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OZBD: A smarter way to invest in Australian bonds

ASX: OZBD

Betashares Australian Composite Bond ETF

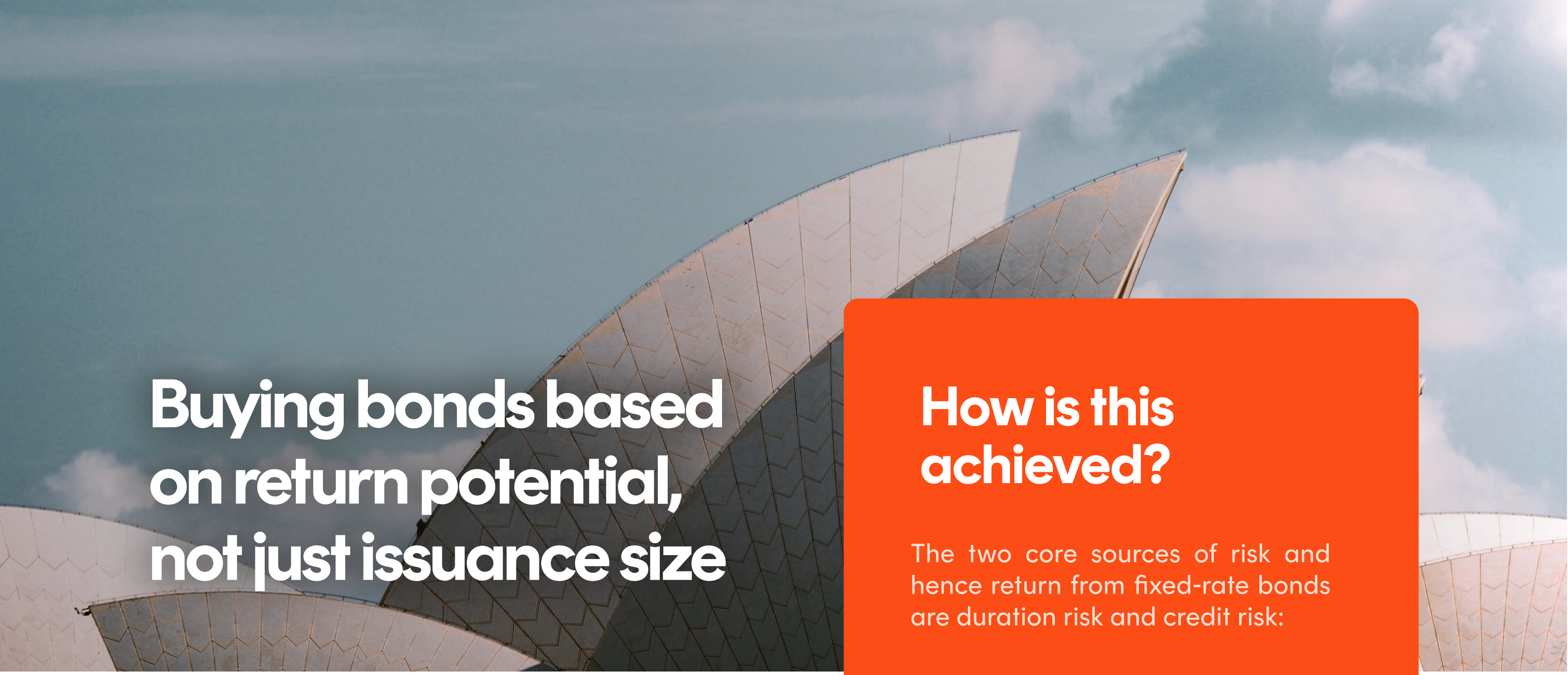
Fixed-rate bonds form an important part of most well-diversified investment portfolios.

However, to this day, innovations in bond market investing have tended to lag those in the equity market. Bond investors still largely need to choose between high-cost active managers and low cost - yet very simple - passive index approaches.

Yet as has been discovered in the equity market, an alternative 'smart beta' approach – which uses rules-based methods beyond that of simple market-cap weighting – can potentially generate superior returns to both active and simple passive approaches.

In the bond market, simple market-cap weighting approaches arguably make little sense – as they effectively involve investing more in those companies or governments that have issued the most debt, and hence that can pose potentially more investment risk!

To overcome these limitations, and bring much-needed innovation to bond market investing, Betashares has recently launched its Australian Composite Bond ETF (ASX: OZBD), which complements its existing suite of sector-specific bond ETFs.



