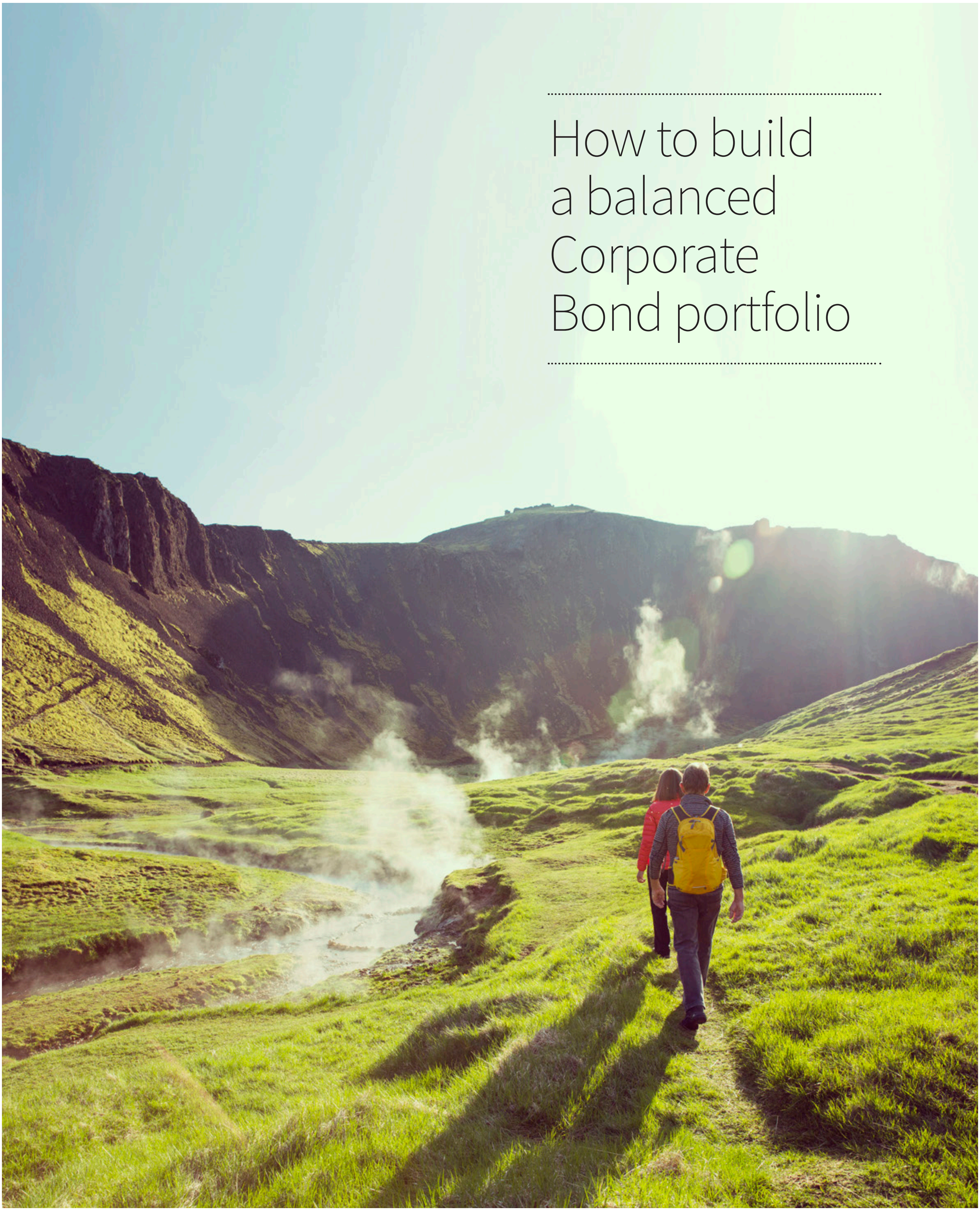
