s led the Commonwealth bond market to fall to a nominal size.

GOVERNMENT BONDS

However, with the aggressive fiscal stimulus spending in response to the Global Financial Crisis (GFC), the Commonwealth moved into substantial budget deficit, requiring a sharp increase in bond issuance. The net issuance of Commonwealth Government bonds in 2011-12 is expected to be about $37 billion, and the total outstanding is forecast to reach a peak of $198 billion at end-June 2012[1].

How to buy Commonwealth Bonds

Individuals can purchase Treasury Fixed Coupon Bonds and Treasury Capital Indexed Bonds. Your Bell Potter adviser can discuss your requirements and make the appropriate arrangements.

4.1.2 STATE AND SEMI-GOVERNMENT BONDS

Securities issued by the central borrowing authorities of the State and Territory Governments are known as semi-government securities. The semi-government securities market is highly liquid and also a very actively traded sector of Australia's capital market. In addition, as with Commonwealth bonds, state government bonds are exempt from Interest Withholding Tax (IWT) providing an opportunity for offshore investors to participate.

Figure 3: Australian Commonwealth and State Credit Ratings as at June 2011

Ratings	S&P	Moody's	Fitch
Australia	AAA	Aaa	AAA
NSW	AAA	Aaa	AAA
QLD	AA+	Aa1	AA+
VIC	AAA	Aaa	AAA
WA	AAA	Aaa	AAA
SA	AAA	Aaa	AAA

Source: Bloomberg, Bell Potter Research

1 Australian Office of Financial Management, Operational Notice No. 3/2011

State Government / Commonwealth Margin

A State Government security carries additional risk above a Commonwealth bond, as the debt is guaranteed by the issuing State Government rather than the Commonwealth. The difference in risk is known as the trading margin and is determined by the relative credit rating, economic fundamentals, supply/demand and other factors relating to each state, as well as the liquidity of the market as a whole. Theoretically, the Commonwealth government has less possibility of default than a state government, and therefore, the yield on a comparative duration issue will be slightly lower.

Prior to the financial crisis, semi-government bonds usually traded around 20-30bps over CGS. However, during the GFC, spreads widened making it more expensive for the states to raise debt. However, with the aid of the Commonwealth Government's Guarantee Scheme, state government bond spreads have narrowed.

How to purchase State Government Bonds

Conditions and requirement of State Government bonds vary between states. Your Bell Potter adviser can discuss your requirements and make the appropriate arrangements.

CORPORATE BONDS

4.2 CORPORATE BONDS

The largest component of the Australian fixed income market is the non-government bond segment that includes bank and financial corporation issuance, non-financial corporation issuance, asset-backed and non-resident issuance - for our purposes we refer to this as the corporate, or non-government bond market. This section comprises 55% of the total market, more than the Commonwealth and State Government bond markets combined.

Corporate debt securities have historically traded in the over-the-counter wholesale market, however, with changes to the regulations by ASIC, corporate debt is now also traded on the ASX.

For more information about changes to corporate regulations see Appendix 5.0.

Corporate bonds can either be purchased through:

1. An Initial Public Offer (IPO) or primary issue
2. The ASX, the secondary market issue
3. The wholesale, or over-the-counter, bond market

What are vanilla bonds?

Vanilla bonds, or plain bonds, have a fixed maturity and coupon rate meaning that cash flows are known throughout the life of the bond and the face value is repaid at a fixed date in the future.

4.2.1 ASX LISTED DEBT SECURITIES

- PLAIN BONDS
- FLOATING RATE NOTES
- PERPETUAL NOTES

Debt securities listed on the ASX include plain or vanilla bonds, floating rate notes and perpetuals. Bonds can either be secured, unsecured or subordinated. Listing on the Australian Securities Exchange (ASX) has the benefit of providing a visible and liquid market for all investors:

- Institutions may provide depth to the market;
- Listing provides a wider distribution of investors outside traditional sources;
- Offers retail clients the ability to buy and sell secure investments; and
- Listing may satisfy the growing demand for fixed income securities from retail clients.

The distinct advantage of ASX listing allows holders of these securities to be able to redeem their holdings at the market rate.

