Australian Debt Securities and Corporate Bonds

How to add Australian Debt Securities and Corporate Bonds to a portfolio

An independent report prepared for National Australia Bank by the Australian Centre for Financial Studies.

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1. Introduction

This is the third in a series of reports on the Australian debt securities and corporate bond market, prepared by the Australian Centre for Financial Studies (ACFS) for NAB.

The first report[1] outlined key features of fixed income investments, examined the importance of corporate bonds as an asset class for investors, and discussed the reasons they should be considered as part of a diversified investment portfolio. In particular, as an investor ages, weighting investment portfolios more heavily towards fixed income investments (relative to equities) reduces the risk of suffering a major loss of value which cannot be reversed before retirement.

The second report analysed the different types of fixed income instruments available and the characteristics and risks associated with various classes of fixed income securities. A complexity spectrum was included to assist investors in understanding the technical expertise required in evaluating different types of fixed income securities. The report also highlighted the importance of understanding the ranking of various securities in the event of liquidation and that corporate bonds rank higher than equities should such an event transpire.

This third report turns to the important topic of accessing the fixed income market and the methods used to add debt securities and corporate bonds to an investment portfolio. We first consider the different methods by which companies issue fixed income securities. As explained in the next section, the manner by which debt securities are issued has an impact on the types of investors that are able to invest in those securities. We then look at the characteristics of the various secondary markets in which fixed income securities trade – through an exchange such as the Australian Securities Exchange (ASX) or through the over-the-counter (OTC) market. Again, the manner in which the securities are initially issued determines the secondary market on which they can trade. The later sections identify the various direct and intermediated methods investors can use to access debt securities and corporate bonds. A summary of the costs and benefits associated with each of these methods is also provided.

It should be noted that the optimal method of investing in corporate bonds is highly dependent on the individual characteristics of the investor. These characteristics include technical expertise, experience, total wealth and the time an investor can commit to the investment process.

1. This report can be accessed at nab.com.au/insights

2. The methods by which companies can issue debt securities and corporate bonds

There are a number of factors which must be considered by a corporation issuing corporate bonds such as costs incurred in the issuance process, the time to take the issue to market and the primary and secondary market that will be eligible for the issue.

The remainder of this section identifies the methods by which corporates can issue debt securities and the implications each method has on those factors.

2.1 Wholesale issues

Wholesale issues, as the name suggests are only available to wholesale and sophisticated investors and are completed through a book build process. A book build involves an issuing company engaging a bank who subsequently contacts their wholesale and high-net worth clients who bid for the securities. These bids are used to determine investor demand and the price for the issue. On completion of the book build process the securities are transferred to the successful bidders directly rather than through a securities exchange. In late 2012, a report by the Reserve Bank of Australia noted that more than 95 per cent of all corporate bonds are issued via a book build process and are available almost exclusively to wholesale investors.[2]

As securities issued in this manner are only available to wholesale and sophisticated investors[3] the disclosure requirements and compliance costs associated with the issue are less onerous than those for a retail issue. For example, a corporate bond offer that is accessible to retail investors must be accompanied by a full disclosure prospectus while a company issuing via a book build process is not required to prepare and release a prospectus with the issue.

Table 1: Costs and benefits of wholesale issues

Costs	Benefits
• Only available to wholesale and sophisticated investors	• Lower compliance costs
• Do not trade on a listed exchange[4]	• Generally less time taken to complete the issue
	• Available to firms who do not meet the investment grade and size requirements for retail listings

2.2 Retail issues

In contrast to a wholesale issue, retail issues can be marketed to all potential investors. This can increase both the total potential demand for the securities and the diversity in funding sources for an issuing company. However, the regulatory requirements have traditionally been seen as a sizeable barrier to retail corporate debt issuance. These requirements include the requirement to issue a full prospectus with the issue as well as for the issuing company to have an investment grade credit rating.

As mentioned, currently less than 5 per cent of all corporate bond issues are available to retail investors. However, the Australian Financial Markets Association notes that there has been an increase in retail issuance in recent years with $9.7 billion of retail debt issued in the first half of 2012.[5] One factor that has probably contributed to the recent increase in retail issues is the relaxation of issuance rules for corporate bond issues that meet specific requirements.

Table 2: Costs and benefits of retail issues

Costs	Benefits
• Generally requires full prospectus disclosure (exception applies for vanilla bonds)	• Potentially increased funding diversity
• Securities generally require an investment grade credit rating	• Potentially increased liquidity of securities
	• Available to a much greater pool of investors

2. A History of Australian Corporate Bonds, Susan Black et al.

3. A definition of sophisticated investor was provided in the second report in this series.

4. ASX does have a bulletin board listing wholesale debt issues; however, trades made in these securities must be conducted in the same manner as over-the-counter transactions.

