THE CASE FOR QPON

BetaShares Australian Bank Senior Floating Rate Bond ETF (ASX: QPON)

BetaShares
Exchange Traded Funds

JUNE 2017

Rising Rates, Rising Income! The Case for the BetaShares Australian Bank Senior Floating Rate Bond ETF (ASX: QPON)

In today's world of very low interest rates, investors face a challenging trade-off in seeking decent income returns outside of the volatile equity market. While most cash and deposit products offer relative security and liquidity, returns are currently very low. By contrast, investors seeking higher income returns from fixed income, and who turn to fixed-rate bonds, are exposed to potential poor total returns - and even some capital loss for a period - as and when today's very low bond yields eventually rise to more normal levels.

Indeed, rather than offering reasonable returns at relatively low risk, getting exposure today to "fixed-rate" bond indices tracked by most passive bond managers, can be likened to accepting "return-free risk".

Against this challenging background, the **BetaShares Australian Bank Senior Floating Rate Bond ETF (ASX: QPON)** has been designed to offer today's investors a potentially better risk-return alternative within the bond investment space. As the name implies, the Fund invests in some of the largest and most liquid senior floating rate bonds (FRBs) issued by Australian banks. Due to their floating interest-rate structure and high credit quality, these bonds tend to offer an income premium over traditional cash and short-term deposit products for only marginally greater interest rate risk and credit exposure. And especially in times of rising interest rates, FRBs have also tended to historically outperform fixed-rate bonds.

As such, the QPON ETF continues the BetaShares tradition of offering Australian investors innovative and intelligent investment solutions to help them meet their financial objectives, which are highly relevant to the prevailing macro-environment.

The special features of Floating Rate Bonds (or FRBs)

As noted above, the risk-return advantages of senior bank FRBs stem from their floating interest rate structure and high credit quality.

As distinct from "fixed-rate" bonds – where nominal regular interest payments are fixed over the life of the bond – variable or "floating-rate" bonds have their interest payments reset at regular intervals to reflect the prevailing level of market-determined interest rates[1]. Accordingly, the market value of floating rate bonds is much less sensitive to changes in the general level of interest rates (i.e. have lower interest-rate risk) compared with fixed-rate bonds.

1Specifically, in the case of senior bank FRBs, part of their quarterly interest payment is based on the prevailing market-determined interest rate at which banks agree to lend each other funds over the following 3 month time period (known as the 3 month bank bill swap rate, or BBSW). In addition, these bonds also pay a fixed interest-rate margin over BBSW that is fixed at the date of bond issue and reflects the bond's maturity and the prevailing market assessed "credit risk" associated with each bank.

As seen in the table below, this has historically tended to result in lower total return volatility, less downside risk and better risk-adjusted returns for the index that QPON aims to track compared to other commonly used bond and equity investment benchmarks.

INDEX RISK AND RETURN COMPARISONS: 28/2/2007 – 31/5/2017

Index	Asset	Return (p.a.)	Average Yield*	Volatility (p.a.)	Risk Adjusted Return	Max Drawdown
QPON's Index	Aus. Bank Senior Floating Rate Bonds	5.2%	2.6%	0.6%	9.1	-0.8%
Bloomberg Corporate Bond Index	Aus Fixed Coupon Corporate Bonds	6.5%	2.8%	1.9%	3.4	-2.4%
Bloomberg Composite Bond Index	Aus Fixed Coupon Bonds	6.1%	2.2%	3.0%	2.1	-3.6%
MSCI World (unhedged)	Int Equity	4.6%	2.5%	17.5%	0.3	-57.8%
S&P/ASX 200	Aus Equity	4.5%	4.4%	18.4%	0.2	-51.6%
RBA overnight cash rate	Aus Cash	3.8%	1.5%	--	--	--

*Yield as at 31/5/2017. QPON's Index is the Solactive Australian Bank Senior Floating Rate Bond Index. Yield shown is total expected return for QPON's Index given current margin to 3 month BBSW, exclusive of QPON's management costs of 0.22% p.a. You cannot invest directly in an Index, and total return figures shown do not include QPON's management costs. QPON's yield is variable. Inception date of QPON's Index is 30 May 2017 and data prior to this date has been simulated and may not be reflective of actual results. Risk Adjusted Return is return divided by volatility. Current yield available at www.betashares.com.au. Past performance whether simulated or actual is not indicative of future performance. Source: Bloomberg.

