AUSTRALIAN BOND INVESTOR TOOLKIT

Overview

Issued by a wide variety of entities for many different purposes, bonds are part of the fixed income family of investment vehicles. As of February 2012, there are over AUD 515 billion worth of investment-grade bonds outstanding in the Australian market, as measured by the S&P/ASX Australian Fixed Interest Index Series. These bonds are issued by government and corporate entities, and are held by individual investors, managed funds, superannuation funds, banks, insurance companies and other financial institutions. While investment-grade bonds have historically boasted low defaults rates, the credit quality of the issuer (borrower) can vary, and some sectors and sub-sectors are more prone to default than others.

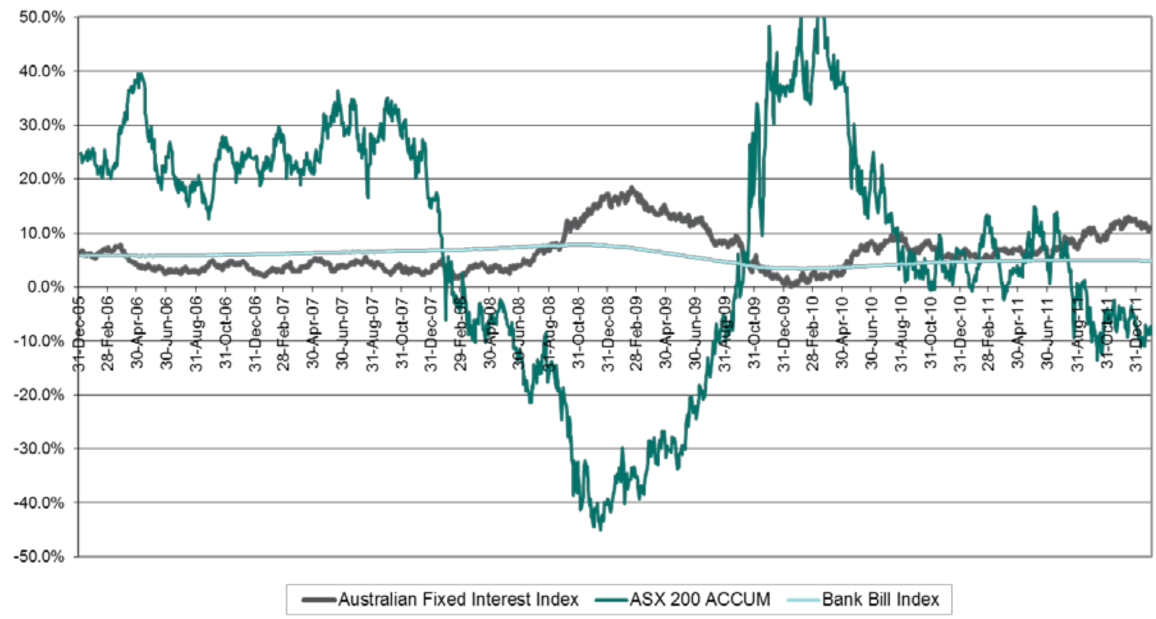
In the Australian market there are three broad categories of bond issuers:

1. Government
2. Corporate
3. Supranational

Investing in bonds can help diversify an investment portfolio's risk and simultaneously provide a steady source of income. While the general role of equities is to generate long-term growth potential, bonds can be used to deliver an income stream. Diversifying investments across various asset classes could mitigate various risk factors and reduce return volatility.

Exhibit 1 shows the rolling annual returns for the S&P/ASX bond and equity indices since 2005. It clearly highlights the defensive nature of the bond market and the volatility of the equity market, showing the potential benefits that diversification can provide.

Exhibit 1: Rolling Annual Returns since Dec. 2005: S&P/ASX Australian Fixed Interest Index, S&P/ASX 200 Accumulation Index and S&P/ASX Bank Bill Index



Source: S&P Dow Jones Indices. Data as of January 31, 2012. This table is provided for illustrative purposes. This table may reflect hypothetical historical performance. Please see the Performance Disclosure for more information regarding the inherent limitations associated with back-tested performance. Australian Fixed Interest Index represents the S&P/ASX Australian Fixed Interest Index, ASX 200 ACCUM represents the S&P/ASX 200 Accumulation Index and Bank Bill Index represents the S&P/ASX Bank Bill Index.