Unlike a bank term deposit where there are considerable break fees charged by the banks, ASX listing ensures that holders will receive a fair market value for their securities.

Figure 4: A Comparison of Different Types of ASX Listed Debt Securities

	Retail Bank Bonds	Senior Bonds	Subordinated Notes
EXAMPLES	▪ CBA Retail Bonds ▪ Bendigo Retail Bonds	▪ Tabcorp Bonds	▪ AMP Notes ▪ Primary Healthcare ▪ Australian Unity
RATIONALE	Diversify funding sources	Diversify funding sources and extend maturity profile	Refinance regulatory capital
PROS	Cash distribution Senior ranking Capital preservation No equity risk	Fixed maturity (5 years) with no risk of extension No deferral on interest Cash (no franking) Ranks as senior No equity risk	Fixed maturity Cumulative interest Cash (no franking)
CONS	Not protected by Government Guarantee Scheme	Liquidity in aftermarket may be poor	Subordinated ranking (below senior debt) 10-year maturity with step-up at year 5 Interest can be deferred

Advantages of ASX Listed Debt Securities

- Regular interest payments. As corporate bonds are debt securities, interest payments must be paid ahead of dividend distributions.
- Fixed-term investment. Debt securities have a fixed term when the company is obligated to redeem the debt for cash at par value, generally $100.00
- ASX listing offers holders the ability to trade bonds providing liquidity. This may result in capital gains or potential capital losses dependent on market conditions at the time.
- The ASX market allows holders to assess the value of their investment at any given time.
- Potential capital gains if sold prior to maturity. Capital gains may result from positive interest rate movements, credit margins contracting and improved financial health of the issuer.
- Structure of the bond may allow holder to participate in the potential upside of the company's ordinary shares. This is done through a long dated implied call option built into the structure of the issue.
- Access to funds is quick-settlement of trades T+3 days.

Disadvantages of ASX Listed Debt Securities

- Varying liquidity.
- Potential capital losses if sold prior to maturity resulting from adverse credit conditions or interest rate movements.
- Structure of the issue needs to be assessed. Listed corporate bonds may be subordinated which means that the corporate bond is unsecured and in default, holders rank equally with unsecured creditors but ahead of ordinary shareholders.

How do I buy listed debt securities through an Initial Public Offer?

Most retail investors are able to buy corporate bonds through a public offering (IPO). The debt issuing company will provide a prospectus that will explain the key features and risks of the investment. It's the prospectus that provides all the details of the capital raising including;

- Comprehensive explanation of the key features and risks of the investment
- Details of the timing and structure of the interest rate payments (i.e. coupon payments may have a fixed or floating) and conditions governing the payments
- The maturity date or conversion date of the bonds
- Other information that will enable investors to assess the risks including profitability of the issuer, acquisition events, tax effects or insolvency issues.
- A prospectus must be lodged with ASIC before the company can raise money from investors.

If you are interested in participating in debt security new issues please speak to your Bell Potter adviser who can discuss your needs and let you know if there are any relevant upcoming issues to suit your requirements.

How do I buy ASX listed debt securities through the ASX ?

Trading of listed corporate bonds is identical to that of an ordinary share. The ASX offers holders the ability to trade their securities before the redemption date. This offers liquidity for these securities that may be advantageous compared to other types of fixed income assets such as a bank term deposit that may only be redeemed through the issuer and generally at a significant penalty.

The ASX not only provides liquidity to facilitate the buying and selling of these securities. Listed companies must also give information relating to their bonds to the ASX as part of their disclosure obligations.

If you are interested in purchasing a listed debt security please speak to your Bell Potter adviser who can provide you with leading market research and discuss your needs and requirements.

4.2.2 WHOLESALE CORPORATE BONDS

Bonds or debt securities can be simply described as an IOU where the Issuer guarantees to pay the holder a regular distribution (interest) at specific periods until maturity. On the maturity date the holder will receive the original face value of their capital investment. These are plain or vanilla bonds with no unusual features.

In the case of corporate bonds, debt is raised by an entity to assist in running its operations and usually forms part of its balance sheet to underpin the running of its business.