5. AFMA annual report.

3. Understanding listed and OTC markets

Box 1: Recent initiatives to increase retail corporate bond issuance

Since 2010 ASIC has permitted companies to issue "vanilla corporate bonds" to retail investors using a transaction specific prospectus or a two-part prospectus to reduce the issuance costs.

Full disclosure prospectus: A full prospectus according to the Corporations Act must "contain all the information that investors and their professional advisers would reasonably require to make an informed assessment on". This includes all information pertaining to the issue **and** all information on the underlying company.

Transaction specific prospectus: Unlike a full prospectus, a transaction-specific prospectus does not need to contain as detailed background information on the issuing company and instead focuses on the specific characteristics of the security being issued as well as the reasons for the capital raising.

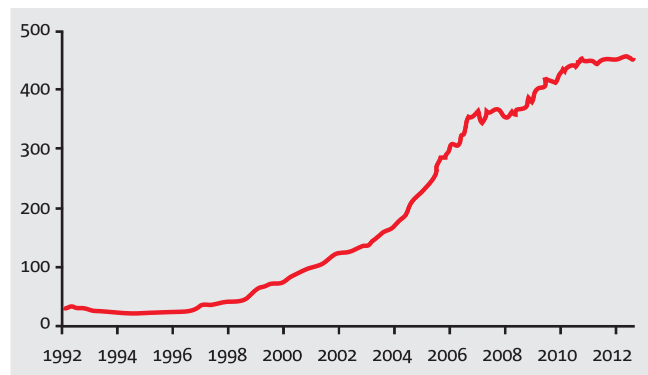
Two-part prospectus: Under this model the issuing company lodges a base prospectus which contains detailed information about the issuing company which is valid for three years. During this period the issuing company can issue corporate bonds under a transaction specific prospectus which provides key details on the specific issue.

When we think of securities markets we generally think of a central trading place like the ASX. The ASX is a listed market where prices on the most recent trades are readily available to all market participants. For the equity market, most trading occurs on listed markets with the remainder completed by specialist private equity firms. In the corporate bond world, however, listed markets make up only a small percentage of total trading and the over-the-counter (OTC) market plays a much more significant role.

Unlike listed markets, the OTC market does not have a central trading place. The OTC market is instead a network of brokers and banks that trade bilaterally with one another and also act as market makers for their clients. Due to the fragmented nature of the OTC markets, price and transaction data are not available to all participants. This means that OTC markets are generally less transparent and regulated than listed markets.

The Reserve Bank of Australia estimates the total value of long-term non-government debt securities issued in Australia to be in excess of $450 billion (Figure 1). Of this only less than 5 per cent is listed.

Figure 1: Total long-term non-government debt securities issued in Australia ($450 billion)



Source: RBA, Table D4, 2013.

3.1 The listed market

Stock markets are best known to most investors as places (once physical, now electronic) where company shares are traded. But debt securities and corporate bonds can also be listed and traded on stock exchanges – and are, although that has been a very small part of the ASX. In some overseas markets, the corporate bond component of the market is significantly bigger – although sometimes, while bonds are listed on the exchange, most trading takes place off-exchange. The Luxembourg exchange is a case in point, where many Eurobonds are listed, but most trading occurs over the counter.

As of 29th June 2013, there were less than 70 fixed income corporate securities listed on the ASX including 4 listed corporate bonds, 24 floating rate notes, 7 convertible securities and 32 hybrid securities. Six fixed income securities have been listed in 2013. (See Table 3 below.)

The requirements for listing on the ASX may provide some insight into why corporate issuers have preferred to forgo listing their debt securities. These requirements include:

- The company must be a public company limited by shares, a government borrowing authority, a public authority, or an entity approved by ASX
- The aggregate face value of a fixed income issue must be at least $10 million to be listed
- The issuing corporate must meet continuous disclosure obligations in relation to the listing
- The securities must generally receive a rating of at least investment grade by an approved credit rating agency.

In addition, some fixed income corporate debt investors (particularly retail investors) have traditionally been more inclined to buy and hold to maturity when compared to equity investors, meaning turnover in listed corporate debt securities has been much lower than that of equities.