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Risks Associated with Bond Investing

While bonds can help to minimize risk in a diversified portfolio, investing in bonds carries its own risks. As interest rates change, so do the prices of most bonds. Bond prices, representing the present value of the cash flows of the investment, fall when interest rates rise. Conversely, when interest rates fall, bond prices rise. This is known as interest rate risk. Closely associated with interest rate risk, reinvestment risk occurs as the bondholder receives periodic interest payments and principal returns, and the investor's ability to reinvest those funds at the original rate of return is impacted by the current interest rate environment. For example, when interest rates fall, the next investment made will provide a lower return than the previous investment. Credit risk is the perceived or actual creditworthiness of a particular issuer. Asset class-specific risk can occur within any asset class where performance can vary among different assets. The ability and willingness of the issuer to pay the principal and interest on the bonds as scheduled is known as default risk. Liquidity risk is the ability of the bondholder to sell the bond in the secondary market prior to maturity. This type of risk also includes the ability to sell the bond at a price equal to where the bond is valued. Income tax risk refers to when bondholders are impacted by taxable events such as tax on income or capital gains derived from the sale of bonds. The uncertainty of inflation and its impact on the value of future cash flow to an investor is known as inflation risk.

Mitigating Risk

While it is impossible to eliminate risk entirely, investors can try to manage or reduce risk by diversifying their portfolios, selecting appropriate bonds and managing the duration of their fixed income investments.

Portfolio diversification is often cited as an investment core principle, especially following volatile periods in the market (e.g., 2007 to 2011). By investing in various issuers of debt and not centralising investments in one or a few bonds, advisors can assist an investor in reducing the effect of negative news ("headline risk") on the values of the bonds they hold and, in the worst cases, the effect of a bond default on the value of their portfolio. Portfolio diversification also helps to reduce the impact of the liquidity risk associated with owning a bond that may become difficult to sell prior to maturity.

Carefully selecting bonds suitable for an investor's risk tolerance, investment horizon and investment objective can also assist an investor in reducing risk. Historically, the Australian investment-grade bond market has had a low default rate. However, some sectors have experienced higher incidences of default than others.

Using Bond Funds to Mitigate Risk

In order to mitigate risk factors (interest rate, reinvestment, liquidity, etc.), an investor might consider a diversified bond portfolio. When diversifying, it is important to account for factors such as issuer, sector and maturity. An investor can choose either to create his/her own portfolio by purchasing individual bonds or to invest in managed funds, which may be managed actively or passively. When a bond portfolio is actively managed, a portfolio manager determines the composition of the portfolio and how often it is traded. Passively managed portfolios, which typically employ a buy-and-hold strategy, tend to be invested in an index, which tracks a group of bonds that conform to particular inclusion criteria.

Whether an investor chooses actively managed funds, passively managed funds or simply invests in individual bonds, there are several ways to try to mitigate risk within a bond or bond fund portfolio. One way is to simply invest in bonds and/or funds that have short-term maturities. As yields fluctuate, the price of short-term bonds is affected less than that of longer-term bonds. The investor solely utilising this approach would not benefit from the higher yields of longer-term bonds during a normal-shaped yield curve environment, and therefore, would not benefit to the same extent if yields fall. However, the investor should experience less volatility as yields fluctuate.

A second method of managing bond investing-related risk is laddering a bond portfolio. Laddering is an investment technique whereby investors segment their bond investments such that some bonds in the portfolio mature each year.

Below is an example of a simple laddered Commonwealth Government bond portfolio:

AUD 10,000 face value of 6.50% bonds maturing in two years
AUD 10,000 face value of 6.25% bonds maturing in three years
AUD 10,000 face value of 6.25% bonds maturing in four years
AUD 10,000 face value of 6.00% bonds maturing in five years
AUD 10,000 face value of 5.75% bonds maturing in six years

Over time, the proceeds from bonds that mature are reinvested in longer-term bonds, which are typically issued at higher yields than shorter-term bonds.

Laddering a bond portfolio, as opposed to investing in one bond maturing in four years, for instance, may offer investors the following benefits:

- Diversified duration exposure as a laddered bond portfolio spreads duration risk across the yield curve
- Reinvesting cash flows in longer-term bonds tends to provide yield premium.

