BetaShares
Exchange Traded Funds

INVESTOR GUIDE

BETASHARES FIXED INCOME SOLUTIONS

betashares.com.au

BETASHARES FIXED INCOME SOLUTIONS

Fixed income has long been acknowledged as a core building block of a balanced portfolio, providing defensive characteristics and diversification benefits to investors.

However, research indicates that many Australian investors are underweight fixed income, particularly in superannuation. As an example, the average Australian superannuation fund's allocation to fixed income is just 35% of the OECD average (16% vs. 45%).[1]

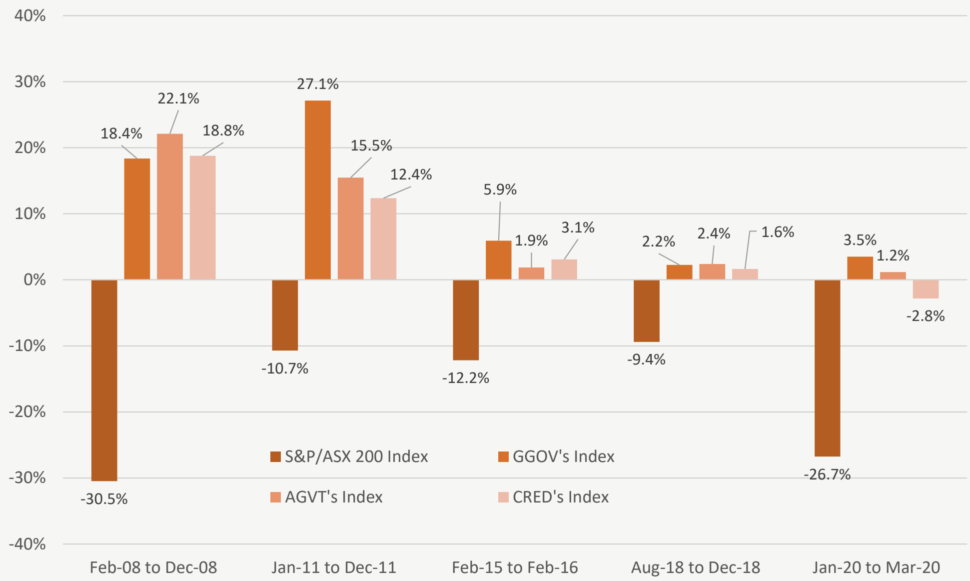
We believe the role of fixed income in an investment portfolio is significantly under-appreciated.

In times of uncertainty, such as when the outlook for economic growth deteriorates and investors lack confidence in the performance of equity markets, an exposure to fixed income becomes more important than ever. Investment grade corporate and government bond returns tend to be negatively correlated with shares while still yielding more than cash, and as a result, may help smooth out portfolio volatility, mitigate the effects of sharemarket drawdowns and reduce the risk of failing to meet investment objectives.

The chart below illustrates the defensive benefits of fixed income exposures. It shows the performance of the indices that three BetaShares fixed income funds aim to track during periods of equity market weakness between 2008 and 2020:

- CRED provides exposure to a portfolio of investment grade Australian corporate bonds
- AGVT provides exposure to a portfolio of primarily Australian government bonds.
- GGOV provides exposure to a portfolio of very long-dated high-quality global government bonds.

BONDS RETURN DURING PERIODS OF EQUITY MARKET WEAKNESS: 2008-2020



Source: Bloomberg. AGVT's Index is the Solactive Australian Government 7-12 Year AUD TR Index. CRED's Index is the Solactive Australian Investment Grade Corporate Bond Select TR Index. GGOV's Index is the S&P G7 Sovereign Duration-Capped 20+ Year AUD Hedged Bond Index. Shows performance of index, not ETF, and does not take into account ETF fees and costs. You cannot invest directly in an index. **Past performance is not indicative of future performance of any index or ETF.**

[1] Source: OECD, Pension Funds in Figures 2020. As of 31 December 2019.

WHAT IS FIXED INCOME?

Before taking a closer look at why it is important to have exposure to fixed income, it's necessary to understand how fixed income investments work, and how this asset class performs in different market environments.