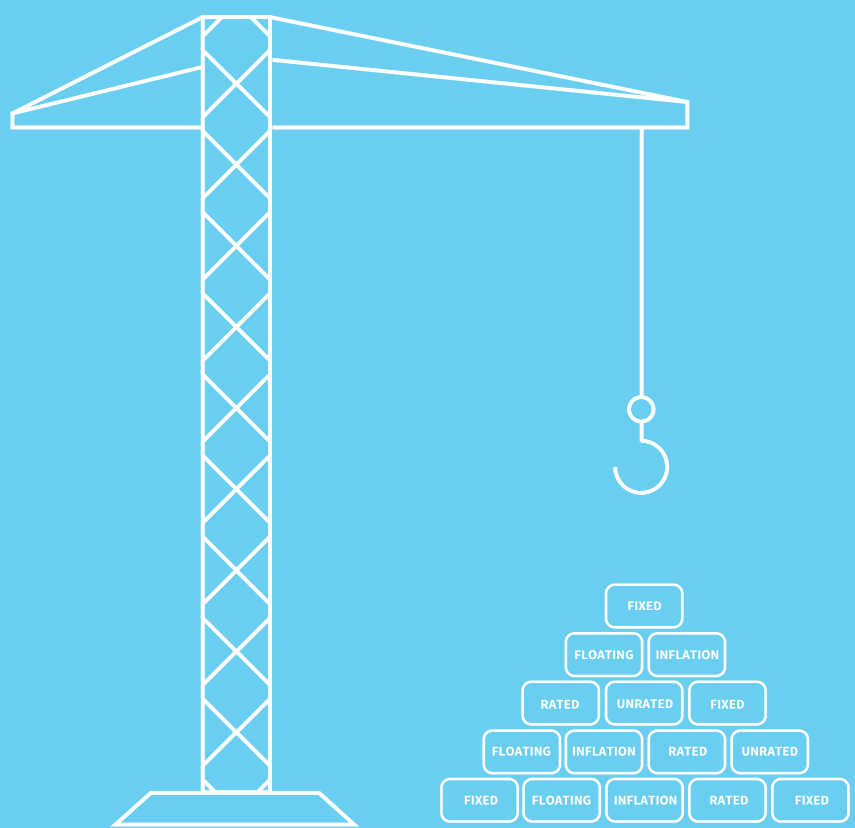