A well-diversified portfolio that invests in bonds across different maturities, sectors and issuers may enjoy a risk/reward profile that is not offered by a concentrated portfolio.

S&P/ASX Australian Fixed Interest Index Series

To assist investors in understanding the Australian fixed income market, S&P Indices publishes a detailed set of data about the market through the S&P/ASX Australian Fixed Interest Index Series.

The S&P/ASX Australian Fixed Interest Index measures the performance of the Australian fixed rate bond market. It is a broad, market value-weighted benchmark that tracks investable investment-grade, Australian dollar-denominated bonds issued in the local market with maturities greater than one year. Sub-indices are defined by sectors, maturity buckets and rating bands.

Sector-level indices include:

S&P/ASX Commonwealth Government Bond Index: Comprises bonds issued by the Australian Government (Treasury Bonds).

S&P/ASX State-Government Bond Index: Comprises bonds issued by State Governments and Territories.

S&P/ASX Government Bond Index: Comprises bonds issued by the Commonwealth Government and State Governments.

S&P/ASX Corporate Bond Index: Comprises bonds issued by Australian corporations and bonds issued by non-Australian corporations (Kangaroo bonds).

S&P/ASX Supranational and Sovereign Bond Index: Supranational bonds are defined as those issued by entities formed by two or more central governments to promote economic development for the member countries, such as the World Bank. Includes sovereign bonds issued in the Australian dollar.

Maturity bucket indices include:

- S&P/ASX Australian Fixed Interest 1-5 Year Index
- S&P/ASX Australian Fixed Interest 5-10 Year Index
- S&P/ASX Australian Fixed Interest 10-15 Year Index
- S&P/ASX Australian Fixed Interest 10+ Year Index

Rating band indices include:
AAA, AA, A and BBB ratings bands on the S&P/ASX Australian Fixed Interest Index and the S&P/ASX Corporate Bond Index, respectively.

S&P/ASX Australian Bank Bill Index

To assist investors in understanding the Australian bank bill market, S&P Indices publishes a set of data about the market through the S&P/ASX Australian Bank Bill Index.

The S&P/ASX Australian Bank Bill Index is designed to measure the performance of the Australian short-term money market. The index consists of 13 weekly maturities out to 91 days; interest rates applied to these maturities are interpolated from cash and Bank Bill Swap (BBSW) rates using a cubic spline methodology.

The data provided by these indices can be useful tools for investors who seek to evaluate market conditions, employ investment strategies, mitigate risk or achieve specific investment objectives.

Exhibit 2: Characteristics of the S&P/ASX Australian Fixed Interest Index Series as of Feb. 1, 2012

Index	Number of Issues	Market Value (AUD Billion)	Yield	Modified Duration
S&P/ASX Australian Fixed Interest Index	290	517	4.34%	4.19
S&P/ASX Government Bond Index	71	355	3.96%	4.62
S&P/ASX Supranational and Sovereign Bond Index	99	109	4.83%	3.52
S&P/ASX Corporate Bond Index	120	53	5.53%	2.74
S&P/ASX Bank Bill Index	13	n/a	4.64%	0.13

Source: S&P Dow Jones Indices. Data as of February 1, 2012. This table is provided for illustrative purposes.

Conclusion

The S&P/ASX Australian Fixed Interest Index Series and S&P/ASX Bank Bill Index provide sets of data that give insight into various segments of the Australian bond and bank bill markets, as well as a broad market overview. Investors who want to better understand the risks associated with bond investing and seek ways to mitigate these risks may find this data useful. This information can assist investors in assessing individual bonds and comparing performances of bond funds across various investment horizons. The data can also serve as a consistent foundation for tracking various segments of the market and examining the impact of differing maturities and credit risks on returns.