Another positive feature of senior bank FRBs is that they rank fairly high in the corporate capital structure, meaning their "credit risk" is relatively low[2]. Indeed, Australian banks remain among the most profitable and highly capitalised in the world, and the securities in the Index that the QPON ETF aims to track have an average upper-investment grade A+ credit rating at the time of writing[3]. As part of its investment strategy, moreover, the Fund will invest at least 80% of its assets equally weighted across FRBs selected from the Big-4 Australian banks, with up to 20% invested equally weighted across FRBs selected from the large "regional" banks, including Macquarie Bank and AMP Bank.

Attractive income for little extra risk

As seen in the chart overleaf, as a result of the special features of senior bank FRBs, the QPON ETF is able to offer potential for relatively attractive income returns compared to more traditional cash and deposit products generally available to retail investors. Given low fixed-income government bond yields, moreover, the income returns are, at the time of writing, even comparable to that of the more volatile Bloomberg AusBond Composite Index.

[2]In the unlikely event of a bank default, FRB investors are lower in the credit chain than investors in traditional cash and term bank deposits, though still rank ahead of investors in bank unsubordinated debt, hybrids and, of course, shareholders. Note the Federal Government's recent imposition of a levy on the bank liabilities of Australia's major banks was in part justified by the implicit government guarantee they are considered to enjoy.
[3]Bloomberg Composite Rating as at 31 May 2017. Credit ratings should not be used as a basis for assesing investment merit.

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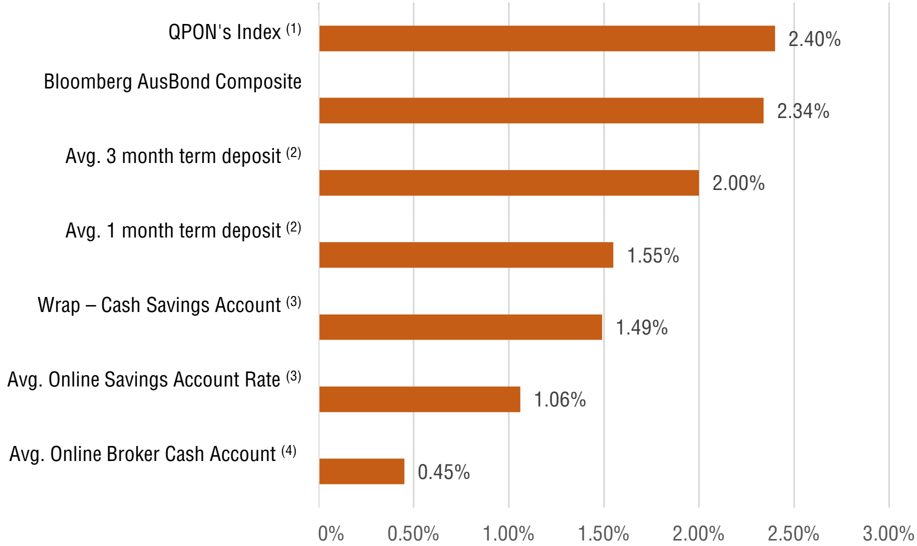
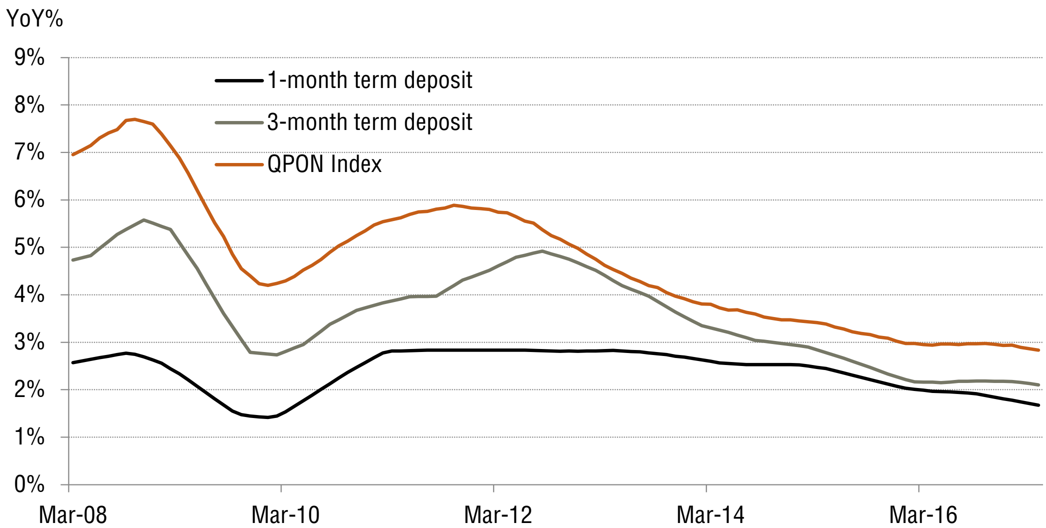
INTEREST RATE COMPARISON - AS AT 31 MAY 2017