The secondary market for bonds encompasses all of the exchanges, trading rooms, and electronic networks where these transactions take place - this is known as the over-the-counter (OTC) market where trading takes place by institutional investors. The OTC market is comprised of securities firms, banks, and brokers; including Bell Potter Securities Limited.

Bonds in Australia are traded on the basis of yield to maturity, unlike most international markets and the ASX listed debt and hybrid market that trade to a price.

Bonds usually pay a coupon semi-annually, and generally go ex-interest 7 days prior to the coupon payment.

Foreign investors are now no longer liable to pay withholding tax (IWT) on interest payments for Corporate, State and Federal Government bonds.

To find out about the calculations used to value and price bonds, the RBA has a publication titled "Treasury Bond Information memo 18 December 2009."

How to buy wholesale corporate bonds

Bell Potter can purchase bonds on a client's behalf in the wholesale secondary market. Minimum amounts are typically in the order of $100,000.

Understanding Corporate Bonds and Risk

Corporate Bonds are higher risk assets than Government Bonds, and can be broken down into 3 categories of debt:

- Secured;
- Unsecured; and
- Subordinated.

SENIOR OR SECURED DEBT

Senior or secured debt issues rank above any debt security issued by a company as the debt is secured against collateral provided by the borrower. In the event that the borrower defaults, the holder of a secured bond can take possession of the asset that was provided as collateral. Typically, the security will be in the form of property, physical assets, cash and receivables owned by the issuer. Secured bonds typically rank equally with existing bank facilities and other senior debt obligations of the Issuer.

UNSECURED DEBT

Unsecured debt refers to debt where no underlying collateral has been provided by the borrower. In the event that the borrower defaults, the repayment of the unsecured debt will depend on the assets remaining after the obligations to various secured creditors have been met. It ranks equally with all unsecured and unsubordinated obligations of the Issuer (other than obligations mandatorily preferred by law) in relation to interest payments and the repayment of the issue price, and given its debt characteristics, it continues to rank above equity.

SUBORDINATED DEBT

Subordinated debt ranks behind senior debt, and generally behind senior unsecured debt as well, but above hybrid equity and ordinary equity. In essence, the creditor is subordinated to other higher debt obligations that have a higher claim on an asset.

Australian banks issue subordinated debt in the wholesale debt capital markets. The structure of issues offered by Australian banks usually carry a maturity structure called a "10 non-call 5" with a coupon structure type of a "fixed-to-floating". This means that after the initial 5 year fixed coupon period has passed, the Issuer, at its option, can continue the security for another 5 years but at a floating rate, offering a margin significantly higher than the current market rate.

HYBRID SECURITIES

4.3 HYBRID SECURITIES

4.3.1 ASX LISTED HYBRID SECURITIES

The ASX listed hybrid securities market offers investors a fixed income style of security that has the potential to increase yield albeit with a slightly increased risk than a traditional bank term deposit or government bond.

Hybrid securities are a complex capital instrument that combines characteristics of interest rate securities and equity capital. Hybrids may incorporate a more debt like bias or have more equity like features depending on the needs of the issuing company. These differing characteristics will have an impact on the performance of the instrument over the life of the security.

Hybrid securities differ from traditional interest rate securities as, unlike debt securities, a hybrid has both interest bearing and equity characteristic. Hybrids that are listed on the ASX may form part of a fixed income portfolio depending upon the risk criteria of the investor. Every ASX listed hybrid has its own unique characteristics and the details are outlined in the original prospectus.

In most cases, a hybrid will rank above ordinary equity and provide a regular cash flow (like fixed income). However, unlike senior debt securities, the income from hybrid securities may be withdrawn or deferred at the issuer's discretion and the hybrid instrument ranks below senior debt securities in the capital structure of the issuing company. Hybrids also contain equity characteristics by offering an option to convert the hybrid into an underlying equity when a particular event occurs (e.g. at maturity or following a change of control).

HYBRID PERFORMANCE

Bell Potter tracks the performance of the hybrid sector through its own specialist indices - the Bell Potter Industrial Hybrids Index and the Bell Potter Bank Hybrids Index.

