ASX & Westpac present:
Insights - Interest Rate Securities.

Contents

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- Why invest
- The basics refreshed
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Who are We ?

- Australia's largest bank, and the world's 15th largest bank, ranked by market capitalisation[1]
- The Westpac Group is one of only 10 banks in the world with an AA or higher credit rating,[2] and one of the "20 safest banks globally"[3]
- Over 10 million clients
- Westpac Institutional Bank-
  - 3400 Staff
  - Global Presence
  - Equities, FX, Commodities and Debt markets.

1. As at 29 April 2009. Source: IRESS, CapitalIQ and www.xe.com
2. As at 22 September 2009. Excluding government-owned banks. Rated AA and higher by Standard & Poor's.
3. Global Finance Magazine, February 2009.

State of Play

Demand

- Demand for yield by investors
  - Falling dividend payouts
  - Low term deposit rates
  - Frozen income funds
- Investors looking for a fixed term, with a return of capital
- Desire for a low level of capital risk
- If comfortable with equity risk, should be comfortable with higher ranked debt risk.

Supply

- Corporates looking to diversify debt profile
- Senior Bonds are back
- Equity raisings have diluted ownership and earnings
- Capital markets have begun to thaw (e.g. WBC $2 Billion bond issue, non GG)

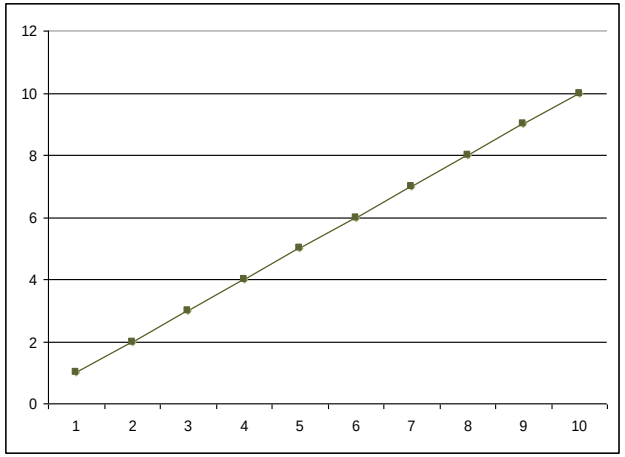
Differences between debt and equity

	Debt	**Equity**
Holders	Holders of debt securities are creditors of the company	Shareholders are owners of the company
Returns	Returns can be a fixed rate of interest, paid regularly until maturity, regardless of earnings	Returns are dividends, related to company performance
Ranking / maturity	Creditors rank higher than shareholders in the event of company liquidation	Shares have no fixed maturity
Initial investment	Holders are repaid their investment at a set date	Shareholders can decide when to sell their shares at the prevailing market price
Risk	Lower risk than shareholders due to regular income, however the returns can be lower	Shareholders seek to be rewarded by receiving an equity risk premium

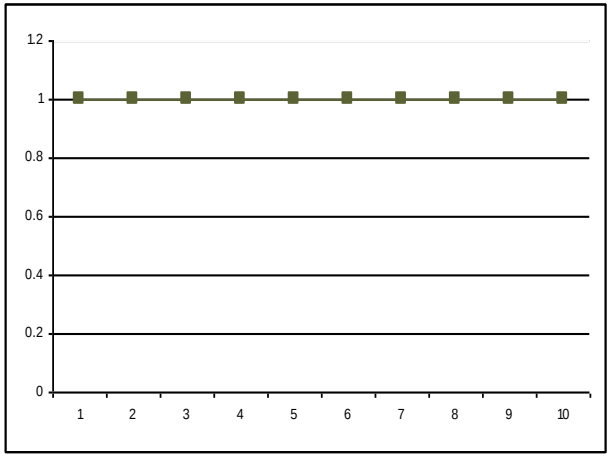
Yield Curve

- Direct link between maturity and yield
- The yield curve can highlight market expectations regarding future interest rates.

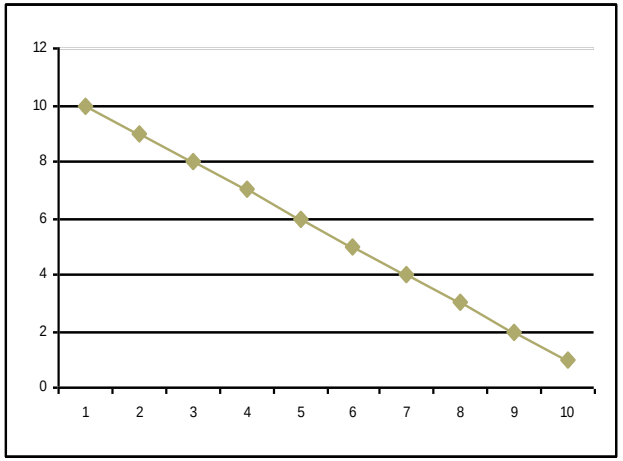
Normal



Flat



Inverse



Ranking - Who gets paid first

Assuming an AA rated Corporate, the priority of their security holders could look like this:

Senior secured (AA)

Senior Unsecured (AA)

Subordinated (AA-)

Hybrid/Preferred Securities (A+)

Equity/Common Shares

- Secured: a security backed by a charge over an asset of the borrower
- Unsecured: a security that is not backed by an asset or charge over an asset
- Senior: a security that ranks ahead of other debt and equity
- Subordinated: a security that ranks behind other debt but ahead of equity.