Table 3: Corporate debt listings 2013

Company name	Date listed	Issue type	Issue price $	Total issued $
Healthscope Notes Ltd	4/04/2013	Sub Notes-HLN II	100	305,000,000
Westpac Banking Corporation	18/03/2013	Cap Notes-WBC	100	1,383,569,000
Noble Mineral Resources Ltd	4/03/2013	Convertible Notes	0.12	5,032,246
Noble Mineral Resources Ltd	4/03/2013	Convertible Notes	0.12	79,967,754
Firestone Energy Ltd	7/02/2013	Convertible Notes	1	27,145,000
Lakes Oil NL	31/01/2013	Convertible Notes	10	1,414,020
				1,802,128,020

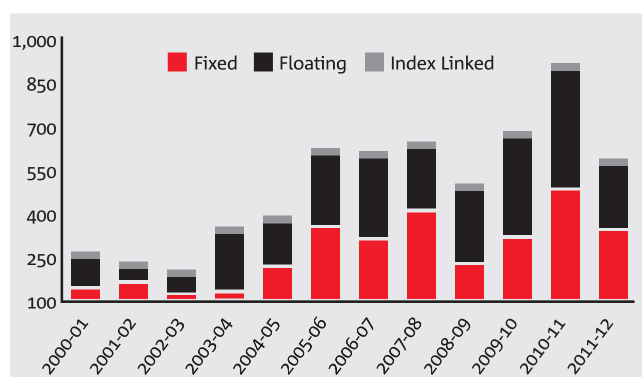
Source: Thomson Reuters, New Issues Database, Accessed 29/7/2013.

6. Accretive Asset Management *The Bond Market: Where the Customers Still Have No Yachts* http://www.accretiveasset.com/noyachts.pdf (2011). They estimate that a retail investor who bought a long term bond and sold it after one year would receive a yield of around 65 basis points lower than an institutional investor (who would have paid a lower buying price and received a higher selling price).
7. http://www.nyse.com/bonds/nysebonds/1095449059236.html

3.2 The OTC market

In contrast to equities, the majority of secondary trading in corporate bonds is done via the OTC market. As mentioned in section 2, it is estimated that more than 95 percent of all corporate bonds are issued via a book build process and subsequently traded OTC. After a rapid increase in the early 2000s total turnover in OTC corporate bonds has remained relatively unchanged at around $550 billion since 2005. (See Figure 2.)

Figure 2: OTC turnover in non-government debt securities



Source: AFMA, 2012.

In the USA, there has been a long history of significant retail investor involvement in bond markets – including corporate bonds and particularly "munis" (municipal bonds which provide tax free interest). However, even in the USA, most of the trading has been off-exchange via brokers, with limited transparency for investors on market prices, leading to concerns that retail investors may get worse prices when trading. This is the conclusion of a study by Accretive Asset Management[6] and highlights the importance of a listed market where prices are transparent. The cost of the "spreads" they calculate when retail investors buy and sell, also illustrate the benefits of a "buy and hold" strategy, rather than a frequent trading strategy. For investors wanting to trade on-exchange, the New York Stock Exchange has a bond platform.[7]

An advantage of OTC markets for issuers is that they are not subject to the same ongoing disclosure and listing requirements imposed by exchanges however there are a number of potential drawbacks for investors using OTC markets. These include the lack of transparent transaction and price information, typically less liquidity than listed markets, the necessity of creating bilateral agreements to initiative trades and the lack of anonymity when trading in the market. These drawbacks make the OTC markets primarily the domain of institutional investors who have the expertise and networks to arrange bilateral agreements and manage counterparty and liquidity risk.

4. Accessing debt securities and corporate bonds

There are various methods and vehicles investors can use to invest in debt securities and corporate bonds. As the previous sections have explained, an investor can access these securities either through participating in a new issue or through the secondary markets. Furthermore, the secondary markets can be broken up into listed and OTC markets. However, retail investors are unable to invest directly through all of the above methods and even sophisticated investors may have limited direct access to primary issues.

There are a number of services available to retail investors to increase their access to corporate bonds. These services include direct engagement with intermediaries such as brokers or indirect investment in corporate bonds through a managed vehicle such as an Exchange Traded Funds (EFT) or managed fund. The following sections provide information on the various methods by which investors can access debt securities and corporate bonds along with an outline of the various costs and benefits associated with each method.

In considering the alternative approaches there are a number of issues to bear in mind.

First, there is a risk of default on a corporate bond. That is why the promised rate of return exceeds that available on risk free assets such as bank deposits or government bonds. The expected return on a corporate bond (ie after allowing for the probability of default) will be less than the promised rate of return – but not by much for highly rated corporate issuers where there is a high probability that promises will be met. For lower rated issuers, there may be a significant gap.

