BetaShares
Exchange Traded Funds

ASX: AGVT

BetaShares Australian Government Bond ETF

GOVERNMENT BACKING FOR YOUR PORTFOLIO: THE CASE FOR AUSTRALIAN GOVERNMENT BOND EXPOSURE

June 2019

Cash and bond investments have long been recognised by investors for their ability to deliver relatively stable and regular income streams over time – as well as their ability to offer diversification benefits when held alongside equities in a multi-asset class portfolio.

In this regard, BetaShares already offers a strong range of cash and bond investments with varying risk-return features, such as:

- BetaShares Australian High Interest Cash ETF **(ASX Code: AAA)**;
- BetaShares Australian Bank Senior Floating Rate Bond ETF **(ASX Code: QPON)**;
- BetaShares Australian Investment Grade Corporate Bond ETF **(ASX Code: CRED)**;
- BetaShares Active Australian Hybrids Fund (managed fund) **(ASX Code: HBRD)**; and
- BetaShares Legg Mason Australian Bond Fund (managed fund) **(ASX Code: BNDS)**.

To provide even further investor choice in this area, the BetaShares Australian Government Bond ETF (ASX Code: AGVT) is our first product launched that offers specific exposure to government bonds, a category that enjoys the highest level of credit rating within the Australian bond market.

AGVT is an index fund that specifically invests in relatively "long-duration" Australian government bonds - so as to offer investors not only potential for attractive income over time but strong diversification benefits when held alongside equities.

GOVERNMENT BONDS: SUPERIOR CREDIT QUALITY

As the majority of AGVT's portfolio is invested in Australian federal and state government bonds, AGVT offers fixed-income exposure of superior credit quality in the Australian bond market, relative to corporate bonds[1]. Indeed, given Australia's relatively well functioning economy and low public debt, Australian federal government bonds currently retain the premier AAA global credit rating from all three major credit rating agencies - S&P, Moody's and Fitch[2].

This means that in times of economic stress, when both equities and corporate bonds could come under market pressure, highly rated government bond exposures are likely to remain an important "safe-haven" opportunity for investors. It could be said that government bonds are the ultimate "port in a storm"!

[1] As at 30 June 2021 the weighted average credit rating of the bonds in AGVT's Index was AAA. The Index predominantly comprises Australian government bonds, with the remainder invested in supranational, government agency and similar bonds.

[2] As at 30 June 2021. Credit ratings merely reflect the opinions of particular ratings agencies, and do not provide any assurance regarding the bond issuer's ability to meet its payment obligations in relation to a bond. Credit ratings are not intended to be an investment recommendation or used as a basis for assessing investment merit.They are limited in scope and may be changed or withdrawn at any time.

INCOME OPPORTUNITY

By focusing on longer-duration government bonds, moreover, AGVT is also able to offer potential for relatively attractive income compared to other government bond ETFs available on the Australian market that do not have this focus.

Weighted by their issuance value, for example, the average duration of bonds within the Australian government bond market as at June 2021 was 6.5 years, compared with an average of 8.0 years for bonds within the Index which AGVT aims to track.

As seen in the table below, as at 30 June 2021 AGVT's Index offered a yield-to-maturity[3] of 1.5%p.a., or around 0.46% to 0.49%p.a. higher than comparable government bond indices.

Portfolio characteristics of Australian Government Bond Indices: as at 30 June 2021

	AGVT's Index	Bloomberg AusBond Government Index	Bloomberg AusBond Treasury Index
Average Credit Rating	AAA	AAA	AAA
Exposure	Federal & State Government bonds	Federal & State Government bonds	Federal Government bonds
Mod. Duration (yrs)	8.0	6.5	6.7
Yield (p.a.)	1.5%	1.04%	1.01%

Source: Bloomberg. AGVT's Index is the Solactive Australian Government 7-12 Year AUD TR Index. Past performance is not indicative of future performance. Yield will vary and may be lower at time of investment. Shows performance of index, not ETF, and does not take into account ETF fees and costs. You cannot invest directly in an index.

Longer duration bonds tend to offer higher yields than shorter duration bonds as compensation for their generally higher price volatility - which in turn reflects the fact that their market value is more sensitive to changes in market interest rates over time[4].

Yet, as will be explained below, this greater sensitivity to interest rates not only means longer duration bonds offer relatively attractive income returns over shorter duration bonds, it also gives rise to important diversification benefits from a broader portfolio perspective.

[3] Yield-to-maturity is the purest measure of expected long-run income returns from a fixed-rate bond, as it captures the effective yield an investor would earn if the bond were purchased today, held till its maturity, and the principal (or "par value") of the bond were returned at maturity. A similar concept is running yield, which measures income returns over the coming year divided by the bond's current market price. Running yield is an indicator of short-run income returns, but does not allow for potential long-run capital losses (gains) at maturity if the bond's market price is significantly higher (lower) than it's par value. With declining interest rates in recent years, for example, the market value of many bonds has increased relative to their par or maturity value – implying future capital losses if these bonds are held till maturity. This has led to the running yield on many bonds – and bond indices – being somewhat higher than their yield-to-maturity, thereby potentially overstating their long-run likely return.