Buying bonds based on return potential, not just issuance size

The key innovation underpinning the OZBD ETF is that it aims to track a rules-based index that selects bonds based on their risk-adjusted income potential, while still controlling for overall interest rate and credit risk (the Bloomberg Australian Enhanced Yield Composite Bond Index).

That's a big difference from the typical passive fixed-income approach, as adopted by Australia's widely-followed Australian Composite Bond Index (hereafter the "AusBond"), which weights all investment grade fixed-rate bonds issued within Australia by their total issuance outstanding. The more bonds on the market, the higher the weight of those bonds in the AusBond Index!

In the equity market, passive strategies that weight stocks by market capitalisation have some potential investment merit, as a stock's rising market capitalisation is usually driven by a rising share price (and hence perceived corporate success).

In the bond market, by contrast, when a company or entity issues more bonds they become more indebted, hence a larger or increasing value of bonds outstanding from a particular issuer is less likely to be associated with improved investment merit. All else equal, deeper indebtedness in fact increases the potential credit risk associated with that issuer.

How is this achieved?

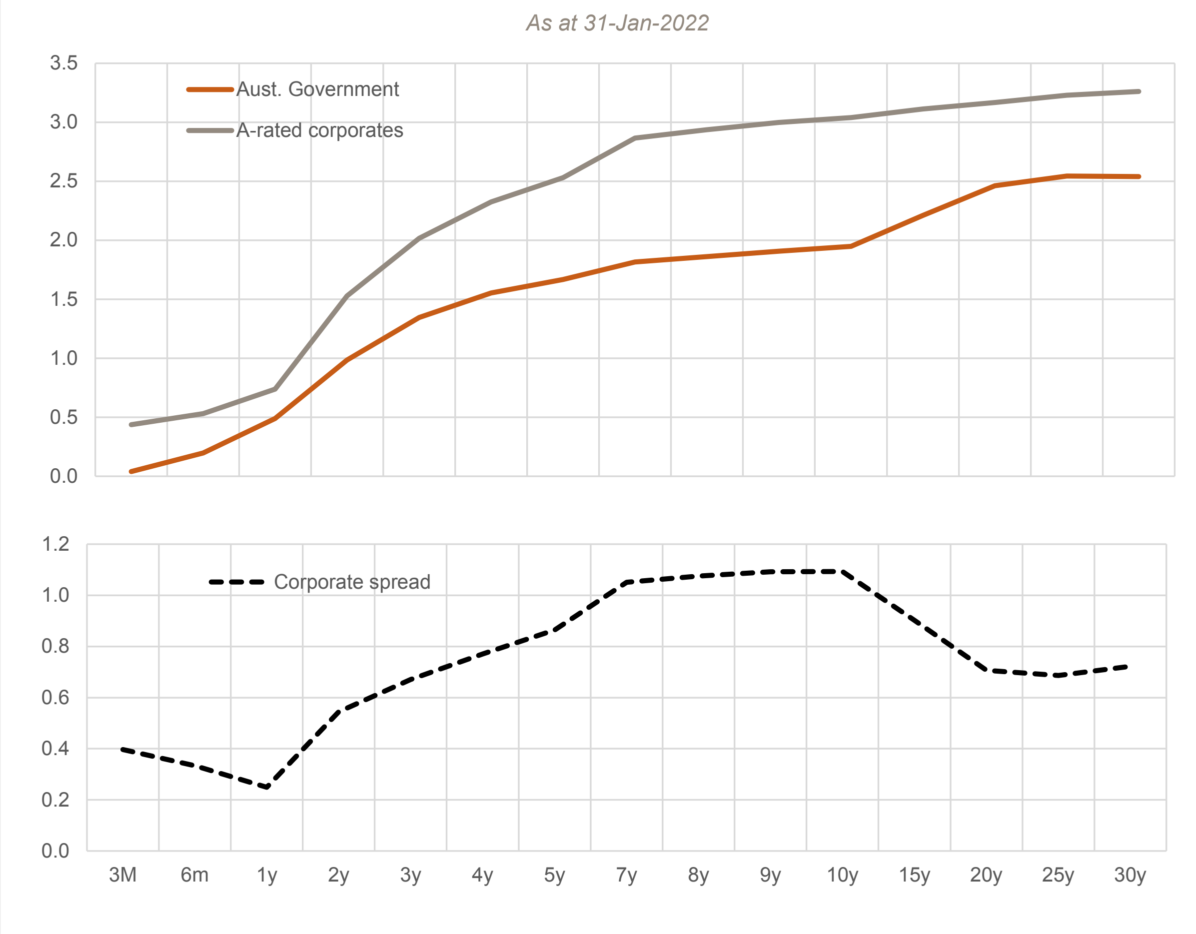
The two core sources of risk and hence return from fixed-rate bonds are duration risk and credit risk:

- Duration relates to the sensitivity of a bond's market price to changes in market interest rates over time, and is positively related to a bond's remaining term to maturity. Generally speaking, longer duration bonds tend to offer higher yields, in part due to the compensation demanded by investors for the increased interest rate sensitivity.
- Credit risk relates to the risk that the issuer of the bond could get into financial difficulty and default on either interest or principal repayments. Due to their ultimate taxing powers, governments tend to have less credit risk than private companies. All else constant, corporate bonds tend to offer higher yields than government bonds, given their higher risk.

Rather than just accepting bond weights according to their issuance into the market, the strategy underpinning OZBD's Index is to explicitly seek more exposure to those bonds offering the best risk-return payoff, subject to the overall risk characteristics of the resulting 'optimised index' still being reasonably close to that of the AusBond Index.

The chart over the page shows the yield curve for both government and highly-rated corporate bonds as at 31 January 2022. Here we see that the longer duration government and corporate bonds were offering higher yields than shorter duration bonds. What's more, corporate bonds were offering a higher yield than government bonds at each level of duration. Note also that the extra yield premium or 'credit spread' that corporate bonds offer over government bonds has tended to rise with duration and has been most attractive around the 10-year mark.

Australian bond yield curves

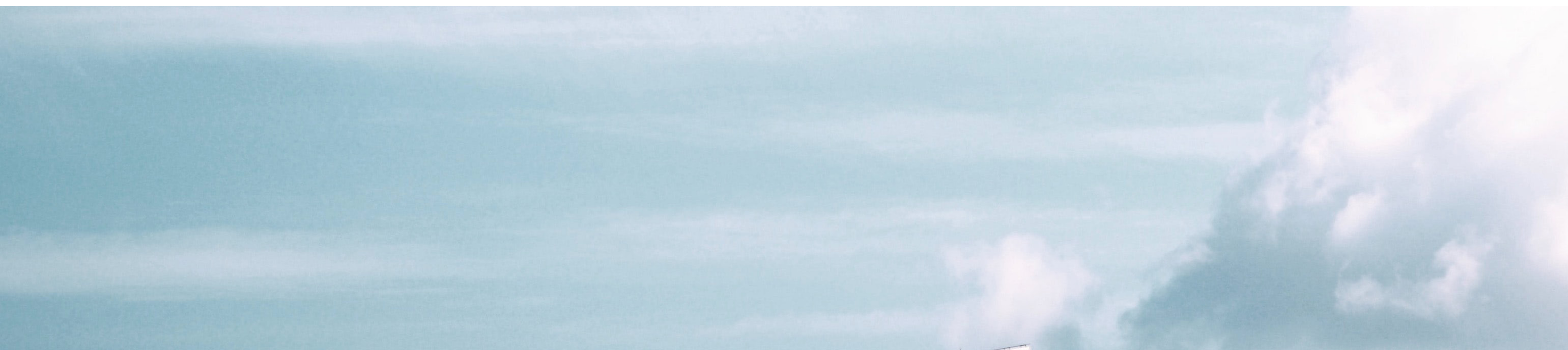


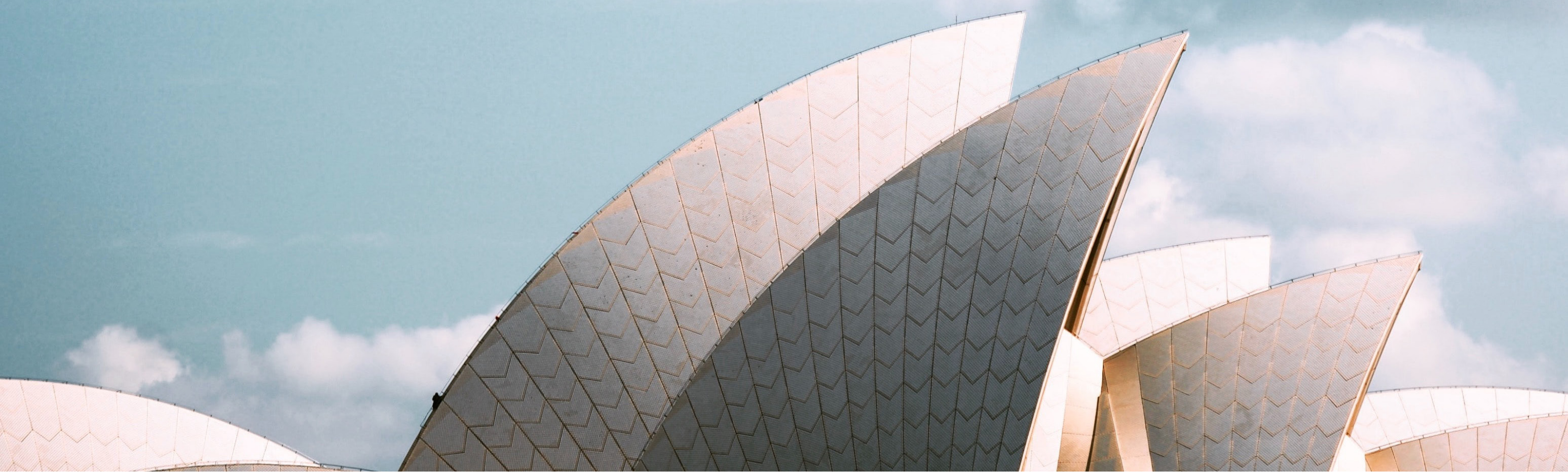
Source: Bloomberg. Past performance is not an indicator of future performance. Yield curve is subject to change over time.

Of course, one could maximise yield by just taking on more duration and/or credit risk – such as simply owning, for example, more long-duration corporate bonds. But the optimisation process underpinning OZBD's Index construction seeks to constrain both overall duration and credit risk, to ultimately not stray too far from the AusBond Index[1], while retaining flexibility to choose which market segments to have the most exposure to in a way which seeks to maximise yield potential.

Effectively, the optimisation process uses the relative attractiveness of the credit spread or yield pick-up to decide where along the yield curve OZBD's Index should have more or less exposure to corporate bonds over government bonds than the AusBond Index (subject to relevant exposure guidelines described in the Index methodology).

[1] For example, under OZBD's index methodology, the overall duration of OZBDs Index should be within -/+ 1 year of the AusBond Index. Federal and State Government bonds should be between 40% to 75% of the overall index. There also needs to be sufficient exposure to longer-duration government bonds, with the duration-weighted government share of the index between 50 to 85%. OZBD's Index 'tracking error' to the Ausbond Index (an estimate of the degree to which relative monthly returns can vary over time) can be no more than 2% annualised. No more than 5% of the value of bonds within the index can be turned over at each monthly rebalance.