Importantly, an investor is unlikely to receive the expected rate of return. Either the promise will be kept and the return will be that promised, or it won't and the return will be less (possibly zero). This uncertainty of outcomes (not particularly different from investing in shares) is something that most investors want to avoid. Apart from investing in only bonds issued by "blue chip" companies, where the probability of adverse outcomes is (perhaps) sufficiently low to be of little concern, the way to avoid such uncertainty is by diversification. With sufficient diversification, the actual return on the bond portfolio will tend to be close to the average expected return on the bonds included. There may be some adverse outcomes, but they are offset by the other bonds paying out as promised.

Second, while retail bond investors should generally think of these investments as being longer term in nature (such as holding the bond until it matures) there is always the possibility of wanting to quit the investment at some earlier time. This could arise because of a desire for cash (for expenditure or other investments), or because of concerns that the credit rating of the issuer of the bond in question may be declining and increasing the risk of default on the bond. Thus the ability to exit the investment easily and with

minimal costs is important.

A third consideration is the extent to which the investor wants to have direct control over the decision as to which bonds will be included in their portfolio. Some may prefer to select particular bonds themselves (perhaps with the assistance of a financial adviser). Others may be willing to take on the risk of investing in corporate bonds, but prefer to leave the choice about which securities up to a third party. In the latter case, investment via some form of managed fund can make sense, where the investment gives a pro-rata share of returns on the portfolio of investments of the fund.

It is important to remember while reading this section that the optimal method for any individual investor is dependent on both the characteristics of the desired investment and the characteristics of the investor.

4.1 Investing directly

Bonds can be invested in directly by making an application to an issuing company through the issue's accompanying prospectus and, for a small number of securities, via a listed market such as the ASX. However, as previously mentioned, only a very small proportion of the total corporate bond market is available to retail investors. The industry is evolving and there are now some avenues available to access parcels of less than $500,000.

There are also a number of potential barriers for sophisticated investors interested in investing directly in debt securities and corporate bonds. For example, the minimum parcel size of most OTC bonds is $500,000 making it difficult for most investors to adequately diversify their corporate bond holdings and gaining access to high quality primary issues is highly competitive and often reserved to those with strong relationships with the underwriting firm. Direct investment also requires time and skill in fixed income security evaluation. As mentioned in section 3, OTC markets are not always as transparent as listed markets and price information may not be readily available to all participants creating risks that transactions may sometimes not be at the best price available. Dealing with reputable counterparties who cannot afford to suffer reputational damage from not offering best prices is one way of ameliorating this risk.

There are advantages, however, for those that have the skill and access to effectively invest in corporate bonds directly. Direct investment in corporate bonds does not come with the added fees of many of the other modes of access. Furthermore, direct investment provides by far the most flexibility and discretion regarding individual bond selection and in the timing of purchases and sales.

4.2 Full service corporate bond brokers

As mentioned, direct investment in corporate bonds requires time, skill, the right networks and a portfolio big enough to be able to accommodate large holdings of individual assets. Full service corporate bond brokers can provide assistance in these regards.

Full service corporate bond brokers provide research support for existing and new corporate bond issues to clients. Brokers generally provide this research in exchange for an ongoing fee or in exchange for a minimum amount of brokerage commission. There are many high quality research analysts working at brokerage firms, however as with all financial advice it is worth understanding the assumptions and key risk factors associated with any buy or sell recommendation received before acting on the advice.

Another valuable service often provided by full service brokers is improved access to primary issues due to their relationships with underwriting institutions and access to international securities. The amount of access afforded to an individual broker is dependent on the broker's reputation and networks. Access to primary issues is something that should be discussed with a full service broker before engaging their services.

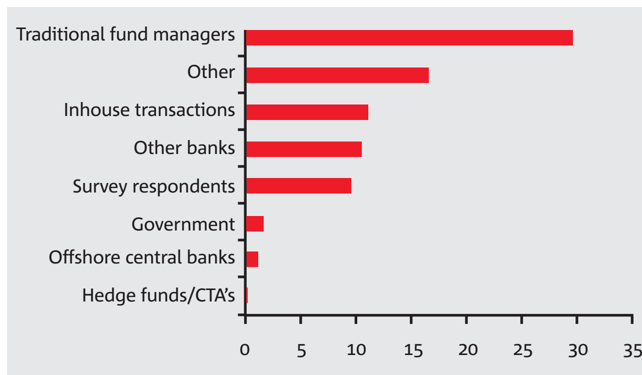
A relatively new innovation being provided by some full service brokers is allowing clients to invest in smaller packages of corporate bonds through beneficial interests in larger parcels. This allows investors with smaller portfolios greater ability to diversify their bond holdings.[8]

4.3 Managed funds

Managed funds are the most active class of investor in the Australian corporate bond market. The Australian Financial Markets Association reports that managed funds make up more than 30% of total non-government debt securities turnover (Figure 3 on next page). Managed funds are professionally managed unit trusts that invest to a mandate in a diversified portfolio of underlying securities. There are managed funds that specialise across the broad spectrum of asset classes including equities, fixed income, real estate, private equity and international securities. Managed funds provide retail investors with the ability to hold a well diversified portfolio of securities for a relatively small minimum investment; some managed funds allow a minimum investment of less than $5,000. In addition to specializing in a particular asset class, managed funds invest using a vast array of different investment styles and techniques. The broadest distinction between managed fund styles is between active management and passive management.