How to build a balanced Corporate Bond portfolio

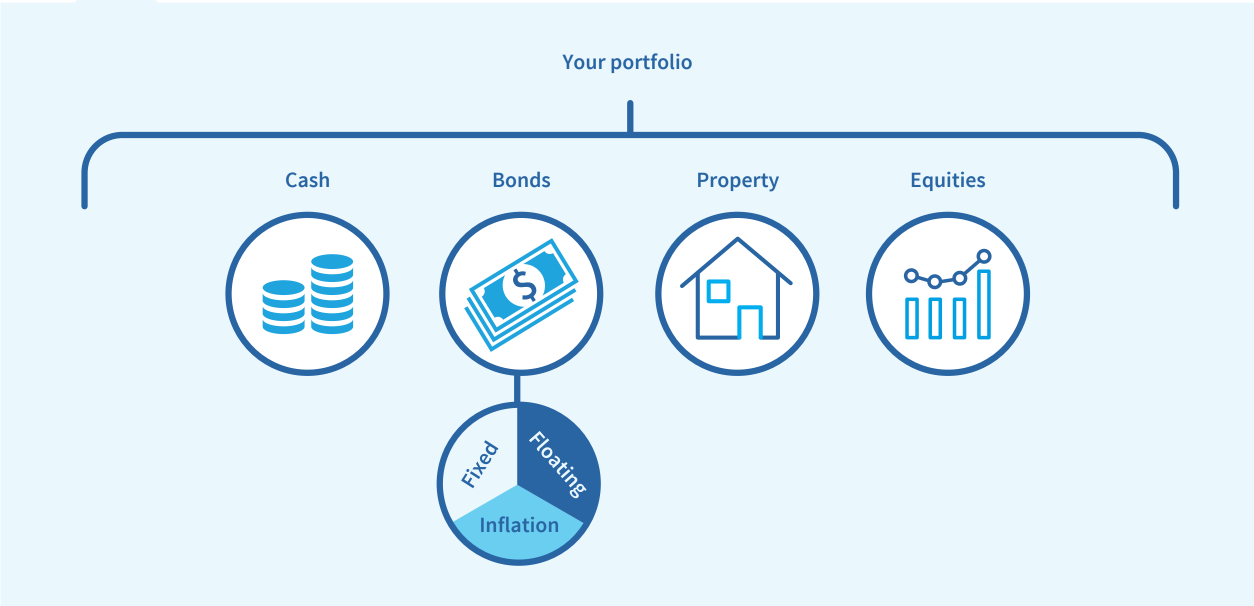
Contents

SECTION 1

Build your diversified bond portfolio



Build your diversified bond portfolio



Experienced investors appreciate the need to diversify their portfolio, but it isn't enough to just add Corporate Bonds to the mix. You still need to diversify within your Corporate Bond portfolio – and this diversification needs to be in line with your appetite for risk and return.

With every investor, it makes sense to start with a neutral base portfolio with equal allocation across the three types of bonds - fixed, floating and inflation linked. You can adjust from there depending on your circumstances.

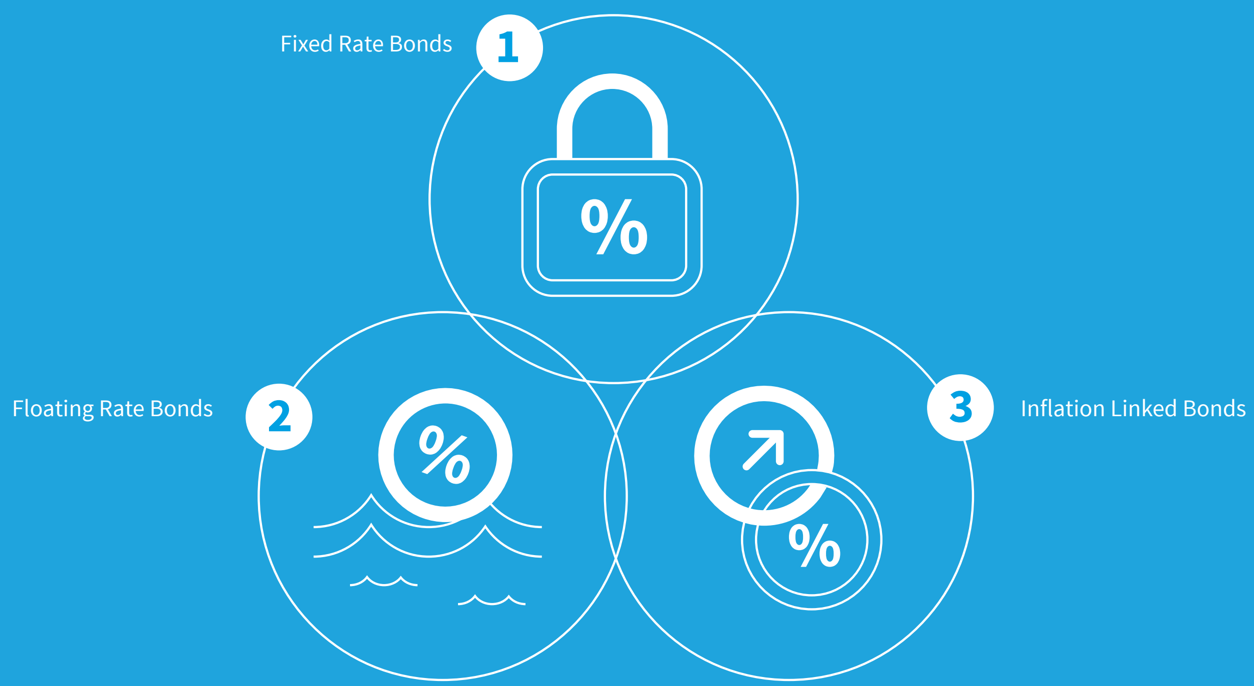
There is no cookie cutter for a portfolio. Every client's balance point is different. If you're retired and relying on your bonds to generate a consistent income stream, you may tip the balance to investment grade rated bonds. However, if you're still working and have the capacity to earn, you may be able to take a little more of a risk with high yield unrated bonds.