Fixed income covers several types of investment, the most well-known being bonds.

When you invest in a bond, essentially you are lending money to the bond issuer, which may be a company, government or other entity. Bonds pay a regular income stream to investors, called 'coupons' - some pay a fixed rate of interest, others pay a floating rate.

FIXED VS. FLOATING (PART 1)

A **FIXED RATE BOND** pays a set rate of interest for the term of the bond. You know at the time you make the investment how much interest you will receive on each payment date.

A **FLOATING RATE BOND** pays a rate of interest that varies in line with a benchmark interest rate. As the benchmark interest rate changes, the interest you receive also changes.

As well as regular income payments, capital returns (gains or losses) are also possible from fixed income investments, as the market price of a bond is not fixed.

Depending on how interest rates move, the capital returns from a fixed income investment can be significant, and may exceed the returns from interest payments.

Investments that pay fixed interest tend to fluctuate more in price than those that pay floating rate.

WHAT DETERMINES A BOND'S VALUE?

A bond can be thought of as a series of cashflows, comprising:

- regular interest payments (coupons), and
- repayment of the bond's face value at maturity.

BOND CASH FLOWS

A bond's value comes down to what those future cashflows are worth in today's dollars.

Where a bond pays fixed interest, the valuation of its cashflows depends significantly on current interest rates:

- The lower current interest rates are, the higher the value attributed to those cashflows, and so the more an investor will be prepared to pay for them.
- The higher interest rates are, the more those cashflows will be discounted, and the less someone will pay for them.

So there is an ***inverse*** relationship between the price of a bond and its yield (being the bond's expected annualised return to the bond's maturity) – as a bond's yield falls, its price rises (and vice versa). The longer the maturity of the bond, all else equal, the more sensitive its price is to yield movements.

BOND PRICE VS. YIELD

Where an investment pays floating rate interest, its value will not fluctuate nearly as much with changes in interest rates. In contrast with fixed rate bonds, the income you receive from a floating rate investment varies in line with movements in a benchmark short-term interest rate such as the 3-month bank bill swap rate (BBSW).

HOW CAN YOU INVEST IN FIXED INCOME?

It's generally impractical for individual investors to invest directly in bonds. Minimum investment size is usually much larger than for share investments, and investors may not necessarily have the time and skills required to properly research and analyse individual bonds. In addition, most bonds trade over the counter (OTC) in a dealer-based market, making it hard for most individual investors to assess if they are getting a fair price.

ETFs provide a simple-to-access and convenient way to gain exposure to a portfolio of bonds.

The benefits of investing via a fixed income ETF instead of directly in individual bonds include:

- **DIVERSIFIED EXPOSURE** – because a fixed income ETF will include bonds issued by a range of issuers, it means you are not exposed to the credit risk of just one issuer.
- **SIMPLER INVESTMENT PROCESS** – there is no need to analyse and select individual bonds, rebalance into newly-issued bonds or manage maturing securities, as this is undertaken by the issuer or manager of the ETF.
- **ABILITY TO FINE-TUNE YOUR DEFENSIVE ALLOCATION IN ONE TRADE** – fixed income ETFs function as asset allocation building blocks, making it easy to adjust your portfolio based on your specific needs for equity diversification and income, and your tolerance for interest rate and credit risk.

The features of BetaShares' fixed income ETFs include:

- traded on the ASX, so can be bought and sold just like shares.
- no minimum investment size (aside from any required by your broker).
- proceeds from selling an ETF generally available T+2.
- income paid on a monthly basis, compared to the typical quarterly or six-monthly interest paid by individual bonds.
- cost-effective, with management fees significantly lower than traditional unlisted actively managed funds.

We offer several index-tracking fixed income ETFs that are outlined later in this brochure.

We also offer the actively-managed BetaShares Legg Mason Australian Bond Fund (managed fund) (BNDS), which invests in a portfolio of Australian government, semi-government, and corporate bonds, and other eligible fixed income securities.

Whether index-tracking or actively-managed, all our Fixed Income solutions offer the transparency of an ETF - portfolio holdings, the value of the Fund's assets, yield information and net asset value per unit are available on our website.