Why invest in interest rate securities?

- **Income** - regular income payments which can be fixed or floating

- **Capital Growth -** buying a discounted security or those that are trading below “Par” (e.g. a security with a face value of $100 trading below $100)

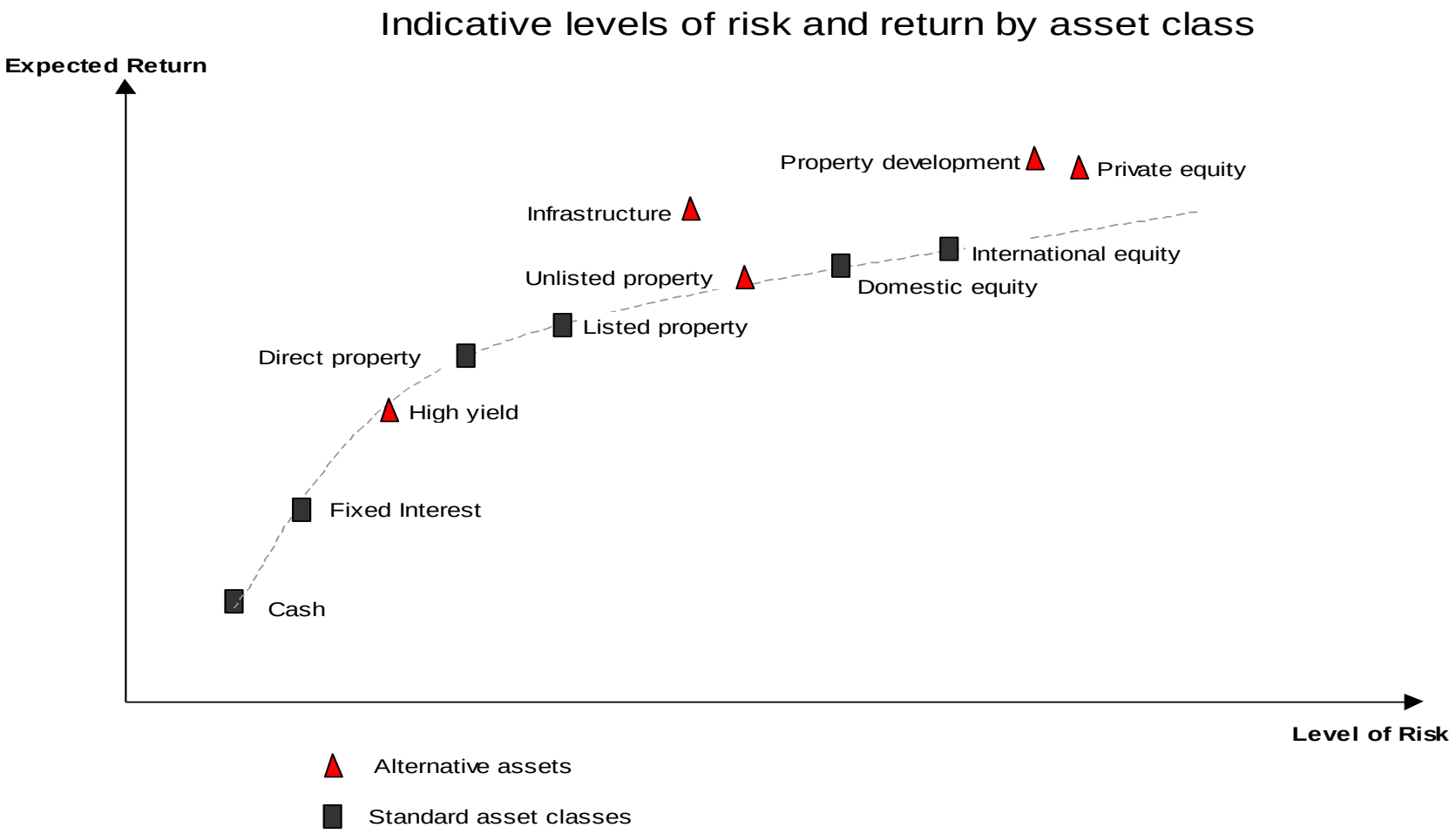
- **Diversification** - achieved through a number of different asset classes in a portfolio plus increasing the number of individual investments within an asset class:
  - Interest rate securities may help you reduce risk and diversify your portfolio. Combining interest rate securities & shares could maximise return, minimise risk and achieve an 'optimised portfolio' where risk equals reward.
  - Interest rate securities typically have a lower standard deviation (volatility) of returns (risk)
  - By combining two or more assets that have correlations of less than 1 (i.e. the two assets do not move exactly) you gain the benefits of diversification