Over a 3 and 5 year period industrial hybrids have outperformed both the All Ordinaries and ASX 200 Industrials on a cumulative basis as shown in the table below with lower volatility.

Bank hybrids have also significantly outperformed the All Ordinaries and ASX 200 Financials indices over a 5 year period as shown in the table below.

KEY FEATURES OF ASX LISTED HYBRIDS

- Hybrids pay a predetermined distribution (either fixed or floating) at regular intervals, so the investor has a known cash flow;
- At the conversion date, holders may have a number of options including converting the securities into the underlying ordinary shares of the issuer or receiving the repayment of the original capital at par value;
- Hybrid securities have a wide variety of maturities and structures across the risk spectrum allowing for diversification of term and risk;
- Hybrids generally offer higher returns than more senior securities due to their position in the capital structure of the company; and
- Distributions paid may offer franking credits.

Table 4: Performance of ASX listed Hybrids (Industrial and Bank) versus All Ordinaries and ASX 200 Acc Indices as at 31 July 2011

Accumulation Index Performance	Index	1 month	3 months	6 months	1 year	3 years	5 years
All Ords Acc Index	32,957.33	-3.4%	-7.5%	-5.4%	4.0%	0.4%	2.2%
ASX 200 Industrials Acc Index	26,335.31	-0.7%	-2.4%	-4.6%	6.6%	-5.3%	-3.6%
Bell Potter Industrial Hybrids	119.60	0.3%	-4.3%	-0.6%	8.7%	4.8%	2.8%

Accumulation Index Performance	Index	1 month	3 months	6 months	1 year	3 years	5 years
All Ords Acc Index	32,957.33	-3.4%	-7.5%	-5.4%	4.0%	0.4%	2.2%
ASX 200 Financials Acc Index[1]	38,161.87	-6.2%	-11.1%	-7.2%	-2.7%	4.8%	0.3%
Bell Potter Bank Hybrids	125.56	0.5%	0.0%	0.9%	7.3%	5.4%	3.9%

[1] The ASX 200 Financials Index is ex-Property Trusts

Note: performance for years 3 and 5 is annualised, past performance is no indication of future performance.

ADVANTAGES

- Offer a wide range of issuers, maturities and structures ensuring that investors are able to construct a diversified portfolio;
- Generally offer higher returns than senior debt of the issuing company reflecting the higher associated risks of the securities;
- Potential tax benefits through fully franked distributions;
- Opportunity to participate in the company through the share conversion option;
- Hybrids rank ahead of ordinary shareholders; and
- ASX listing provides liquidity, full company reporting and disclosures.

DISADVANTAGES

- Higher risk than debt issues but ranks higher than equity;
- Conversion/Redemption options that may not be favorable to holders;
- Adverse interest rate movements, floating rate payments means that income will decrease if interest rates fall;
- Credit spread risk;
- Perpetual in that they may only be redeemed either at the issuer's option or if certain conditions have been satisfied; and
- Varying liquidity although ASX listed

RISKS ASSOCIATED WITH ASX LISTED HYBRIDS

The main risks associated with holding hybrid investments are:

- Credit risk: The risk that the issuer may not be able to pay its obligations (distributions or capital) at the due date. Hybrid investors rank ahead of ordinary shareholders in the capital structure of the company. The higher the credit risk, the greater the required return. Investors need to assess their risk tolerance before purchasing any security including hybrids;
- Interest rate risk: this is the risk to the market value of the securities due to changes to the interest rate cycle. A fixed rate interest security will typically appreciate in capital value if interest rates fall and depreciate in value in a rising interest rate environment. Investors may mitigate this risk by purchasing floating rate notes (FRN's) in a rising interest rate environment;
- Margin risk: All fixed income securities trade at a margin above "risk-free" assets (Commonwealth Government Bonds.) The margin received over the risk-free rate is dependent on many factors including general economic conditions, the balance sheet and solvency of the issuer. The higher the margin the greater the risk associated with the investment;
- Liquidity risk: this is the risk that you will not be able to sell your bonds when you want at the price you want as there may not be sufficient buyers; and
- Early redemption risk: This is the risk associated with early redemption that may be due to changes in interest rates, potential take-over, listing of the parent company or default.