FIXED VS. FLOATING (PART 2)

While an ETF may invest in fixed rate bonds, this does not mean that the interest paid by the ETF is fixed. As bonds in the portfolio mature or are sold, new bonds are purchased, which are likely to pay a different coupon rate to the bonds they are replacing. The interest paid by the fund will change to reflect the composition of the portfolio at any point. However, this is generally a gradual process, as bond maturities/sales are typically spread out over time.

In contrast, the income profile of a fund that holds floating rate bonds will be more responsive to changes in the interest rate environment, as the interest paid by the bonds in the portfolio will move in line with interest rate changes. The BetaShares Australian Bank Senior Floating Rate Bond ETF (ASX: QPON), for example, holds a portfolio of floating rate bonds. As interest rates increase, the interest paid on the bonds in the portfolio – and therefore the interest paid by the ETF – will increase (and vice versa).

WHAT DRIVES THE RETURN FROM A FIXED INCOME INVESTMENT?

The yield on fixed income exposures reflects the following risks:

- interest rate risk, and

- credit risk.

INTEREST RATE RISK/DURATION

Part of a fixed income investment's return is linked to the current 'risk-free' interest rate i.e. what can be earned on a high-grade government bond with a similar maturity. Government bond yields in turn are affected by short term (cash) rates, expected future cash rates and by expectations around economic growth and inflation over the term of the bond.

As the risk-free rate changes, the price of a bond (or bond portfolio) changes. As interest rates increase, the price of a bond will fall. As interest rates fall, the price of the bond will rise.

How much a bond's price changes in response to changes in interest rates depends on its duration – the timeframe over which its cashflows are received.

Duration is a measure of sensitivity to movements in interest rates. The longer the duration of a bond, or bond portfolio, the more sensitive its price will be to changes in interest rates.

This has important implications for how a fixed income portfolio is constructed. In a falling interest rate environment, it will generally be best to have a portfolio with long duration, so as to gain the most benefit from rate decreases.

CREDIT RISK

Credit risk refers to the additional risk of a fixed income investment over and above a risk-free (government) bond. An investment in corporate bonds, for example, involves the risk that the issuer of the bond will default on its obligations. This risk will be reflected in the 'credit spread' – the spread above the risk-free yield to compensate for taking on credit risk.

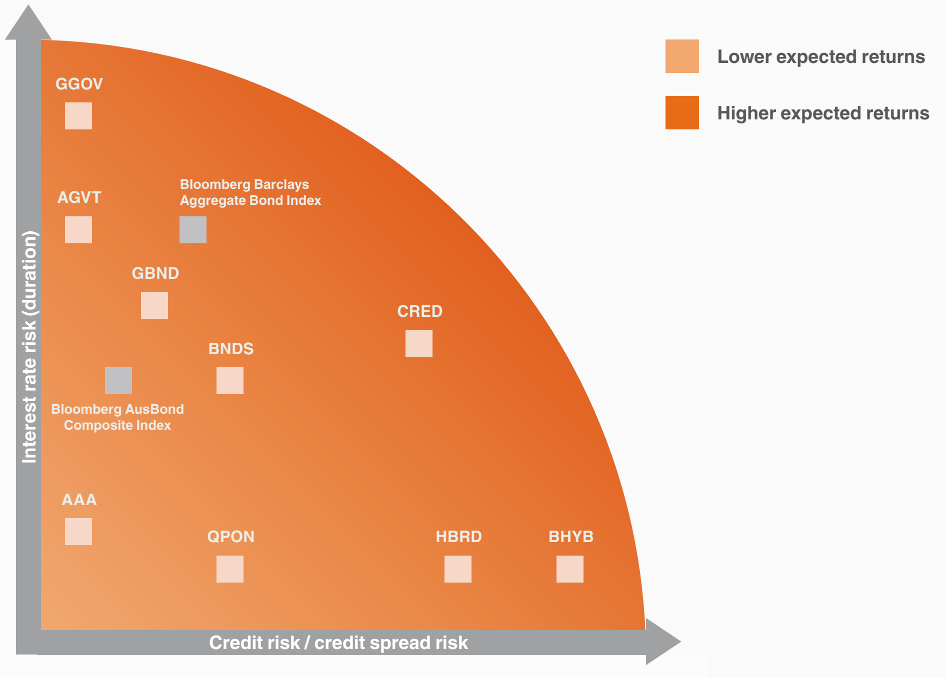
A bond of lower credit quality must offer a greater return to investors than a higher quality bond of the same maturity, because of the increased risk it involves. In addition, the credit spread at a given credit quality typically increases with maturity. Like duration, the impact of credit spread changes on a bond's price also increases with maturity ('credit spread duration').