Key Terms

- **Accrued Interest:** Interest that has been earned on a security but not yet paid to the investor.
- **Asset Back Security (ABS):** A debt security backed by cash flows from a pool of underlying assets e.g., automobile loans.
- **Basis Point:** One one-hundredth of a percent (0.01%).
- **Bond:** A bond is a debt security. The owner of a bond effectively lends money to the bond issuer. In return, the issuer provides a promise to periodically pay a specified rate of interest and repay the face value of the bond (principal) at maturity. Bonds are issued by governments, semi-government organisations and corporations.
- **Convertible:** A corporate bond that can be exchanged, at the option of the holder, for a specific number of shares of the company's stock.
- **Corporate Bond:** Issued by companies to fund expansions and other projects. Generally, corporate bonds have higher risk levels than government bonds.
- **Coupon Rate:** The annual rate of interest to be paid by the issuer (borrower) to the bondholders (lenders).

- **Derivative:** A financial contract whose characteristics and/or value are derived from other securities. This category includes a wide range of exchange-traded and over-the-counter securities such as futures, options and swaps.
- **Emerging Market Debt:** Refers to bonds issued by governments in less developed countries.
- **Eurobond:** A bond that is issued in a currency that is not native to the country where it is issued.
- **Face Value/Par Outstanding/Principal**: The amount of money due to be repaid to the bondholders at a bond's maturity.
- **Fixed-Rate Bond**: A fixed-rate bond's interest rate (coupon) remains static throughout the life of the bond.
- **Floating Rate Notes/Variable Rate Bond**: The interest rates of these bonds fluctuate based on underlying interest rates, which are usually those of bank bills.
- **Government Bond:** Issued by a government and explicitly guaranteed. Examples include Commonwealth Government and State Government bonds issued by the Australian state and territory governments.
- **High-Yield Bond**: These bonds are rated below investment-grade bonds. Bonds considered to be of lesser credit quality than investment-grade bonds have ratings of BB+ and below, as determined by Standard & Poor's Ratings Services' credit ratings.
- **Hybrid Security:** A security that combines both debt and equity characteristics. A convertible bond is a type of a hybrid security.
- **Inflation-Linked Bond (ILB):** Pays regular income that increases in line with increases in inflation.
- **Investment-Grade Bond**: The term "investment-grade" refers to the credit quality of a bond. To be considered investment-grade, bonds must fall within Standard and Poor's Ratings Services' investment-grade rating range of AAA to BBB-.
- **Kangaroo Bond:** Issued in the Australian market by non-Australian firms and denominated in Australian currency. Kangaroo bonds are subject to Australian laws and regulations.
- **Maturity**: The date at which a bond is scheduled to be repaid in full.
- **Modified Duration:** A measure of a bond's price sensitivity to interest rate movements based on the average time to maturity of its interest and principal cash flows. Modified duration follows from the concept that interest rates and bond prices move in opposite directions, and is used to determine the approximate effect that a 100-basis-point (1%) change in interest rates will have on the price of a bond. For example, the price of a bond with a modified duration of three years will change by approximately +3% if there is a 1% decline in interest rates (or -3% if yields rise 1%).
- **Money Market Security:** A short-term interest bearing security that is cash-like, can be easily redeemed and has a near-term maturity.
- **Mortgage Backed Security (MBS):** A type of ABS that is common in the Australian market. The cash flows are based on an underlying pool of mortgages, which may be residential (RMBS) or commercial (CMBS).
- **Perpetual Bond:** This type of security does not have a maturity date and pays coupons in perpetuity.
- **Supranational Bond:** Issued by entities formed by two or more central governments to promote economic development for the member countries. Examples include bonds issued by The World Bank, European Investment Bank and Asian Development Bank.

- **Yield:** The annual rate of return expected on a bond based on its current price and the assumption that it will be held to maturity.
- **Yield Curve:** A line drawn through the yields of the bonds issued by a particular issuer over a range of maturities. The most commonly referenced yield curve in Australia is the Commonwealth Government Bond yield curve, or the risk-free yield curve.
- **Zero Coupon Bond:** Bonds that do not pay periodic interest. Instead, the bonds are sold at discounts to face value. At maturity, the bondholder receives the face value of the bonds.

For more information, please visit **www.spindices.com/Australia**.