How to buy hybrid securities

Bell Potter has market leading research in the hybrid sector. As every ASX listed hybrid has its own unique characteristics, we recommend that before entering this market, investors consult with their Bell Potter adviser.

The hybrid securities market offers investors a fixed income style of security that has the potential to increase yield, albeit with a slightly increased risk than a traditional bank term deposit or government bond.

TYPES OF HYBRID SECURITIES

- INCOME SECURITIES - PERPETUAL FLOATING RATE NOTES
- CONVERTIBLE PREFERENCE SHARES
- RESET PREFERENCE SHARES
- STEP-UP PREFERENCE SHARES
- MANDATORY CONVERTIBLE PREFERENCE SHARES

Income Securities-Perpetual Floating Rate Notes

Income securities are a perpetual debt obligation of the Issuer. They comprise two components: a fully paid debt security of $100 and an unpaid preference share. These two components are "stapled" together to form the Note. The Note will form part of the shareholder equity base of the Issuer and, like shares, distributions are declared out of profits.

Income securities are perpetual debt obligations, with no specified maturity date. Investors generally have no right to require the Issuer to redeem or repay their investment.

Convertible Preference Shares

Convertible preference shares are preferred shares that on a specified date, convert into a number of ordinary shares based on a predetermined ratio. There is generally no cash option available and holders have no rights other than receiving the equity conversion. The value of the Convertible Preference Share will therefore reflect to some extent the value of the underlying ordinary shares in the lead up to conversion. Before the conversion date, the issue is ranked as preferred equity, and the holder receives a predetermined and regular rate of return, which ranks ahead of ordinary shareholders.

Reset Preference Shares

Reset Preference Shares (RPS) are regarded as an unsecured note for the purposes of section 283BH of the Corporations Act, and are a limited recourse debt obligation of the Issuer, secured over the portfolio for the benefit of the RPS holders.

These securities are perpetual unless, on the Reset Date, they are converted or exchanged by the Issuer. RPS holders have the right to request redemption at each reset date and the Issuer will determine whether it will offer to:

- Redeem for a cash amount equal to the redemption value;
- Convert into ordinary shares of the issuing company; or
- Arrange for a third party to acquire the RPS for the redemption value plus any accrued income.

Step-Up Preference Shares

Preference shares are fully paid equity capital of the issuing company. Preference shares are perpetual and are entitled to receive preferred (over ordinary equity), non-cumulative, distributions subject to a payments test.

On the step-up date, the issuer may either convert the security into ordinary shares or offer cash at the redemption value. If however, the Issuer does not do this and instead decides to continue with the issue, then holders are entitled to receive a one time step-up in the Margin.

Holders cannot ask the issuer to offer redemption in either form.

Mandatory Convertible Preference Shares

This style of security ranks as preferred equity. It ensures that the issuer must convert the security into ordinary shares or redeem for cash on a specified date, but only if certain mandatory conversion conditions are met.

If the mandatory conversion conditions have not been satisfied, the issuer at its option, may seek redemption for cash, however, it is generally expected that the issue will continue until the mandatory conversion conditions have been satisfied at a subsequent review period.

Banks to qualify as non-innovative Tier 1 capital have issued Mandatory Convertible Preference Shares (CPS). APRA has imposed restrictions on the banks that the CPS has a maximum conversion number in order to limit the dilution of ordinary shares upon conversion.

If the Mandatory conversion conditions are not satisfied, the issue will not be converted until the conditions have been satisfied. The Mandatory conversion conditions are tested on each subsequent distribution period.

The issuer does have to apply to APRA should they require cash conversion.

Bank issued Mandatory Convertible Preference shares -Basel III changes

As a response to the Global Financial Crisis, the Basel Committee on Banking Supervision has published Basel III, a new global regulatory framework for more resilient banks and banking system.

The Basel III framework introduces a number of changes affecting the eligibility of capital instruments, including stricter criteria for eligible Tier1 capital instruments.

Key changes for bank hybrid issues

The new issues of hybrid securities will have to meet "Additional Tier 1" capital requirements.