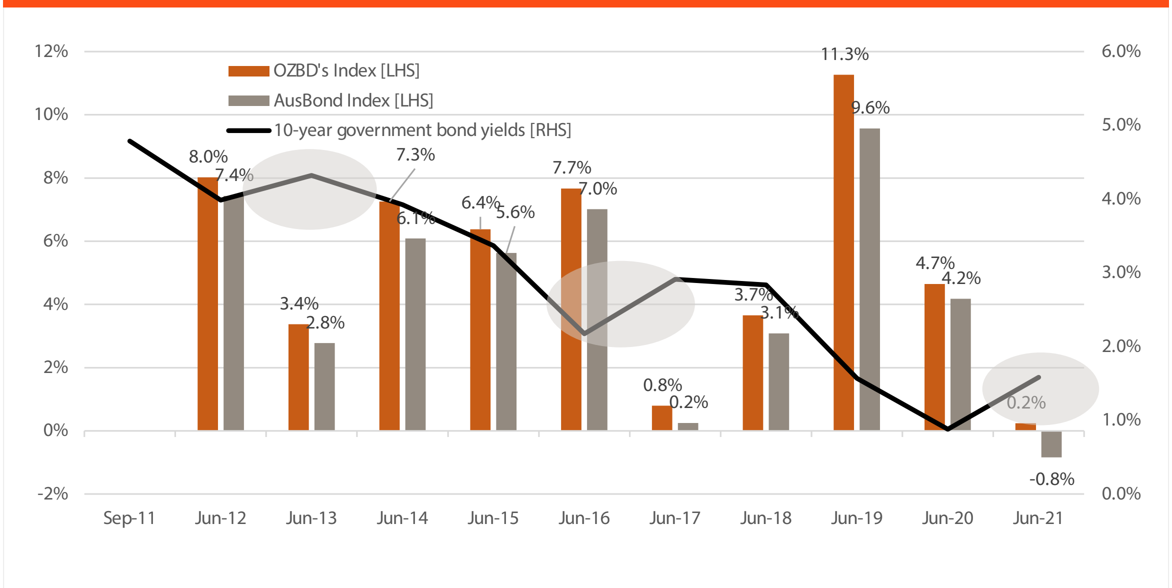


Improved return potential with good diversification benefits

OZBD's Index optimisation process has historically beaten returns from the AusBond Index over the longterm. From inception in September 2011 to end-January 2021, OZBD's Index produced annualised returns of 4.8% p.a. compared with 4.1% p.a. from the AusBond Composite.*

As evident in the chart below, OZBD's Index has also delivered stronger returns in each of the past 10 financial years, irrespective of whether government bond yields rose (shaded areas) or fell.

Financial year bond index performance

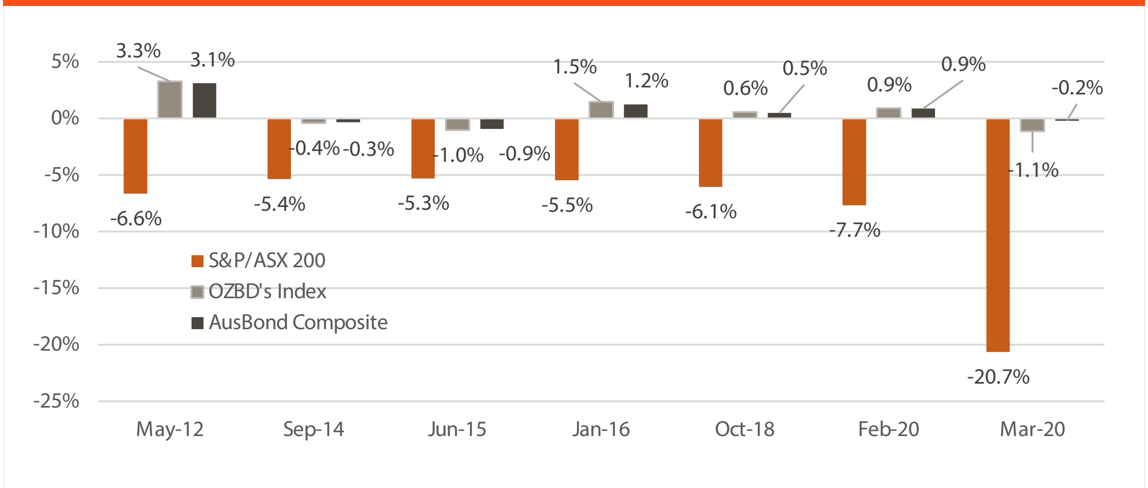


Source: Betashares, Bloomberg. Past performance is not indicative of future performance of Index or OZBD. Does not take into account OZBD's fees and costs. You cannot invest directly in an index. OZBD's Index is the Bloomberg Australian Enhanced Yield Composite Bond Index.

As evident in the chart over the page, moreover, OZBD's Index has also provided good portfolio diversification benefits comparable to that of the Ausbond Composite Index. During the seven worst monthly performances for the S&P/ASX 200 Index over the past decade, OZBD's Index return has tended to broadly match that of the AusBond Index, producing a modestly better return four times and a modestly lower return three times[3].

[2] Past performance is not indicative of future performance. Does not take into account OZBD's fees and costs.

Historical performance during equity sell-offs



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The relatively attractive returns of OZBD's Index in varied market environments reflect its focus on bonds with high income potential – which often fully or at least partially compensates investors for periods of capital return weakness in periods of either rising government bonds yields or increasing credit risk.

The average yield on bonds within OZBD's Index, for example, has been around 0.3% p.a. higher than that of the AusBond since inception to 31 January 2022, reflecting modestly higher duration and credit exposure within its acceptable risk limits[4]. By focusing on bonds at relatively steep parts of the yield curve, moreover, OZBD's Index generated another 0.2% p.a., from extra 'roll return'[5].