- An alternative to other cash products, e.g. Term Deposits and Cash Management Trust accounts

Risks of investing in interest rate securities

- Illiquidity – potential inability to sell/buy volume and not move the market price significantly.
- Failure of the issuer to pay distribution, or return the principle at maturity (default risk). ?Dividend Stoppers?
- Timing risk – portfolio's securities timing of maturity differs from that of the investor's time frame
- Fluctuating interest rates changing the quoted price of the security
- Changes in the credit rating, resulting in a larger credit risk premium (lower quoted price).
- Whilst characteristics are similar, each security offers different features- Read PDS.

Risk Return Spectrum



Buying Corporate Bonds

On 10 May 2009, you buy 50 corporate bonds of a fixed-rate issue by WBC of '6.50% 11 February 2011 bonds' at a price of $103.50 with a yield of 5.39%

Issuer	Westpac Banking Corporation
Coupon	6.50%
Coupon Frequency	Semi-annual: 11 February & 11 August
Maturity Date	11 February 2011
Face Value	$100
Purchase Price	$103.50
Yield to Maturity	5.39%

Bond Example cont

You bought the bonds on the date of 10 May 2009 this is 88 days after the last coupon was paid on the 11 February 2009 therefore there is accrued interest incorporated into the securities price:

- The accrued interest amount is the coupon of $6.50 per $100 face value per year. This coupon accumulates per day for a calculation of $6.50/365 days = 1.78 cents per day
- Therefore the accrued interest is for 88 days = $0.0178 x 88 = $1.57
- Leaving the capital amount of = $103.50 – $1.57 = $101.93
- The total investment amount is $103.50 x 50 = $ 5,175.00

Income Stream

Income stream

The coupon is 6.50%. The coupon is paid semi-annually so the amount you will receive twice a year:

- = (number of bonds x face value) x (coupon rate/coupon frequency)
- = (50 x $100) x (6.50%/2)
- = $162.50

At Maturity

Payment at maturity

The maturity date is 11 February 2011, at which point you will receive the face value of the bonds as well as the final coupon Maturity payment:

- = (50 x $100) + (50 x $100 x (6.50%/2)) = $5,162.50

Yield to Maturity

- **Current Yield** of a bond measures only the cash income provided by the bond, as a percentage of the bond price. It ignores any prospective capital gains or losses

- We need to measure the **rate of return** that accounts for both current income and the price increase/decrease over the bonds life (to par, or $100 for example)

- Using the bond price, maturity date and coupon payments, we can determine the Yield to Maturity (‘**YTM’)**

- YTM is the interest rate that makes the **present value** of a bond's payment equal to its price. It is often viewed as the average rate of return earned on a bond bought now & held until maturity, or the IRR - Internal Rate of Return

- **?Internal rate of return** on an investment in the bond.?

Yield

Yield

The nominal yield (coupon rate) of this bond is 6.50%.
The nominal yield will remain at 6.50% throughout the life of this bond.

Given the above cashflows, the yield to maturity on the purchase price is 5.39%. This yield will fluctuate during the life of a bond, reflecting the changing level of interest rates generally, in addition to other factors.

Factors determining the price of a debt security

- The price you pay for a debt security is based on a number of factors including:

  - interest rates
  - credit quality- Rating and credit spread.
  - maturity terms – risk premium
  - market forces (demand / supply) , Liquidity

- Primary issued debt securities- Priced by book build

  VS

- Secondary Market- Priced by market

Significance of credit ratings- Guide not a Guarantee

- Credit ratings seek to rank the ability of a company to pay its debts. The ability of a company to pay interest and the principal amount borrowed in full and on time is crucial for investors
- All investors should check the credit rating of debt securities before buying them, whilst noting a rating is not a recommendation to buy, sell or hold securities
- Debt securities rated "investment grade" are widely considered to be high enough quality for a prudent investor to purchase them
- Un-rated does not mean low rated. Some Corporates choose not to become rated due to the cost and burden.