[4] Duration (or more specifically "modified duration") is a summary measure of the price sensitivity of a bond, or bond index, to changes in the general level of interest rates, which, in the case of fixed-rate bonds, is closely linked to their remaining term to maturity. A modified duration of 5 years, for example, would indicate that the price return of the bond or bond index would decline by around 5% for every 1 percentage point change in interest rates. Financial markets usually reward bonds with a higher price sensitivity to interest rates with a higher yield, due to their likely greater return volatility – as a standalone investment – over time.

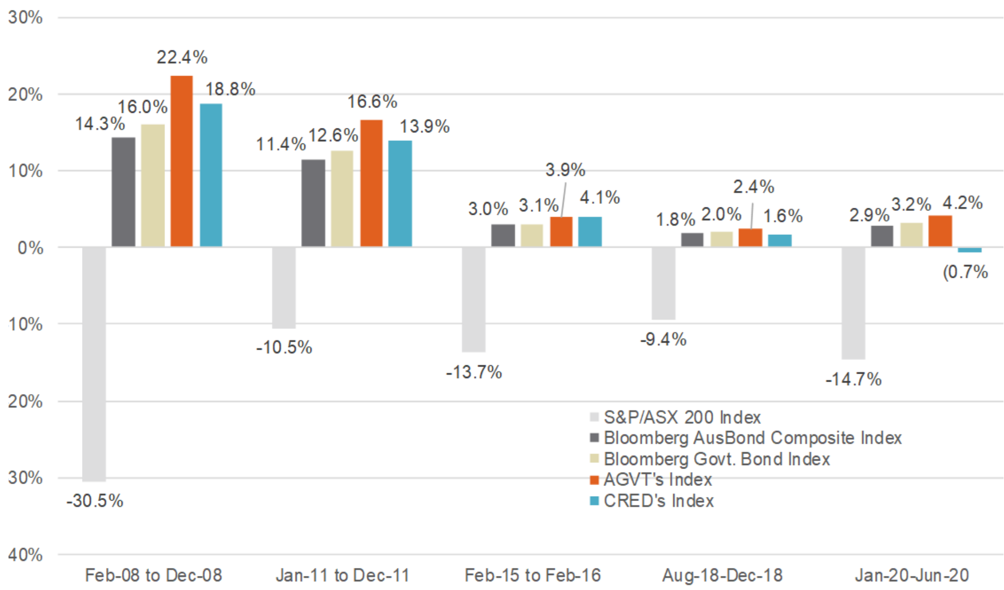
DIVERSIFICATION ALONGSIDE EQUITIES

The price sensitivity of longer duration bonds to interest rates creates a handy diversification feature - the returns on these bonds have tended to be negatively correlated with equities over the cycle. Equities tend to fall, for example, when economic conditions weaken, which also tends to be periods when interest rates are falling due to reduced demand for credit and interest rate cuts from the central bank. Falling interest rates, in turn, boost the market value of fixed-rate bonds, as the stream of fixed nominal income payments they offer are worth more in today's dollars.

So, when equities are falling in value, long-duration bonds tend to be rising in value – and vice versa – which, through the beauty of diversification, helps reduce the overall volatility of a multi-asset class portfolio over the cycle. Note, moreover, in periods of equity market weakness, government bonds tend to perform better than corporate bonds (of similar duration) as credit spreads tend to widen – reflecting the greater liquidity of government bonds in times of stress and their lower perceived risk of default.

As seen in the chart below, for example, the Index which AGVT aims to track has tended to provide positive returns in recent periods of significant equity market decline.

Bond returns during periods of equity market weakness: 2008 – 2020



Source: Bloomberg. AGVT's Index is the Solactive Australian Government 7-12 Year AUD TR Index. Shows performance of index, not ETF, and does not take into account ETF fees and costs. Past performance is not an indication of future performance. You cannot invest directly in an index.

The returns from AGVT's Index in these negative sharemarket environments have also tended to be stronger than those of Australia's best-known benchmark bond index, the AusBond Composite – reflecting the fact that the latter has some exposure to corporate bonds and has been of lower overall duration.

And, as might be expected, AGVT's Index has also produced stronger returns in these periods than long duration corporate bonds – as represented by the index which the CRED ETF aims to track. Not only is CRED's index made up entirely of corporate bonds, but overall duration is also slightly less than that of AGVT's Index[5].

[5] That said, in general CRED's index outperformed the AusBond Composite Index in these periods as it holds longer duration bonds which benefit more when interest rates decline – as is typical during periods of equity market weakness.