A portfolio with lower risk could mean lower returns, but if your key driver is to protect capital, that may be right for you. Others may be prepared to take on more risk in order to potentially access higher returns.

All bonds are not created equal. Find the balance that works for you.

SECTION 2

Types of bonds



SECTION 1
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WHY FIIG?

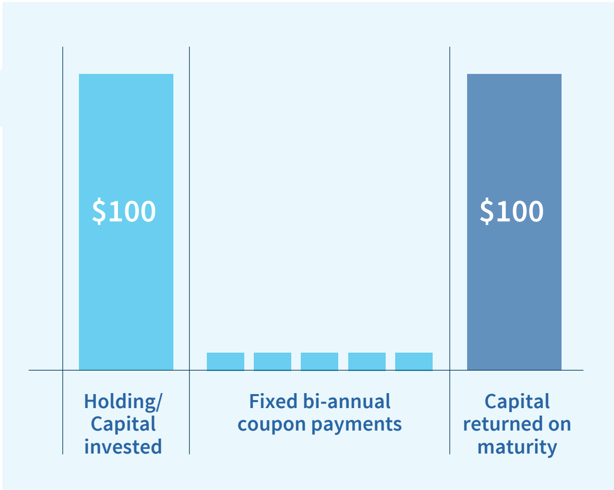
Types of bonds

A balanced bond portfolio will include different weightings of the following three types of bonds.

1

Fixed Rate Bonds

As the name suggests, the interest rate is fixed for the duration of your investment. The predictability of income means Fixed Rate Bonds usually make up at least a quarter of a balanced portfolio. On the maturity date, the face value of the bond is repaid to you.



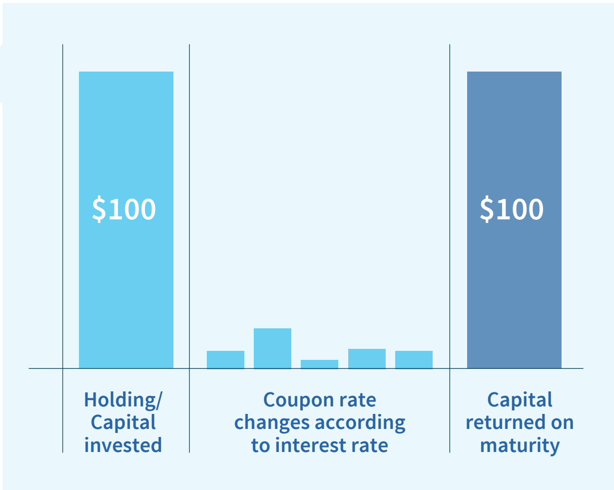
2

Floating Rate Bonds

The income from Floating Rate Bonds varies, based on the level of current interest rates as measured by the Bank Bill Swap Rate (BBSW). You could get higher returns if the benchmark interest rate goes up, but you also risk getting lower returns if the benchmark rate goes down.

On the maturity date, the face value of the bond is repaid to you.

Floating Rate Bonds are popular among those who want fluctuating coupon payments in line with interest rates.