Changes that have been introduced under Basel III;

- Prohibition on the inclusion of step-ups or other provisions which act as incentives to redeem for all forms of Additional Tier1 Capital
- Exclusion of stapled securities
- Requirement that eligible Additional Tier 1 Capital instruments must include a provision that they will convert to ordinary shares of the issuer if the Level 2 group's Common Equity Tier 1 ratio falls below 5.125%
- Application of criteria governing conversion of all forms of eligible Additional Tier 1 Capital instruments into ordinary shares
- Exclusion of instruments issued through a special purpose vehicle

Mandatory "Additional Tier1" Convertible Preference Shares

The new style of bank hybrids will be more "equity like" rather than "debt like", meaning that investors will be taking on additional risk and therefore will be receiving an additional risk premium.

Investors will receive a slightly higher yield for taking on "additional risk", as the issue will have equity like features including the distributions being fully franked and equity conversion.

A new hybrid security issued by an Australian bank or ADI will be an attractive alternative to a bank term deposit. The risk, theoretically, has more to do with the conversion into the issuer's ordinary equity rather than a cash conversion alternative. Conversion is possible before redemption if the Common Equity Tier 1 ratio falls below 5.125%

Convertible Bonds or Notes

A convertible bond or note is a type of fixed income security that has more equity traits than a traditional debt issue. A convertible bond has a feature

Figure 5: A Comparison of Different Types of ASX Listed Hybrid Securities

	Step - Up Hybrid	Convertible Preference Shares
EXAMPLES	▪ Goodman PLUS ▪ Dexus RENTS ▪ Seven TELYS4	▪ Westpac SPS ▪ ANZ CPS ▪ CBA PERLS IV/V
RATIONALE	Issued to achieve diverse objectives including rating, tax and accounting	Strengthen regulatory capital and reduce after-tax cost of funding
PROS	At the time the securities were offered the return was attractive and the pereceived risk was low	Bank credit/good names Conversion creates liquidity event
CONS	No fixed maturity - perpetual with a step-up at year 5 Preferred ranking (only just above ordinary shares) Dividends can be deferred Complex structure to achieve objectives	Extension risk if share prices falls Dividends subject to available profits Conversion into shares, not a cash liquidity event Preferred ranking

that allows the investor the ability to convert into ordinary share of the issuing company at any time up to the predetermined maturity or redemption date at a specified price.

The key features of a convertible bond include:

- Payment of a regular distribution of income;
- Holder has the option to convert into equity at the holders discretion;
- Holders of convertible bonds are able to participate in the upside share growth of the issuing company; and
- Repayment of principle at maturity if not converted.

Convertible bonds provide companies, typically unrated, the ability to access a relatively cheap source of funding. These securities are popular with both investors and issuers.

Factors affecting general interest rates.

Generally, when you buy a fixed income security you lock in the yield and your return on investment by holding it to maturity. However, if interest rates look set to rise in the meantime, you may decide to switch from fixed rate to a floating rate security in order to capture the upside in interest rates. In order to make such a decision there are several main factors that influence interest rates including:

- Inflation
- Gross Domestic Product
- Balance of payments
- Borrowing and lending in Australia
- Overseas economic factors, and
- Government policy

5.0 APPENDIX

REGULATORY BODIES

The main independent regulatory bodies overseeing financial markets in Australia are the:

- Reserve Bank of Australia (RBA);
- Australian Prudential Regulatory Authority (APRA); and
- Australian Securities and Investment Commission (ASIC).

The Role of the RBA

The major roles of the Reserve Bank of Australia (RBA) are to conduct monetary policy and to maintain a stable and strong financial system. The Bank's key aims are to ensure the stability of the Australian currency, the economic prosperity and welfare of people in Australia, and to work towards full employment. In seeking to meet these objectives since the early 1990 s, the Bank has adopted an explicit core CPI inflation target of 2-3% over the course of the cycle.

The Reserve Bank Board meets on the first Tuesday of every month (except January) to decide on the appropriate stance of monetary policy. The Board communicates its policy decisions via a post-meeting statement by the Reserve Bank's Governor. The Reserve Bank also publishes a quarterly Monetary Policy Statement, and senior staff members also regularly communicate their views.