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A SMART INDEXING APPROACH

At the heart of AGVT's attractive risk-return qualities is a smart approach to bond indexing, which has been a feature of all of BetaShares' highly rated fixed and floating-rate bond ETFs.

Traditional fixed-income indexing methods in Australia employ what's known as a "liability weighting" methodology, which essentially weights bonds in an index according to their relative issuance size in the market.

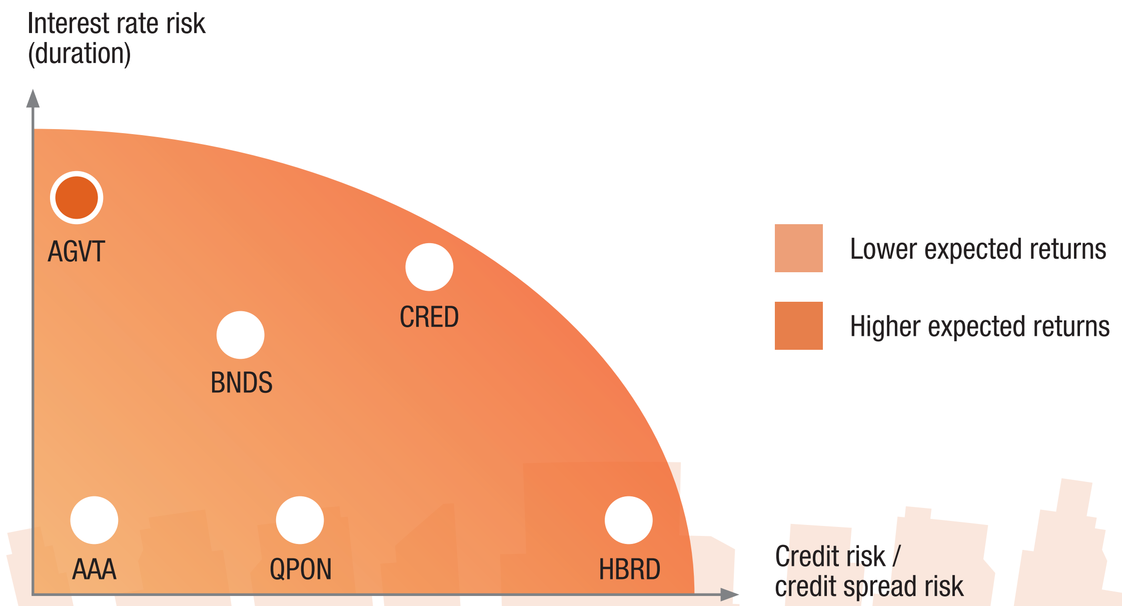
Basing bond weights purely on the issuance or liability size is similar to the traditional "market capitalisation" indexing approach in equities markets. But just as the market capitalisation indexing approach has limitations in the equity market, we consider that weighting by liability size alone has drawbacks in the bond market, as it essentially means issuers with the most bonds outstanding (and potentially, therefore, with higher credit risk) get the highest index weight!

More specifically, an important limitation of liability weighting is that the composition of an index – and its risk-return characteristics – can change over time depending on the types of bonds being issued. Due to relatively heavy government bond issuance, for example, the weight of lower-yielding government bonds within the broad Bloomberg AusBond Composite Index – which covers both government and corporate bonds – has increased in recent years. And even within either the corporate or government bond market, moreover, the duration exposure of bond indices will change in line with the relative duration of new bonds being issued.

To seek to address these limitations, BetaShares adopts indexing strategies that explicitly target certain types of risk and return characteristics (or "risk premia") available in the market – such as duration (or sensitivity to interest rates) and credit (or sensitivity to credit spreads). Although the Index which AGVT aims to track is also liability-weighted, for example, this only applies after selecting Government bonds of a particular duration (7-12 years) - rather than letting duration be dictated by the idiosyncratic issuance patterns taking place in the Australian bond market.

Our aim is to provide the bond "building blocks" that then enable investors to mix and match bond exposures so as to get the risk-return characteristics they most desire.

Risk vs return characteristics of BetaShares' Cash, Bond and Hybrid Fund exposures



Illustrative only.

CONCLUSION

AGVT offers exposure to long-duration Government bonds of high credit quality. As such, it provides potential for regular income as well as important diversification benefits when held alongside equities in a multi-asset class portfolio. Highly rated government bonds are generally considered a "safe haven" trade in times of economic stress.

As such, the AGVT ETF continues the BetaShares tradition of offering Australian investors innovative and intelligent investment solutions to help them meet their financial objectives.

There are risks associated with an investment in the Fund, including interest rate risk, credit risk, market risk and index tracking risk. For more information on risks and other features of the Fund, please see the Product Disclosure Statement.