(1) Total expected return for QPON's Index given current margin to 3 month BBSW, inclusive of QPON's management costs of 0.22% p.a. Rates of QPON's Index are variable. Current rates available at www.betashares.com.au. (2) Average of Big 4 Banks' term deposits for $10,000 invested. (3) Average of current rate offered by three major providers (4) Average of rate offered by Comsec and E*Trade. Source: RBA, Bloomberg, Bank websites, wrap websites. QPON's Index is the Solactive Australian Bank Senior Floating Rate Bond Index. You cannot invest directly in an Index. QPON Index's yield is variable. Inception date of QPON's Index is 30 May 2017 and data prior to this date has been simulated and may not be reflective of actual results. Current rates available at www.betashares.com.au. Past performance whether simulated or actual, is not indicative of future performance

While effectively offering investors two-day access to their money via a convenient instrument that trades on the Australian Securities Exchange (ASX) just like a company share, the Fund currently offers an annualised income return of around 1.3% p.a. higher than that generally being offering by major-bank online saving accounts, and around 1% p.a. higher than that generally available on one-month bank terms deposits. As seen in the chart below, the income returns from the index that QPON aims to track have tended to be consistently above cash and short-term bank deposits in recent years.

ANNUAL INCOME RETURNS (YOY%): QPON'S INDEX VS. 1 & 3 MONTH BANK TERM DEPOSITS – JANUARY 2008 TO APRIL 2017



Source: Bloomberg, RBA. QPON Index's income return shown here is "running yield" inclusive of QPON's management costs of 0.22% p.a. You cannot invest directly in an Index. Inception date of QPON's Index is 30 May 2017 and data prior to this date has been simulated and may not be reflective of actual results. Current rates available at www.betashares.com.au . Past performance whether simulated or actual, is not indicative of future performance.

[4] Especially when investing for relatively short periods, investors should factor into their calculations the brokerage costs involved when seeking fixed income, cash or similar exposures through the ASX.

Note, moreover, the Fund pays interest on a monthly basis, thereby offering a more regular source of income compared to many bank term deposits. Term deposits also require investors to effectively "lock-up" their money for extended periods or risk break-fees, thereby potentially preventing investors from taking early advantage of any lift in interest rates from current very low levels. Unlike term deposits, QPON has no lock-up and therefore no penalties for accessing your investment early or when you need it. It can be bought and sold as simply as any share on the ASX during the trading day.