The Bank's previous role of prudential regulation of the banking system was transferred to the Australian Prudential Regulatory Authority (APRA), established 1 July 1998, along with regulation of all other financial institutions.

The Role of the APRA

The Australian Prudential Regulation Authority (APRA) is the prudential regulator of the Australian financial services industry. It establishes and enforces prudential standards and practices. It oversees the banks, credit unions, building societies, general insurance and reinsurance companies, life insurance, friendly societies, and most members of the superannuation industry.

APRA is also responsible for reviewing and co-ordinating changes to the regulatory structure of the banking system, particularly with regards to the bank capital, liquidity and funding requirements stemming from Basel III.

APRA is funded largely by the industries that it supervises. It was established on 1 July 1998, and currently supervises institutions holding approximately $3.6 trillion in assets for 22 million Australian depositors, policyholders and superannuation fund members.

The Role of ASIC

The Australian Securities and Investments Commission (ASIC) is an independent government body that enforces and administers the Corporations Law and consumer protection laws for investments, life and general insurance, superannuation and banking throughout Australia.

ASIC's purpose is to reduce fraud and unfair practices in financial markets and financial products so consumers can use them confidently and companies and markets can perform effectively.

CHANGES TO CORPORATE REGULATIONS

ASIC has opened up the way for Australian companies to access fixed interest funding from the retail market. Retail investors currently have very limited exposure to corporate bonds as corporations law requires the issuance of a lengthy prospectus from a company wishing to seek funds from retail investors.

ASIC, in discussion with market participants, is supporting the listed bond market and is ensuring that retail investors understand the nature and investment risks associated with corporate bonds.

Facilitating Debt Raisings - with the Regulation

May 2010 - proposes relief from long form prospectus requirements including:

- the size of the issue is at least $50 million to maximise the prospects of a liquid secondary market (this requirement will lapse after 2 years unless ASIC renews it);
- the bonds will be publicly quoted on an exchange on issue;
- the issuer must provide certain upfront and ongoing disclosures in relation to the bonds;
- companies issuing the bonds are listed and have a good, continuous disclosure history;
- the issues must not have been suspended for more than five days over a period of 12 months;
- the bonds are vanilla, that is, they do not have complex or unusual terms of conditions;

- the bonds have a maximum term of ten years; and,
- the relief does not currently extend to the issue of subordinated debt (ASIC intends to consult further on relief for offers of subordinated bonds).

Source: ASIC Class Order (CO 10/321) dated 11/05/2010

INFLATION LINKED BOND MARKET

Inflation linked bonds are the only fixed income security that provides a direct hedge against the impact of inflation. The major issuer of inflation linked bonds until recently is the Australian Government through the Reserve Bank of Australia. Today, several state governments, major banks and infrastructure companies are issuing this style of security.

The appeal of inflation linked bonds will increase as the global economies recover and concerns of deflation give way to higher inflation. This situation is likely to occur more quickly in Australia than other OECD nations given the relatively healthier growth profile and stronger underlying inflationary pressure.

Inflation linked bonds are a good way for superannuation funds to manage their long-term liabilities and provide a hedge against inflation.

BOND PRICING

A fixed interest security consists of a series of future coupon payments, usually of equal size, and the repayment of the principal at maturity. Any formula used to put a value on these payments must rest on certain assumptions. Once these are established, the calculations required to derive a price are relatively simple.

The yield to maturity, which represents the annual rate of return of the security, is derived by solving an equation with the purchase price on one side and the present (discounted) value of the series of payments on the other. However, obtaining the calculated yield to maturity assumes that a buyer is able to reinvest all coupon interest payments at this yield. In practice, this will rarely be the case but peoples' views about re-investment rates during the life of the security being priced can influence their desired yield as calculated by the relevant formula.