8. It should be noted that these smaller packages still tend to be in around $50,000 blocks.

Figure 3: Non-government debt securities turnover 2011-2012 (AUD Billion)



Source: AFMA, Yearbook 2012.

Box 2: Active vs passive

Since the advent of modern portfolio theory and Burton Malkiel's seminal work *A Random Walk Down Wall Street* there has been ongoing debate between both academics and practitioners about the value of active portfolio management.

Proponents of passive management argue that there is very little mispricing in asset prices and that most investors will do just as well holding a well diversified portfolio that replicates the market than try to actively select a portfolio of assets. A number of studies have shown[9] that after fees and trading costs, the average actively managed fund underperforms its benchmark. That is hardly surprising since before fees and transaction costs only above average investors can outperform the market.[10] Based on these arguments, passive funds are indexed to a broad benchmark and strive to minimize fees and transaction costs to closely track the market return.

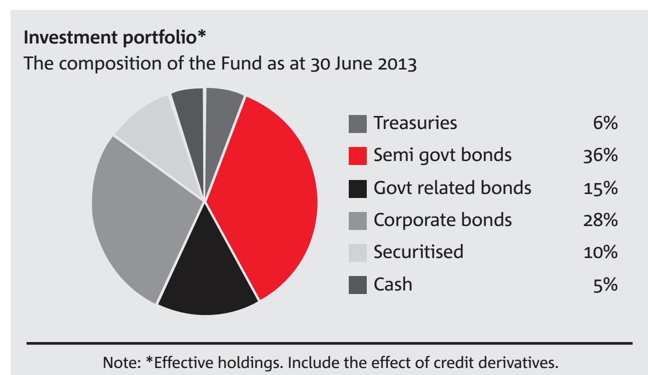
Those that argue for active portfolio management point to those investors that have consistently outperformed the benchmark like Warren Buffett and Peter Lynch. Also in support of active management is the famous Grossman and Stiglitz argument *"If the market were informationally efficient, then no one would have the incentive to acquire the information on which prices are based".*

Regardless of which side of the fence you fall on, it is indisputable that management fees, transaction costs and taxes make a significant difference to the final return and should be carefully considered when choosing a managed fund.

For investors with smaller portfolios and those without the time or expertise to manage their own corporate bond investments, managed funds provide an excellent means of accessing a diversified portfolio of both listed and non-listed corporate bonds. However, investors should also be wary of some of the drawbacks associated with using managed funds as a vehicle for investing in corporate bonds.

Currently, the greatest issue with using managed funds to invest in Australian corporate bonds is that many are investing in other fixed income securities in addition to Australian corporate bonds. This means that to gain exposure to corporate bonds through a managed fund, a retail investor will also generally have to take exposure to other fixed income securities. The asset holdings of some well known Australian bond mutual funds are provided below to illustrate this issue.

Figure 4: Sector allocations of UBS and Aberdeen Australian Fixed Income Funds



	Fund
Cash & cash equivalents	4.02
Government	27.08
Semi government	24.10
Corporate	44.80
• Supra/sovereign	17.81
• Financials	8.95
• Non-financials	12.51
• Asset-backed	5.53
• iTraxx	0.00

Source: UBS Australian Bond and Aberdeen Australian Fixed Income Fund Fact Sheets, Accessed July 2013.

9. For example refer to Luck versus Skill in the Cross-Section of Mutual Fund Returns by E Fama and K French, The Journal of Finance, Vol 65, No.5, October 2010.
10. The Arithmetic of Active Management by W Sharpe, The Financial Analysts' Journal, Vol. 47, No. 1, January/February 1991. pp. 7-9.

Another issue that investors should be wary of when investing in managed funds is the fee structure of the fund. As highlighted in Box 2: Active vs Passive, it may be possible for excellent managers to add additional value to the investment management process however it is the after fee, transaction cost and tax returns that are important to an investor in a managed fund. Therefore, an investor should require a compelling reason to invest in a managed fund with above-average fees.