Investment Grade ↑	'AAA'	Extremely strong capacity to meet financial commitments. Highest rating
	'AA'	Very strong capacity to meet financial commitments
	'A'	Strong capacity to meet financial commitments, but somewhat susceptible to adverse economic conditions and changes in circumstances
	'BBB'	Adequate capacity to meet financial commitments, but more subject to adverse economic conditions
	'BBB–'	*Considered lowest investment grade by market participants*
Speculative Grade ↓	'BB+'	*Considered highest speculative grade by market participants*
	'BB'	Less vulnerable in the near-term but faces major ongoing uncertainties to adverse business, financial and economic conditions
	'B'	More vulnerable to adverse business, financial and economic conditions but currently has the capacity to meet financial commitments
	'CCC'	Currently vulnerable and dependent on favorable business, financial and economic conditions to meet financial commitments
	'CC'	Currently highly vulnerable
	'C'	A bankruptcy petition has been filed or similar action taken, but payments of financial commitments are continued
	'D'	Payment default on financial commitments

Ratings from 'AA' to 'CCC' may be modified by the addition of a plus (+) or minus (-) sign to show relative standing within the major rating categories.

Interest rates

Interest rates*	Bond yields	Fixed-rate bond prices
Rise	Rise	Fall
Fall	Fall	Rise

*In this context, interest rates should be understood as a broad term describing the general level of interest rates in the market.

Example effects of interest rates on price Simple maths to illustrate

A corporate issues a bond paying 5%, raises $100. Coupon paid is $5pa.
Inflation figures announced a day later and interest rates increase to 10%.

- What is the value of the bond now?

- As investors can buy a new bond paying a $10 coupon, what is the value of the old bond that was paying a coupon of $5?

- In simple terms, the value of the bond falls to a value where the coupon equals the current market interest rate of 10%.

The value falls from $100 to $50. ($5 x 10%= $50)

ASX Listed Income Securities

Key features of ASX Listed Income Securities

- Listed and traded on the ASX
- Minimum investment $500 (subject to broker minimum)
- Access to market via ASX Broker
- Secondary market liquidity and Settlement Certainty (T+3)
- Stock held on HIN/SRN
- 5 letter stock code e.g. WBCPB (WBC SPS II)
- Available via Wrap accounts*
- *Depending on the terms of the WRAP provider.

Interest Rate Securities

Security	Description	Income	Equity Exposure	Term	Example
Corporate Bonds	Term deposit issued by a corporate. Can be Senior or Subordinated	Fixed/Variable Coupon	Nil	3-5 years	TAHHA
Convertible Notes	Bond like coupon, with embedded call option	Fixed/Variable Coupon	Yes, above a strike price	3-7 years	DJWGA
Hybrid	Bond like coupon, with conversion to equity	Dividend, often fully franked	At maturity, often at discount to VWAP	5 years +	WBCPA
Preference Shares	Bond-like coupon with equity exposure	Dividend, often fully franked	Yes	Perpetual	
Perpetual FRN	Bond, with a call date from issuer. If not called, step up in coupon	Fixed/Variable Coupon	Nil	N/A	WCTPA

Example dividend calculation

- Dividend Rate = (Bank Bill Rate + Margin) x (1 - Tax rate)
- Where:

  Bank Bill Rate (90BBSW) = 3.28%

  Margin = 3.8%

  Tax rate (Tc) = 30%

- WBCPB example:
  - (3.28% + 3.80%) * (1 - 0.3)= $4.95 cash payment
  - 4.95% or $4.95 per security, per annum
  - $2.12 franking credit
  - Claim the franking credit back at end of tax year.

Choice & decisions

Security	Term	Interest frequency	Rating	Coupon
Commbank Term Deposit	5 years	Monthly	AA (Govt. Guarantee to $1M)	6.5% www.commbank.com.au
Macquarie CPS (MQCPA)	4 years	Quarterly	A- (corporate) BBB (security)	11.09% YTM -10.12% (as at 20/8/09)
Brookfield Multiplex (BZAHA)	3 years	Semi	Unrated	7.82%

Recent Issues

Issuer	ASX code	Rating	Security	Term	Margin
WESTPAC	WBCPB	A	Hybrid	5	380bp above 90BBSW (100% franked)
TAB CORP	TAHHA	BBB+	Senior Bond	5	425bp above 90BBSW
AMP NOTES	AQNHA	A-	Subordinated Bond	10 NC 5	475bp above 90BBSW
BROOKFIELD	BZAHA	unrated	Senior Secured Bond	3	325bp above 3 year Swap
CBA PERLS	CBAPA	A-	Hybrid	5	340bp above 5 year Swap
Heritage Notes		BBB-	Subordinated	10 NC 5	Approx 470bp above 5 year swap

Conclusion

- Increase in issuance from Corporates (borrowers)
- Increase in Demand (Lenders) for yield
- 4 main factors that make up price of security: (Interest Rates, Credit, Maturity, Market Forces)
- All securities are different- so look under the hood
- ASX listing provides liquidity, choice, pricing and reporting.

Next Steps

- http://www.asx.com.au/products/interest_rate_securities/index.htm
- Feed back form
- “Predictable” booklet
- Quiz - to achieve CPD points.

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