The higher the credit risk of a fixed income investment, the more 'equity-like' the exposure will be. It is important to bear this in mind when evaluating the diversification benefits a fixed income investment offers – the greater the credit risk a fixed income investment entails, the less the diversification it offers from your share investments. As a result, high-yield – sub-investment grade – bonds historically have tended to suffer from negative returns at the same time as equities during periods of market stress (the very times you most want the benefits of diversification!).

Variables that affect credit risk include broad expectations of economic growth and corporate profitability, and company-specific factors like balance sheet health. You can substantially reduce the impact of company-specific factors by investing in a bond fund rather than individual securities – the diversified exposure a fund offers means that you are much less exposed to the risk of any one issuer.

The chart below shows, in general terms, the exposure to the two sources of return premia of the funds in the BetaShares fixed income, cash and hybrids suite, and how expected returns vary with credit risk and/or time to maturity (duration). The funds themselves are outlined later in this guide.

FIXED INCOME EXPOSURE GUIDE



Provided for illustrative purposes only. Not a recommendation to make any investment decision or adopt any investment strategy

WHY INVEST IN FIXED INCOME?

There are several reasons we believe it's important to include an exposure to fixed income in your investment portfolio, including:

POTENTIAL FOR OUTPERFORMANCE

DIVERSIFICATION BENEFITS

LOWER VOLATILITY THAN SHARES

REGULAR INCOME

POTENTIAL FOR OUTPERFORMANCE

We believe that in a low, or falling interest rate environment, it's more important than ever to hold fixed income investments.

Investors sometimes make the mistake of thinking that when interest rates are low, fixed income investments will always produce correspondingly low returns. This view typically reflects a focus on the interest component of returns, and ignores the capital returns that can be made from an investment in fixed income.

For example, in the five years to 30 November 2020, the RBA cash rate fell from 2.0% to 0.10%. However, over the same period:

- the index the BetaShares Australian Investment Grade Corporate Bond ETF (ASX: CRED) aims to track returned 7.24% p.a.[2]
- the index the BetaShares Australian Government Bond ETF (ASX: AGVT) aims to track returned 6.29% p.a.[2]
- the index the BetaShares Global Government Bond 20+ Year ETF – Currency Hedged (ASX: GGOV) aims to track returned 9.18% p.a.[2]

These levels of return were largely a result of the increase in the capital value of the portfolio of bonds covered by the relevant indices.

In a falling interest rate environment, capital returns on fixed interest investments can be significant. The longer the duration of a bond portfolio, the more it will tend to benefit from a fall in interest rates. CRED, AGVT and GGOV focus on longer duration bonds.

[2] Source: Bloomberg. Performance information relates to the index that each ETF aims to track, and not the ETF itself. Does not take into account ETF fees and costs. You cannot invest directly in an index. **Past performance is not an indication of future performance of any index or ETF.**

DIVERSIFICATION BENEFITS

One of the most important reasons for including fixed income in your portfolio is diversification. The idea is that your fixed income allocation acts as a defence when equities are not performing well. Historically, in times of uncertainty when sharemarkets were experiencing stress, a 'flight to quality' often resulted in an increase in demand for the relative safety of bonds.

For this to work, your fixed income investments must show a low or negative correlation to equities. Fixed income investments are not all the same, however, and range from risk-free government bonds to sub-investment grade corporate debt. The correlations of these individual investments to shares varies widely.