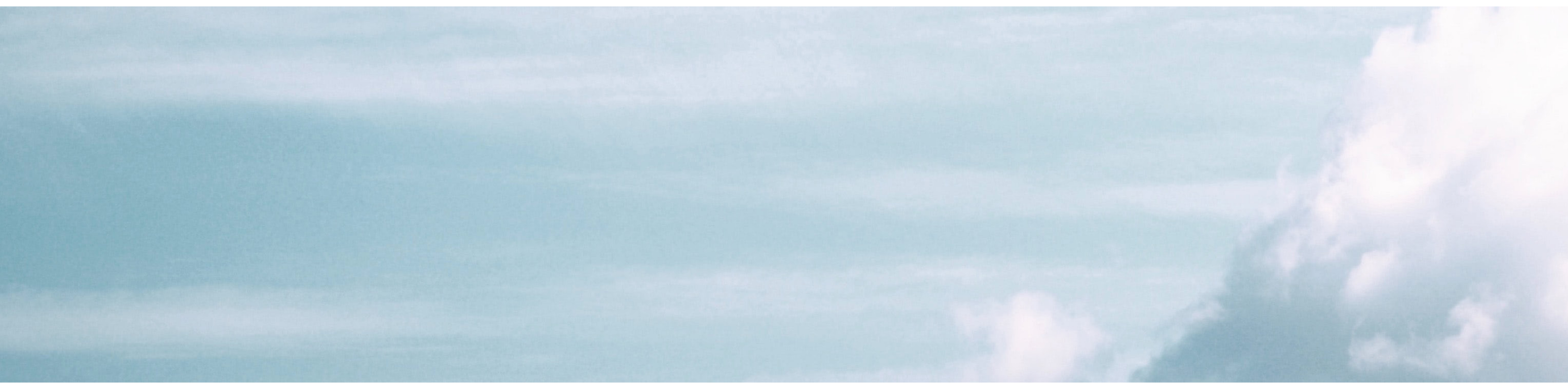
It also helps that the OZBD Index's two sources of extra return premia – duration and credit – have tended to be negatively correlated over time, helping dampen overall return volatility.

For example, while corporate bonds have tended to underperform government bonds, all else constant, during equity sell-offs (due to a widening in credit spreads), the impact on OZBD's Index return performance has tended to be at least partially offset by a general decline in interest rates at the same time, which favours longer duration bonds over shorter duration bonds. Periods of rising interest rates, by contrast, which hurt long duration bonds, also tend to be periods of narrowing credit spreads, which favours corporate bonds.

[3] The biggest difference in return between OZBD and AusBond Index during these periods of equity market weakness was during the COVID shock of early 2020 – where severe short-term market dislocation saw both long duration and credit exposures underperform as investors sought cash. This temporary dislocation was relatively quickly unwound, however, with OZBD's Index recouping most of this performance in subsequent months.

[4] 0.97 years greater interest rate duration and 0.58 years greater credit spread duration since inception.

[5] Roll return is derived from holding bonds of a given duration and benefiting from the capital gain on these bonds as their duration shortens (and interest rate sensitivity or risk lessens) over time. As part of the OZBD Index's regular rebalancing process bonds tend to be sold as their duration shortens and replaced with new bonds at the initial longer duration – so as to maintain overall index duration at target levels. The resulting capital gains on sale is income that is then distributed to end-investors.



Summary

The Bloomberg AusBond Composite Bond Index is the best known and most widely followed benchmark bond index in Australia. As a performance yardstick, it does a reasonable job in assessing the relative performance of active bond managers against 'the market'.

Although also widely tracked by many passive fixed-income managers, the AusBond Index arguably is a relatively simple benchmark, as it merely weights bonds according to their issuance size in the market. Unlike in the case of equities, the value of bonds in the market may be considered a measure of limited investment merit – and potentially a contrary indicator!

To overcome these limitations, the OZBD ETF seeks to track a more intelligent composite bond index (before fees and expenses) specifically designed to maximise potential income returns over time, subject to certain risk constraints. As evident, it has historically tended to produce better income returns than the AusBond Index over time while still providing broadly similar diversification benefits.

Given the importance of bonds within most well diversified investment portfolios, and especially given these times of challenging income returns, Betashares is pleased to offer an intelligent approach to gaining cost-effective passive exposure to this asset class, an innovation we consider long overdue.

There are risks associated with an investment in OZBD, including interest rate risk, credit risk, market risk and index tracking risk. For more information on risks and other features of OZBD please see the Target Market Determination (TMD) and Product Disclosure Statement, which are available at www.betashares.com.au.