The particular fees an investor in a managed fund should be wary of are the "indirect cost ratio" which is generally a percentage of the total amount invested in the fund and includes fees paid to the investment manager and operation costs for the fund and any entry or exit fees charged by the fund.[11] Entry and exit fees can improve a fund's performance through promoting longer term investment in the fund by deterring rapid trading into and out of the fund and are sometimes waved after an investment has been held in the fund for a predetermined period of time. Nevertheless, entry and exit fees can be up to 5% of the amount invested and should be carefully evaluated before committing to a fund.

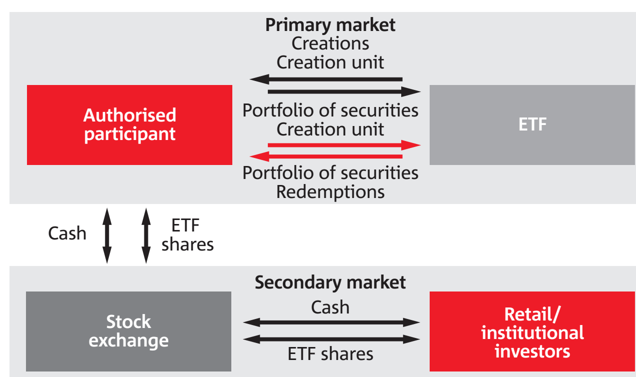
For more information on managed funds, Morningstar provides an excellent search tool for researching Australian fixed income managed funds.[12]

4.4 Exchange traded funds

Exchange traded funds (ETFs) are a relatively new financial innovation that allow investors to trade listed beneficial interests in a diversified portfolio of assets. Like managed funds, ETFs cover a broad range of asset classes. In this respect ETFs can be thought of as managed funds that can be traded via a listed market in the same manner as any other listed security.

A major difference, however, between managed funds and ETFs is the relationship between investor and security issuer. In the case of a managed fund, the investor in the security deals directly with the fund manager when buying and selling units in the fund. Investors in ETFs trade through the listed market with authorized participants such as specialist brokers and banks communicating with the ETF to ensure that the total number of ETF units available meets investor demand and that the market price of units equals the net tangible asset value of the underlying investments.[13] Figure 5 illustrates the ETF investment and creation process.

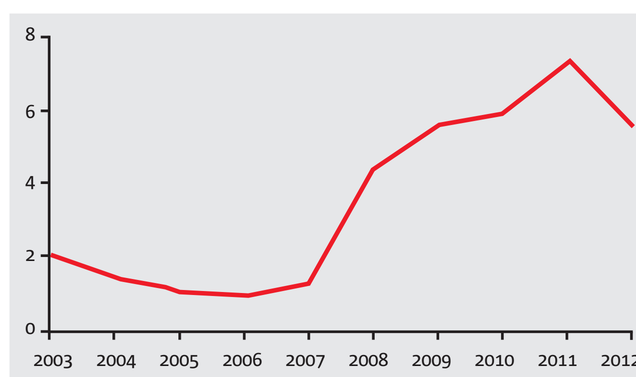
Figure 5: Understanding exchange traded funds



Source: RBA,[14] 2011.

ETFs have rapidly grown in popularity over the last decade with total turnover in Australian ETFs increasing from around $2 billion in 2003 to approximately $6 billion in 2012. (Figure 6) Some possible explanations for this increase in popularity are: the liquidity advantages[15] they hold over managed funds; trade-by-trade price information; the low minimum investment; and the (generally) lower fees than those charged by managed funds. Furthermore, unlike managed funds, the structure of ETFs can provide the individual investor with greater discretion on the timing the realization of capital gains. This is because trading in units is conducted on the secondary market rather than with the fund which generally results in lower turnover at the fund level. A further benefit is that the unit prices have very low "tracking error" – they are always close to the price of the underlying investments or index whose returns the fund seeks to replicate.[16]

Figure 6: Total turnover in Australian ETFs – equity and bonds ($ billions)



Source: World Federation of Exchanges, 2013.

11. A more detailed breakdown of the fees commonly charged by managed funds can be found on page 13 *Appendix 1: Reading a Managed Fund's Product Disclosure Statement*.
12. http://www.morningstar.com.au/Tools/FundScreener
13. It should be noted that ETFs are also quite different from closed-ended funds due to their ability to easily grow or shrink in size based on investor demand.
14. Exchange Traded Funds, http://www.rba.gov.au/publications/bulletin/2011/mar/pdf/bu-0311-8.pdf
15. Some critics have argued that ETF liquidity may suffer greatly during market crashes and periods of stress.
16. Morningstar, On The Right Track: Measuring Tracking Efficiency in ETFs (2013).