As explained in the previous section on the sources of bond returns, the more credit risk a fixed income investment has, the greater the correlation it has to equities, and therefore the lower the diversification benefits. For example, high-yield debt, involving significant exposure to credit risk, behaves in a more 'equity-like' way than government bonds, which generally involve no (or very low) credit risk.

Fixed income investments that tend to provide the greatest diversification benefits from equity exposures are government bonds and high-quality corporate bonds. The focus should be mainly on interest rate risk – and in a falling interest rate environment, on long duration interest rate risk, as this will benefit the most from declining yields.

The three funds mentioned above are examples of this type of exposure:

- CRED provides exposure to a portfolio of investment grade Australian corporate bonds
- AGVT provides exposure to a portfolio of primarily Australian government bonds
- GGOV provides exposure to a portfolio of very long-dated bonds issued by the national governments of G7 developed market economies.

The first chart in this Guide, comparing the performance of the indices CRED, AGVT and GGOV aim to track with the S&P/ASX 200 Index during periods of equity market weakness, illustrated the low/negative historical correlation of both investment grade bonds and government bonds with shares. It demonstrates how a holding of fixed income can help mitigate the effects of market drawdowns.

The diversification benefits that fixed interest investments offer are the main reason we believe it is not enough just to add cash holdings to a share portfolio. Cash, while providing capital stability, does not provide the same level of portfolio insurance or diversification as certain types of bond exposures in periods when equity markets perform poorly.

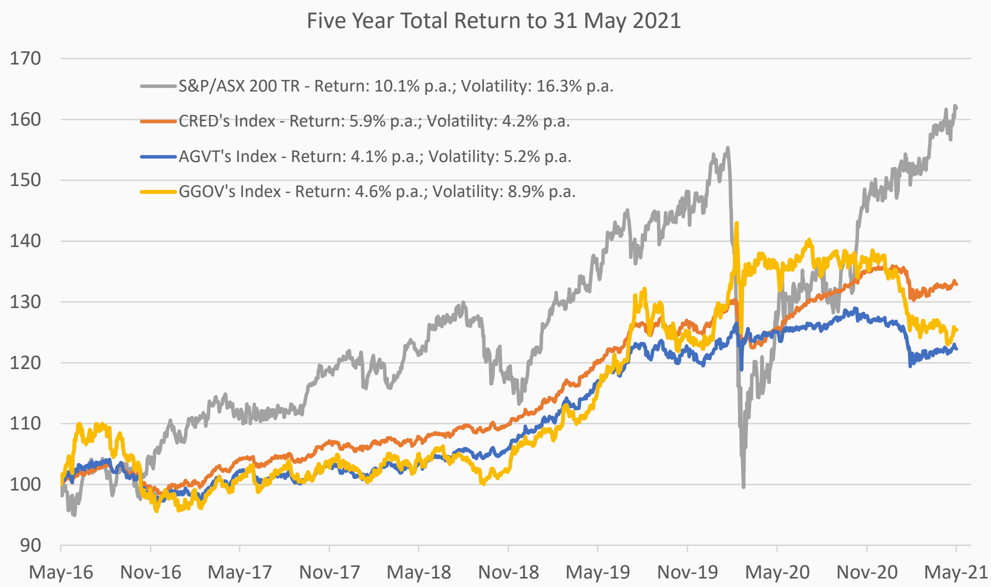
The longer the duration and the higher the credit quality of the bonds, the greater the potential diversification benefits.

LOWER VOLATILITY THAN SHARES

Fixed income investments typically provide a 'smoother ride' than shares. This can be particularly attractive for investors who are seeking to avoid large fluctuations in the value of their portfolio. Having an allocation to fixed income has the potential to reduce overall portfolio volatility.

The chart below illustrates the performance of the indices CRED, AGVT and GGOV aim to track vs. the S&P/ASX 200 Index, over the five years to 31 May 2021. Over this period, AGVT's index showed an annualised volatility less than one third that of the sharemarket index, the volatility of CRED's index was less than a quarter of the S&P/ASX 200 Index, and the volatility of GGOV's index was just over half that of the sharemarket index.