The bond pricing formula implies that the value of the bond P is dependent on:

v - the cost of debt capital,

n - the remaining life of the bond

f - the number of days to the next coupon payment

d - is the number of days in a half year

g - Interest payments (semi-annual)

and the face value of the bond set at 100.

$$P = v^{f/d}\left(g\,(1 + a_{\overline{n}|}) + 100v^{n}\right)$$

Source: Reserve Bank of Australia "Pricing Formulae for Commonwealth Government Securities"

http://www.rba.gov.au/mkt-operations/tech-notes/pricing-formulae.html

6.0 GLOSSARY OF TERMS

Accrued interest

Accrued interest is the amount of interest that has been accumulated from the last coupon payment date to the settlement date when the bond has been traded.

Bank Bill swap rate (BBSW)

This is the average of the market rates supplied by domestic banks to Australian Financial Markets Association (AFMA) relating to specific maturity periods generally 30-180 days.

Bank bonds

A bank bond is a debt security that is an obligation by the issuing bank to repay a specific amount on a specified date subject to conditions. Bank debt maybe issues as senior or subordinated debt.

Basis Points

A basis point is a measure used to calculate interest returns. One basis point is 0.01%

Bond

A bond is a debt security or loan by the issuer and is an obligation by the issuer to pay a specified distribution at regularly defined intervals and to pay the principle (original loan) at maturity.

Call option

An option that gives the holder of the bond to buy a security at an agreed price up to an agreed date.

Commonwealth Government Inscribed Stock

These are debt securities that are issued and guaranteed by the Commonwealth of Australia. The Commonwealth guarantees the coupon interest payments and the return of the original capital at the maturity date.

Convertible bond

A traditional fixed income style security that gives the investor the right to convert into ordinary shares of the company at redemption.

Corporate bond

A debt obligation (bond) issued by a corporation, maybe senior secured, senior unsecured or subordinated. Senior corporate bonds are secured against company property and rank ahead of other secured creditors.

Coupon rate

This is the rate of interest or distribution paid by the issuer. The rate is usually expressed as a percentage of the face value of the security.

There are two types of coupon payments:

Floating rate: distributions are based off a short dated benchmark usually BBSW90. The payments consist of a predetermined margin plus the benchmark

Fixed rate: The coupon rate is fixed at a predetermined rate for the duration of the debt security.

Credit risk

Credit risk assessment that the issuing company may default its obligation to pay interest or principle on maturity.

Credit Spread

Credit spread is the difference in yield between 2 securities. Credit spread generally measures the degree of risk between risk free assets i.e. Commonwealth Government Securities lower rated assets including corporate bonds and hybrid securities.

Discount to Face Value

The trading price of the bond is trading less than the face or original value of the security. Generally, the Yield to Maturity (YTM) is higher than the coupon.

Face Value

Is the original or par value of the bond and is the amount that will be paid by the issuer on redemption. Generally, face value is $100.

Fixed Rate Bond

The coupon interest rate has been set at the time of issue and will remain fixed for the life of the security. Commonwealth and State Government bonds are predominately issued with a fixed coupon rate.

Floating rate note (FRN)

Floating rate note securities have two components, a fixed margin that is set at the time of maturity and the benchmark used to determine the total distribution rate. The most common benchmark is the Bank Bill swap rate (BBSW).

Liquidity

Liquidity is the degree to which an asset can be bought or sold in the market without significantly affecting the price of the 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 per cent of face value; a price of $95.60 is 95.60% of face value and a price of $102.45 is 102.45% of face value.

The 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 of maturity, ranking and credit quality.

Accrued interest-the amount of interest accumulated on a security since the last payment. A security price should increase daily by the amount of interest that has accrued.

Maturity Date

The maturity date is the date when the bond will be repaid by the issuer.

Perpetual securities

Perpetual securities offer regular periodic interest payments for an indefinite period. There is no maturity date.

Reset Date

Hybrid securities and convertible securities offer reset terms rather than offering redemption. The issuer will reset certain terms and conditions relating to the next continuation of the issue.

Running yield

Running yield is a simple calculation that expresses the interest rate return as a percentage of the capital invested. Running yield does not take into account capital accumulation of the investment.

Yield to Maturity

Yield to maturity/redemption is the actual return on an investment that the client is likely to receive if the securities are held to maturity. The yield to maturity calculation takes into account the cash flows from the interest payments received, face value, plus or minus the capital discount or premium paid for the securities at the time of purchase.

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