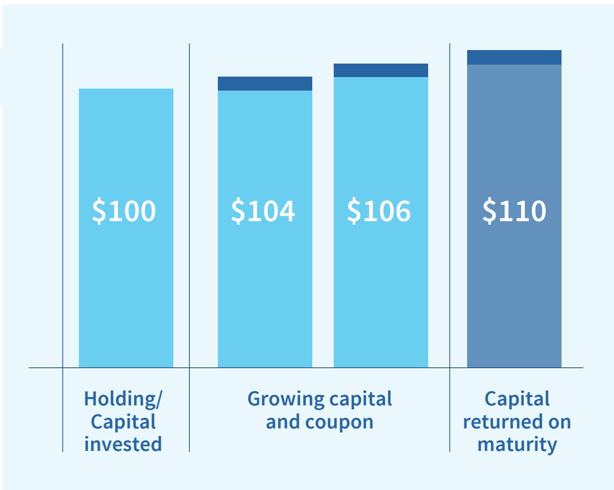
3

Inflation Linked Bonds

Inflation Linked Bonds are linked to the Consumer Prices Index (CPI), or inflation, and usually have a low coupon rate. As the capital amount is linked to the headline inflation rate, it increases every quarter (assuming inflation is positive). The coupon is then calculated on the increased capital amount, so it also rises with inflation.

On the maturity date, your capital will have increased in line with inflation and this increased amount is returned to you.

This is a strong product for those who want to protect against the potential impact of inflation.



SECTION 3

How to find your balance

How to find your balance

To personalise your portfolio, you need to fully understand your financial circumstances. You need to establish what returns you are looking for from your Corporate Bond portfolio, and your risk appetite.

Corporate Bonds have different levels of risk, and are classed as senior secured debt, senior unsecured debt or subordinated debt. Where they sit in the capital structure will determine their risk and return – and the likelihood of getting your capital back in the event of wind up or liquidation.

Any funds must legally be paid to the most senior investors first, before they are paid to investors on subsequent levels. This also works in reverse with losses applied from the lowest rung up. So even though shares may promise potentially higher returns, they are a riskier investment than bonds in the same company. It's a useful way to measure your appetite for risk and return while thinking about how your portfolio balances risk and return.

Let's say the worst possible scenario occurs, and your bond issuer becomes insolvent. Senior bondholders will have priority over hybrid or equity investors when the proceeds of asset sales are applied.

Questions to answer

For more than 20 years, FIIG Securities has been transacting in fixed income products for our clients and we have refined our process down to a series of questions:

1. What return do you aim to achieve?

To calculate the return, you must factor in the cost price, coupon payments over the term of the investment, and the capital returned on maturity.

For Fixed Rate Bonds, these amounts can all be easily calculated upfront.

The changing nature of coupons for Floating Rate Bonds and Inflation Linked Bonds means investors need to rely on educated estimates over the life of the investment. Your FIIG Relationship Manager can provide you with information on the projected returns for these bonds.

2. How much income do you need from your Corporate Bond portfolio?

Many people want to maximise their income once they retire so they can live off this income. They also want the freedom of being able to take advantage of bigger lifestyle decisions, like travel when the opportunity arises.

3. Do you have capital needs from your bond portfolio?

If you have plans to save money to support your children or grandchildren, you need to make sure this capital is preserved – perhaps by taking the options with lower capital risk such as investment grade Corporate Bonds. You also need to set maturity dates in line with the timing you anticipate you will need to access the funds.

4. Do you have any anticipated future expenses?

If you know you have a large expense on the horizon, purchase bonds with maturity dates that correspond with that timeline. Maturity timeframes set by the bond issuer vary from anywhere between 18 months and 20 years. Staggering maturity dates can help you plan and reduce reinvestment risk at any single point in time.

Investors are generally contacted six weeks before a maturity date, allowing you time to consider what to do with the repaid capital. If the bond issuer has a new bond replacing the maturing one, you may choose to reinvest. Or you may take the opportunity to review your circumstances and choose a lower or higher risk investment.

How to find your balance

5. How liquid is your portfolio?

Regardless of how thoroughly you answer these questions and invest accordingly, there's always the possibility of unexpected expenses throwing your best laid plans into turmoil.