FIVE YEAR TOTAL RETURN TO 31 MAY 2021



Source: Betashares, Bloomberg. Shows performance of the index, and not the relevant ETF. Does not take into account ETF fees and costs. You cannot invest directly in an index. **Past performance is not indicative of future performance of any index or ETF.**

REGULAR INCOME

Bond coupons are paid on a regular and pre-determined schedule. An ETF that holds a portfolio of bonds can therefore provide a regular and relatively reliable income stream, often at lower levels of risk than other assets such as shares or property. Fixed income investments also typically pay higher rates of interest than cash or term deposits.

BETASHARES FIXED INCOME AND HYBRID SOLUTIONS

The BetaShares fixed income and hybrids product range has been created to provide solutions for a broad range of investors. Our funds provide a simple-to-access and cost-effective way to construct this important part of your investment portfolio.

You can trade the funds on the ASX like any share. We require no minimum investment for our funds (your broker may require a minimum investment, typically ~$500).

All our ETFs are transparent, so you know exactly how the fixed income portion of your portfolio is invested.

BETASHARES AUSTRALIAN GOVERNMENT BOND FUND **(ASX: AGVT)**	▸ holds a portfolio of high-quality bonds issued by Australian federal and state governments, supranationals and sovereign agencies ▸ offers regular attractive income, defensive benefits and the potential for strong returns in a falling interest rate environment
BETASHARES AUSTRALIAN INVESTMENT GRADE CORPORATE BOND ETF **(ASX: CRED)**	▸ holds a portfolio of investment grade Australian corporate bonds ▸ offers regular, attractive income, and potential defensive benefits when equity markets decline
BETASHARES SUSTAINABILITY LEADERS DIVERSIFIED BOND ETF - CURRENCY HEDGED **(ASX: GBND)**	▸ holds a diversified portfolio of high-quality bonds meeting strict ethical standards ▸ enables ethical investors to invest in fixed income in a way that is consistent with their ethical standards
BETASHARES GLOBAL GOVERNMENT BOND 20+ YEAR ETF – CURRENCY HEDGED **(ASX: GGOV)**	▸ holds a portfolio of long-dated bonds issued by the national governments of the G7 developed economies ▸ offers the security of high credit-quality bonds, and potential diversification and defensive benefits when equity markets decline
BETASHARES AUSTRALIAN SENIOR BANK FLOATING RATE BOND ETF **(ASX: QPON)**	▸ holds a portfolio of senior floating rate bonds issued by major Australian banks ▸ offers regular, attractive income that is expected to increase if interest rates rise, as well as the potential for a high level of capital stability
BETASHARES AUSTRALIAN HIGH INTEREST CASH ETF **(ASX: AAA)**	▸ invests in bank deposit accounts with selected banks in Australia ▸ offers regular income, and high levels of security associated with bank deposit accounts at banks regulated by APRA
BETASHARES LEGG MASON AUSTRALIAN BOND FUND (MANAGED FUND) **(ASX: BNDS)**	▸ holds an actively managed, broadly diversified portfolio of Australian government, semi-government and corporate bonds, and other eligible fixed income securities ▸ offers regular attractive interest, and the potential for added value through professional, active management
BETASHARES ACTIVE AUSTRALIAN HYBRIDS FUND (MANAGED FUND) **(ASX: HBRD)**	▸ holds a portfolio of hybrid securities, bonds and cash ▸ offers attractive, tax-efficient income from a portfolio of hybrid securities that is actively managed with the aim of reducing volatility and risk.
BETASHARES AUSTRALIAN MAJOR BANK HYBRIDS INDEX ETF **(TICKER: BHYB)**	▸ holds a portfolio of listed hybrid securities issued by Australia's 'Big 4' banks ▸ offers attractive, tax-efficient monthly income, and potential defensive benefits when equity markets decline

MORE INFORMATION

For more information about BetaShares fixed income and hybrid funds, visit www.betashares.com.au or speak to your adviser.

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There are risks associated with investments in the BetaShares Funds, including interest rate and credit risk, and complexity risk with hybrids. The value of an investment and income distributions can go down as well as up. Before making an investment decision investors should consider the relevant Product Disclosure Statement, available at www.betashares.com.au, and their particular circumstances, including tolerance for risk, and obtain financial advice.