It is important to note that a major difference between managed funds and ETFs is that managed funds can be either actively managed or passively managed. Conversely, ETFs always track a specified benchmark in a similar manner to passive funds. The rather limited choice investors face when choosing a managed fund that specializes in Australian corporate bonds is even more pronounced when choosing an ETF. Currently, Morningstar only lists 3 ETFs that have exposure to Australian corporate bonds – the Russell Australian Select Corporate Bond ETF, the SPDR S&P/ASX Australian Bond Fund and the iShares UBS Composite Bond Index Fund. Of these, the only ETF that invests solely in corporate bonds is the Russell ETF.[17]

4.5 Summary

As we have highlighted, there are numerous tools and vehicles that can be utilized to gain exposure to Australian corporate bonds. The table below provides a brief summary of the pros and cons of each of the methods explored.

Investment method	Advantages	Disadvantages
Direct investment	• No fees • Discretion in choosing portfolio composition • Discretion in managing turnover	• Limited access for retail investors • Requires skill and time • Relatively high minimum investment
Broker	• Discretion in choosing portfolio composition • Discretion in managing turnover • Professional research support • Increased access • Smaller minimum investment (in some cases)	• Broker fees • Requires enough investment expertise to evaluate advice received
Managed funds	• Professionally managed • Diversified portfolio • Reasonably sized pool of managers and management styles to choose from • Small minimum investment	• Difficult to gain exposure solely to corporate bonds • No flexibility in portfolio composition • Fees
Exchange traded funds	• Diversified portfolio • Liquid • Smallest minimum investment • Relatively low fees • Low tracking error	• Small investment universe to choose from • No flexibility in portfolio composition • No actively managed option

17. The ETF only holds bonds issued by the four largest banks in Australia.

5. Conclusion

While the Australian corporate bond market is still developing there are a number of vehicles that can be utilized by retail investors to increase their portfolio diversification and gain exposure to the asset class. When comparing the various vehicles and intermediaries available for investing in corporate bonds, it is important to consider one's personal situation, objectives and knowledge of investments. All of the investment methods listed in this report require some level of skill to assess. A knowledgeable, trustworthy financial adviser can assist with this assessment.

One key message of this paper is that at the time of writing, the number of corporate bonds available for direct investment by retail investors is limited. However, a number of government and industry initiatives are being undertaken to increase the size, liquidity and participation in the Australian corporate bond market in the future. It is expected that as a result of this desire to develop the Australian corporate bond market, corporate bonds will progressively become more accessible to retail investors. Also increasingly important, and relevant to those initiatives to develop the market, is the role of fixed interest investments for investors approaching retirement. Expected returns may be less than those on equities, but lower risk means that a diversified investment portfolio more weighted towards such investments has less risk of a disastrous outcome for retirement savings from which the retiree or near-retiree cannot recover. Other initiatives and an assessment of the likely future of the Australian corporate bond market will be explored in the next report.

Appendix 1

How to read a managed fund's product disclosure statement

Key points to consider when investing in a managed fund:		
1	**Minimum investment amounts**	Provides information on the minimum initial investment required by the fund. Additional units can often be purchased in smaller increments.
2	**Withdrawals**	Provides information on the notice required to withdraw an investment from the fund. This section will also provide information on the price that will be received when a withdrawal is made.
3	**Distributions**	Provides information on the nature and frequency of income and capital gain distributions to unit holders.
4	**Investment return objective**	Provides information on whether the fund is actively or passively managed. Funds that seek to outperform a benchmark are actively managed while those that seek to match a benchmark are passively managed. The benchmark stated in the investment objective can also provide important information on the nature of securities the fund invests in. However, this should be cross-checked to ensure the benchmark is appropriate.
5	**Investment strategy**	Provides information on the method by which the fund seeks to achieve the stated investment objective. This section will also generally provide an indication of whether the fund utilizes derivative products to alter portfolio exposures.
6	**Risks**	The risks section of the PDS highlights a summary of the significant risks associated with investment in the fund. These risks should be carefully read and understood before investing in the fund to ensure they align with the risk tolerance and portfolio objectives of the investor.
7	**Fees and costs**	Provides information on the nature of the fees the fund charges to investors. The remainder of this appendix provides a brief overview of some of the fees commonly administered by managed funds.
8	**Establishment fee**	This is a fee administered once when initiating an investment with a managed fund. This is typically a flat fee rather than a percentage of assets invested.
9	**Contribution fee**	This is a fee administered every time a new contribution is made to the managed fund. This is also usually a flat fee but can also be a percentage of assets invested.
10	**Withdrawal fee**	This fee is administered when funds are withdrawn from the managed fund and is typically a percentage of assets invested. Funds will often waive this fee once funds have been held within the fund for a set minimum period.
11	**Management costs (or indirect cost ratio)**	This fee is an annual fee usually charged as a percentage of assets under management. It can be a fixed rate or more commonly for active funds a fixed rate plus a bonus if out performance is achieved by the fund.