Bonds can be sold on the secondary market before their maturity date, however the price will be driven by buyer demand and market prices at the time of sale. Depending on the bond, it may sell for higher or lower than what you would have received on maturity.

FIIG's active participation in the bond market gives us good insight into which bonds will sell more quickly than others.

6. How old are you?

A rule of thumb coined by Jack Bogle, founder of Vanguard Investments, is that your bond allocation should roughly equal your age. For example, at age 50 around half your portfolio should be allocated to Corporate Bonds because you have more wealth to protect and less time to recoup unexpected losses on the stock market.

But how does that play out for the different types of bonds?

As your age increases, so does your need for predictability in your portfolio. Most bond investors increase their allocation to Fixed Rate Bonds as they get closer to retirement as this provides more certainty.

7. Do you have the capacity to earn income to supplement losses?

If you're still earning an income, even on a part-time basis, that income gives you a buffer to take a few additional risks. If you are transitioning to retirement, you might consider choosing similar maturity dates for your higher risk bonds, so you can recalibrate your level of exposure once you stop earning.

If you are no longer earning an income and relying instead on your bonds to generate a consistent income stream, you may tip the balance to Fixed Rate Bonds.

8. What is your appetite for risk?

What we're really asking here is, how much are you willing to lose?

A basic premise of investing is the higher the return, the higher the risk; the lower the risk, the lower the return.

Going back to the first three questions in this book about income, capital and return may help you to work out how much risk you need to take in your portfolio.

To help you evaluate the risk of specific bonds, credit ratings agencies independently assess bond issuers' ability to pay coupons and repay capital. They assign credit ratings of AAA (lowest risk) to CCC (highest risk), with BBB- being the cut-off for investment grade securities. Sub investment grade or unrated bonds (often called high yield), tend to have higher risk and return than investment grade bonds. Due to licensing restrictions, credit ratings are only able to be provided to Wholesale investors.

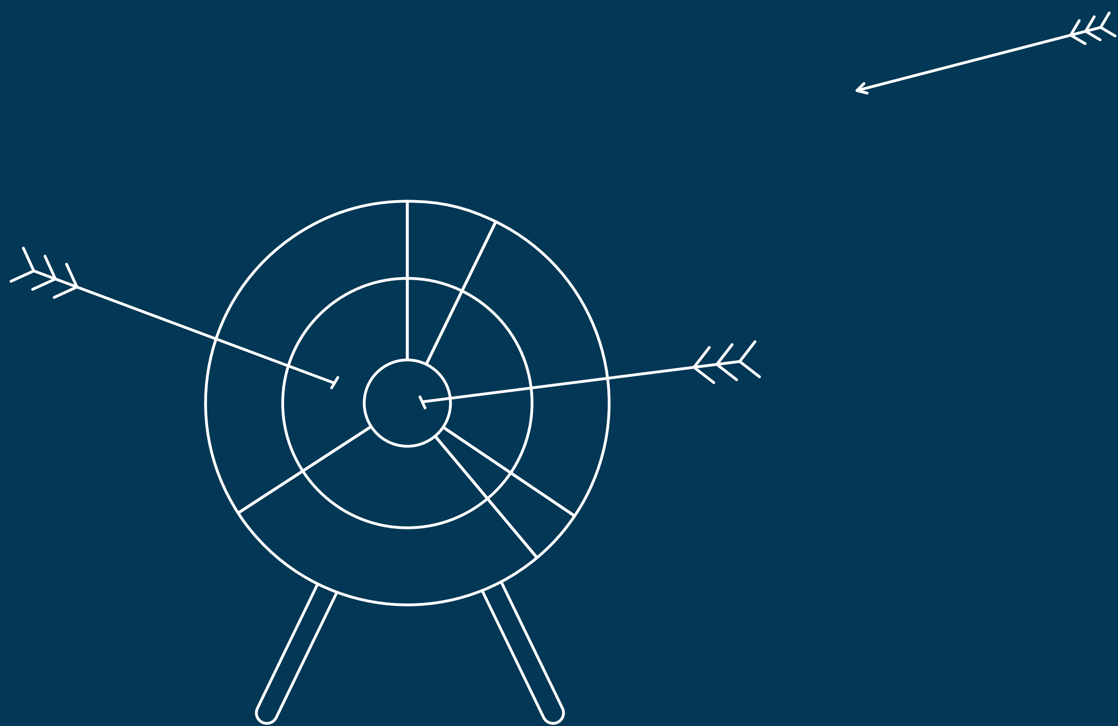
Wholesale investors can also invest in foreign currency denominated bonds such as USD and GBP. Investing in foreign currency bonds adds another layer of risk as you need to factor in exchange rate fluctuations into the returns of the bonds, although foreign currency can provide extra diversification for more sophisticated investors.