Bloomberg Tickers	Total Return	Average Yield	Average Maturity	Average Coupon	Average Bid Price	Average Duration
S&P/ASX Bank Bill	SPBDABBT	SPBDABBY	SPBDABBL			SPBDABBD
S&P/ASX Australian Fixed Interest	SPBDASXT	SPBDASXY	SPBDASXL	SPBDASXC	SPBDASXB	SPBDASXD
S&P/ASX Australian Fixed Interest 1 - 5 Year	SPBDAS1T	SPBDAS1Y	SPBDAS1L	SPBDAS1C	SPBDAS1B	SPBDAS1D
S&P/ASX Australian Fixed Interest 5 - 10 Year	SPBDAS5T	SPBDAS5Y	SPBDAS5L	SPBDAS5C	SPBDAS5B	SPBDAS5D
S&P/ASX Australian Fixed Interest 10 - 15 Year	SPBDA10T	SPBDA10Y	SPBDA10L	SPBDA10C	SPBDA10B	SPBDA10D
S&P/ASX Australian Fixed Interest 10+ Year	SPBDA1PT	SPBDA1PY	SPBDA1PL	SPBDA1PC	SPBDA1PB	SPBDA1PD
S&P/ASX Aus Fixed Interest AAA Rating Band	SPBDAR1T	SPBDAR1Y	SPBDAR1L	SPBDAR1C	SPBDAR1B	SPBDAR1D
S&P/ASX Aus Fixed Interest AA Rating Band	SPBDAR2T	SPBDAR2Y	SPBDAR2L	SPBDAR2C	SPBDAR2B	SPBDAR2D
S&P/ASX Aus Fixed Interest A Rating Band	SPBDAR3T	SPBDAR3Y	SPBDAR3L	SPBDAR3C	SPBDAR3B	SPBDAR3D
S&P/ASX Aus Fixed Interest BBB Rating Band	SPBDAR4T	SPBDAR4Y	SPBDAR4L	SPBDAR4C	SPBDAR4B	SPBDAR4D
S&P/ASX Government Bond	SPBDAGVT	SPBDAGVY	SPBDAGVL	SPBDAGVC	SPBDAGVB	SPBDAGVD
S&P/ASX Australian Government Bond	SPBDAGCT	SPBDAGCY	SPBDAGCL	SPBDAGCC	SPBDAGCB	SPBDAGCD
S&P/ASX Australian Government Bond	SPBDAGCT	SPBDAGCY	SPBDAGCL	SPBDAGCC	SPBDAGCB	SPBDAGCD
S&P/ASX State Government Bond	SPBDAGST	SPBDAGSY	SPBDAGSL	SPBDAGSC	SPBDAGSB	SPBDAGSD
S&P/ASX Corporate Bond	SPBDACPT	SPBDACPY	SPBDACPL	SPBDACPC	SPBDACPB	SPBDACPD
S&P/ASX Corporate Bond AAA Rating Band	SPBDAC1T	SPBDAC1Y	SPBDAC1L	SPBDAC1C	SPBDAC1B	SPBDAC1D
S&P/ASX Corporate Bond AA Rating Band	SPBDAC2T	SPBDAC2Y	SPBDAC2L	SPBDAC2C	SPBDAC2B	SPBDAC2D
S&P/ASX Corporate Bond A Rating Band	SPBDAC3T	SPBDAC3Y	SPBDAC3L	SPBDAC3C	SPBDAC3B	SPBDAC3D
S&P/ASX Corporate Bond BBB Rating Band	SPBDAC4T	SPBDAC4Y	SPBDAC4L	SPBDAC4C	SPBDAC4B	SPBDAC4D
S&P/ASX Corporate Issuer Equal-Weight	SPBDACET	SPBDACEY	SPBDACEL	SPBDACEC	SPBDACEB	SPBDACED
S&P/ASX Supranational & Sovereign Bond	SPBDASAT	SPBDASAY	SPBDASAL	SPBDASAC	SPBDASAB	SPBDASAD
S&P/ASX Government Inflation-Linked Bond	SPBDAIBT	SPBDAIBY	SPBDAIBL	SPBDAIBC	SPBDAIBB	SPBDAIBD

Performance Disclosure

The inception date of the S&P/ASX Bank Bill Index, the S&P/ASX Commonwealth Government Bond Index, the S&P/ASX Government Bond index, and the S&P/ASX State-Government Bond Index was October 12, 2011, at the market close. All information presented prior to the index inception date is back-tested. The back-test calculations are based on the same methodology that was in effect when the index was officially launched. Complete index methodology details are available at www.indices.standardandpoors.com.

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