Appendix 2

Glossary

Accrued interest
The amount of interest accumulated on a bond from the last coupon payment date.

Asset allocation
An investment strategy that attempts to balance risk versus reward by adjusting the percentage of each asset in an investment portfolio.

Asset class
A group of investments that display similar characteristics.

Bank bills
A short-term money market investment.

Bank Bill Swap Rate (BBSW)
The Australian benchmark reference rate. Calculated daily by AFMA as an average rate based on quotes supplied by banks regarding current market interest rates.

Basis point
A measure used to calculate interest returns. One basis point equals one hundredth of one per cent or 0.01%.

Benchmark
An index which measures the change in value of a market over a period of time.

Buy and hold strategy
A passive investment strategy whereby the investor intends to retain the investment until maturity.

Capital markets
A group of markets in which investors can buy and sell various debt and equity securities.

Commonwealth Government Securities
Debt securities issued and guaranteed by the Commonwealth of Australia. The Commonwealth guarantees the coupon 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 security (bond) issued by a corporation, either senior secured, senior unsecured or subordinated.

Corporate bond market
A secondary market for investors to buy and sell corporate bonds.

Coupon rate
The rate of interest paid by the issuer of a bond. The rate is usually expressed as a percentage of the face value of the security.

Credit default swap
A form of insurance against the risk of default by the issuer of a specified corporate bond.

Credit rating
An assessment of an entity's credit worthiness.

Credit risk
Credit risk is an assessment of the likelihood that a company issuing a bond may default on its obligation to pay interest or repay principal.

Credit spread
A spread is the difference in yield between two securities. A credit spread generally measures the degree of risk between 'risk free' assets (ie. Commonwealth Government Securities) and lower rated assets.

Debt securities
May have a fixed or floating rate of interest and are generally issued by governments, financial institutions, companies or securitization vehicles

Derivative
A financial instrument or contract based on (derived from) an underlying financial asset.

Duration (modified duration)
A measure of the sensitivity of a bond's price or market value to a change in interest rates.

Face value or principal
The amount that the issuer borrows which must be repaid to the investor at maturity. Also known as par value.

Fixed income investment
A financial instrument that can be bought and sold between secondary parties that has a defined rate of interest which must be paid on a specified date to avoid default.

Fixed rate bond
Bond on which the coupon rate has been set at the time of issue and will remain fixed for the life of the security.

Floating rate note
A debt security that has a variable coupon, equal to a money market reference benchmark plus a quoted margin.

Hybrid Security
A financial instrument that shares characteristics of both debt and equity securities.

Inflation-linked bond
A bond created to provide protection from the risk of inflation.

Issuer
Borrower (government, financial institution or company) that issues the bond (ie. borrows the money) and pays the interest.

Liquidity
The ease with which an asset can be bought or sold in the market without significantly affecting the price. A liquid bond can be bought and sold more easily than an illiquid one.

Maturity
The end of a bond's life, when capital must be repaid to the investor.

Over-the-Counter
Off-exchange trading that is done directly between two parties.

Perpetuals
A floating rate note with no specific maturity date.

Retail Investor
An investor that does not meet the criteria of a wholesale investor.

Secondary market
A market in which previously issued financial instruments such as stock, bonds, options, and futures are bought and sold.

Secured debt
Secured debt is debt in which the borrower pledges some assets as collateral.

Sub-investment grade bond
A corporate bond rated below BBB- or Baa3 by the credit rating agencies or with no rating. Also known as high yield bond or junk bond.

Subordinated debt
Debt that ranks behind the liquidator, government tax authorities and senior debt holders in the hierarchy of creditors. It should be noted that in the case of liquidation or bankruptcy the holders of subordinated debt rank ahead of equity or shareholders.

Unsecured debt
Unsecured debt has no collateral backing from the borrower.

Wholesale investor
Generally either a professional investor/firm or an individual with more than $2.5 million in assets and an income of more than $250,000 over two years.

Yield
The coupon or interest payment on a bond expressed as a percentage of the bond's market value or price.

Yield curve
A line that maps the yields on comparable bonds (for example, bonds issued by the same borrower) of different maturities (1 year, 2 year, 10 years, etc).

Yield to maturity
The rate of return earned by an investor assuming that the bond will be held until maturity and that all coupon and principal payments will be made on schedule.

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