The challenge is to find a mix of bonds with an acceptable risk profile for you that still provides a suitable yield.

Many investors use bonds not just for the returns, but to mitigate the risks they are taking elsewhere in their portfolio.

SECTION 4

Striking the right balance for you

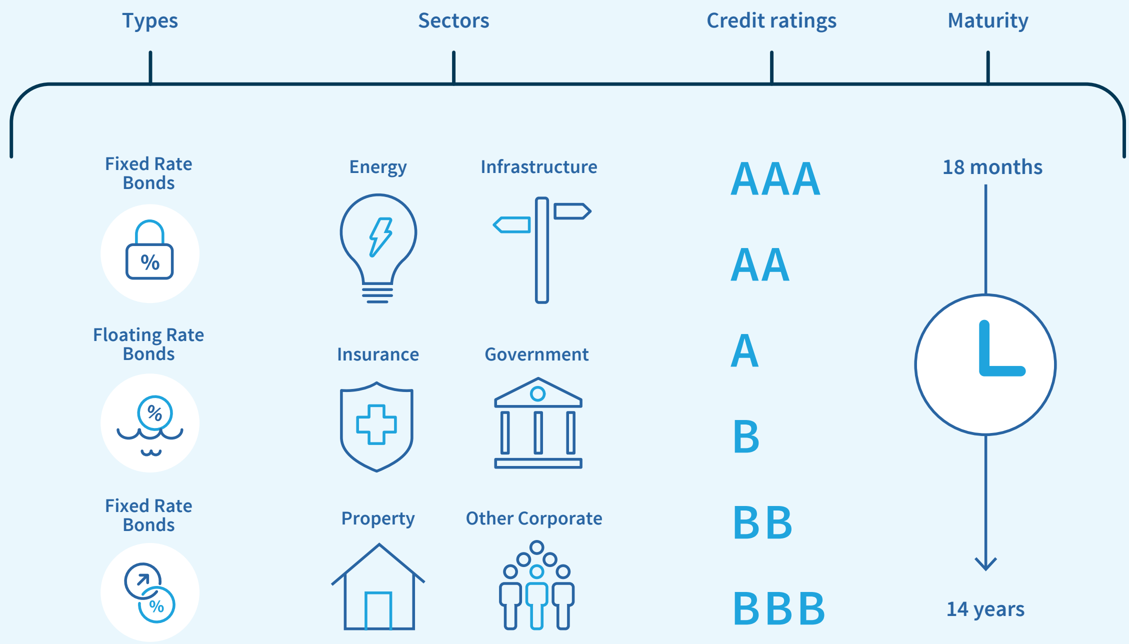


Striking the right balance for you

Creating a balanced bond portfolio for each investor could be likened to adjusting one recipe to suit many palates. While everyone is served the same three core ingredients, the quantities and seasonings are all adjusted to meet the individual's tastes.

A well-balanced portfolio goes beyond the spread of the three bond types. You also need to consider the mix of maturities, risk profiles and industry sectors.