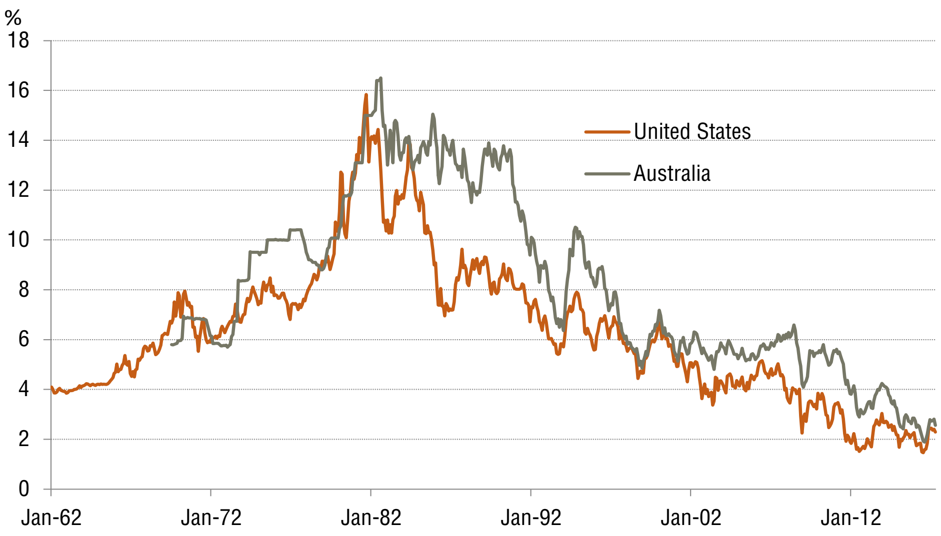
QPON additionally brings investors access to instruments that are traditionally very difficult for the majority of investors to access directly, due to high minimums in institutional bond markets and administrative burdens. Compared to the option of investing in one or more FRBs directly, moreover, the Fund offers investors the convenience of a diversified portfolio of bank FRBs with no minimum investment requirement – all for the low management cost of only 0.22% pa.

Guard against the risk of rising interest rates

As noted above, the capital or price return of floating-rate bonds tend to be much less sensitive to increases in the general level of interest rates than fixed-rate bonds – as their market value is largely preserved by having their regular interest payments automatically adjusted upward. By contrast, with fixed nominal interest payments, the market value of fixed-rate bonds tends to be forced down as interest rates rise, so that their implied yield rises to be more in line with higher competing rates now available elsewhere.

Accordingly, especially in today's environment of very low global interest rates, investing in floating-rate rather than fixed-rate bonds seems to make particular sense. As seen in the chart below, long-term interest rates in both the United States and Australia – along with many other parts of the world – have fallen to historically low levels in recent years, due to both declines in inflation, sluggish global economic growth and exceptional monetary stimulus by the world's central banks in the wake of the global financial crisis.

10-YEAR GOVERNMENT BOND YIELDS: JANUARY 1962 TO APRIL 2017



Source: Federal Reserve Bank of St. Louis

That said, over recent months there have been signs of a bottoming out in yields reflecting an improving global economic outlook and the early unwinding of exceptional monetary stimulus – beginning in the strongest global economy, the United States. As at the time of writing, the US Federal Reserve has already lifted official interest rates three times since late-2015 and has indicated at least two more rate rises are likely this year. The Fed has also indicated it plans to begin selling down the government bonds amassed within its huge $4.5 trillion balance sheet later this year. Provided global growth continues to recover, other central banks – particularly the European Central Bank and the Bank of Japan – are also likely to begin winding back monetary stimulus either late this year or sometime in 2018.

Adding to the likely upward pressure on bond yields, moreover, are the plans of US President Donald Trump to further boost the US economy through fiscal stimulus, including tax cuts and increased spending on defence and public infrastructure.

As and when interest rates eventually rise to more normal levels, this will tend to hurt the returns of fixed-rate bonds and bond funds that track fixed-rate bond indices such as the Australian benchmark Bloomberg AusBond Composite Index. Given already low fixed-rate bond yields, moreover, interest income would only provide a partial buffer against any price decline in fixed-rate bonds over the short-term.