Different attributes of bonds



Striking the right balance for you

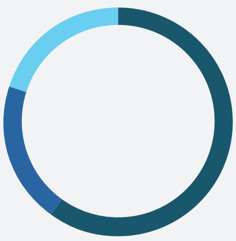
CASE STUDY

A conservative approach to life >

Having watched her parents struggle to make ends meet living on a pension, Susie and her husband Tom started investing early with the goal of a comfortable retirement.

Having always been quite conservative investors, it was no surprise when they allocated 60 percent of their bond portfolio to investment grade Corporate Bonds on retirement. With no children or close family to rely on if something goes wrong, they are risk averse. Predictability of coupon income and the preservation of capital were high on their list of priorities.

They have spread their maturity dates and chosen bonds with high liquidity – just in case.



- 20% Inflation
- 60% Fixed
- 20% Floating

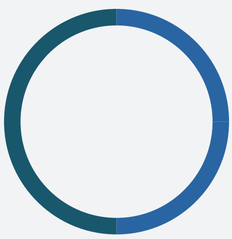
CASE STUDY

Providing income for a comfortable retirement >

Sean and Anna eased into retirement a few years ago, and like Susie and Tom they don't have a high risk appetite. They do, however, want to make sure they generate enough income through their investments, so they don't need to dip into their hard-earned capital to maintain their standard of living.

They would like to travel when the opportunity arises. Now that they have a little more time on their hands, Anna plans to take a writing class while Sean spends time with his golf buddies. These moderate expenses all need to be covered by their investment income.

Since their capital can generate enough income for short-term needs, Sean and Anna decide not to include Inflation Linked Bonds in their mix. Instead, they balance their bond allocation between Fixed Rate Bonds (for regular income) and Floating Rate Bonds (for a predictable coupon above the Bank Bill Swap Rate (BBSW)). They also stagger their maturity dates so they have flexibility to book and pay for their next getaway.



- 50% Fixed
- 50% Floating

Striking the right balance for you

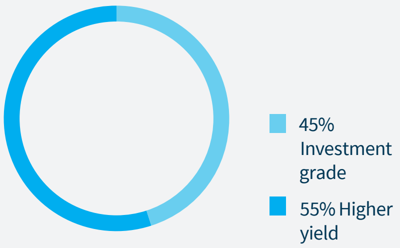
CASE STUDY

Boosting returns before retirement >

Leanne and Gio are in their 50s. Gio runs his own accounting practice, and Leanne plans to go part-time as a legal counsel – but they aren't expecting to retire in the near future.

They've worked hard to build their investment portfolio, but they do have a higher risk tolerance as they are both still earning an income. To maximise their retirement funds before scaling back on work, they're firmly focused on higher return investments. So when Gio brings in a new partner for succession planning, he decides to invest the released capital in a few fixed rate and floating rate high yield bonds. These bonds have a higher risk attached and they also produce a higher coupon rate.

As Gio and Leanne get closer to retirement, they will reassess this strategy – and expect to balance the portfolio more towards investment grade bonds.



Why FIIG?

400+
different bonds

7,000+
Australian investors

100+
employees

Sydney, Melbourne Brisbane, Perth
with offices in

1998
when FIIG was established

$Billions
assets under advice

FIIG's fixed income expertise and market access provides over 400 different Corporate Bonds to more than 7,000 Australian investors.

Our clients appreciate the depth and quality of our research conducted by our highly experienced market research team. And our recommendations are without corporate alignment bias.

With over 100 experts in Sydney, Melbourne, Brisbane and Perth, a dedicated FIIG Relationship Manager will provide guidance and support to help you invest with confidence.

Get started today

Ready to get more certainty over your investment income, and achieve more stability in a volatile market? FIIG can help you build a Corporate Bond portfolio to suit your financial goals and cash requirements.

Please call 1800 01 01 81

Or visit fiig.com.au

FIIG | The fixed income experts

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