Indeed, current statistics imply a 1% rise in the general level of interest rates would tend to produce a 5% price or capital decline in the Bloomberg AusBond Composite Index, compared with only a 0.13% decline in the index which QPON aims to track. Given a current yield-to-maturity for the Bloomberg AusBond Composite Index of 2.2% as at end-May 2017, a 1% general rise in interest rates over the coming year, for example, would imply a negative 2.8% total annual return for the benchmark index over this period (Source: Bloomberg).

What's more, not only should floating-rate bonds tend to be spared from large capital losses in the event of rising interest rates, they will also gain by having their regular interest payments automatically adjusted higher for the benefit of investors.

As seen in the chart overleaf, it is quite evident historically that floating rate bonds (as proxied below by the Bloomberg Floating Rate Note Index), have tended to outperform fixed-rate bond indices over periods in which interest rates have been rising.

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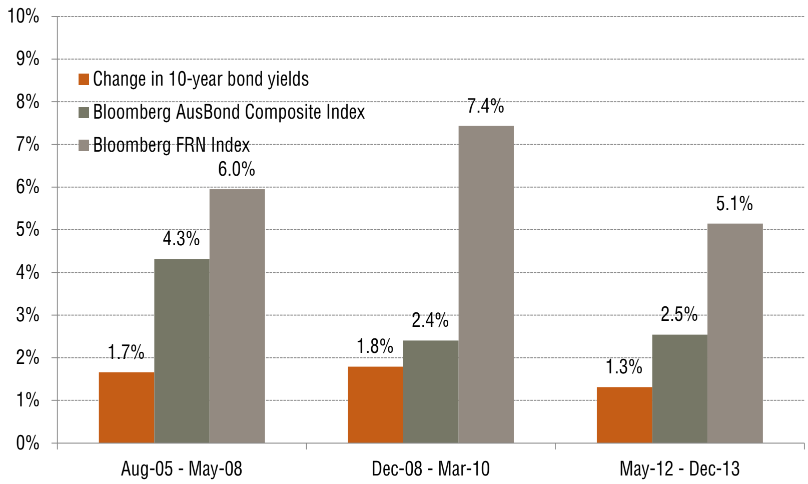
TOTAL ANNUALISED RETURN PERFORMANCE IN THREE PREVIOUS RISING INTEREST RATES PERIODS



Source: Bloomberg. Rising interest rate periods are based on trough to peak increases in end-month Australian 10-year government yields – covering March 2005 to May 2008, December 2008 to March 2010 and May 2012 to December 2013. Past performance is not indicative of future performance.

Conclusion

Given today's low level of interest rates – and the risk of a lift in rates to more normal levels in coming years – investors seeking decent returns from cash, deposit or bond products face difficult choices. Cash and deposit returns are low, while traditional bond funds – dominated as they are by fixed-rate securities – face especially low returns as interest rates eventually rise. In the current environment, therefore, it appears to make particular sense to seek exposure to high quality floating-rate bonds as offered by the BetaShares Australian Bank Senior Floating Rate Bond ETF (ASX: QPON).

For very little effective credit risk, current income returns from these bonds are attractive compared to typical cash and deposit products. What's more, these income returns are even competitive with those from longer-duration fixed rate bonds (as contained in the Bloomberg AusBond Index), even though returns of the latter are more volatile and at greater risk of underperforming as and when interest rates eventually rise to more normal levels.

Trading Information

BetaShares Funds can be bought or sold during the trading day on the ASX, and trade like shares.

EXCHANGE	ASX
ASX CODE	QPON
CURRENCY	AUD
TRADING HOURS	10:00-16:00 (AEST)
BLOOMBERG CODE	QPON AU
IRESS CODE	QPON.AXW

Fund Information

DISTRIBUTIONS	MONTHLY
MANAGEMENT FEE	0.19% P.A
EXPENSES	ESTIMATED AT 0.03% P.A
FUND INCEPTION	01 JUNE 2017

Underlying Index Characteristics

INDEX SOLACTIVE AUSTRALIAN BANK SENIOR FLOATING RATE BOND INDEX

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