



ASX

AUSTRALIAN SECURITIES EXCHANGE

Understanding ASX Interest Rate Securities



ASX.

The Australian Sharemarket

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ASX Markets

ASX is a multi-asset class, vertically integrated exchange group, and one of the world's top-10 listed exchange groups measured by market capitalisation. ASX offers a broad array of products including shares, ASX Listed CFDs, options, warrants, futures and other derivative products as well as Interest Rate Securities providing investors and risk managers with access to a broad range of asset classes including: domestic and international equities, commodities, energy, environment and foreign exchange.

Listed and quoted on ASX

Being listed or quoted on ASX brings many benefits to both investors and those entities seeking to raise either capital (shares in the listed entity) or debt (loans to the entity).

Interest rate securities are a form of capital raised by business entities and governments, which borrow from you – the investor. There is a large variety of Interest Rate Securities listed on ASX by corporations and these corporations are referred to as 'issuers'.

Investors benefit from the integrated nature of ASX infrastructure allowing seamless trading, clearing and settlement to occur through the choice of ASX stockbroker or a growing number of advisory firms connected with ASX stockbrokers.

ASX Interest Rate Securities (IRS)

Debt is raised by an entity to assist in running its operations. In the case of a company, a debt raising usually forms part of the company's balance sheet capital to underpin the running and operation of its business.

Governments at federal, state and local levels also raise debt, however in their case it is to assist with running the functions of government.

While there are a variety of types of debt raisings listed on ASX, all relate to raisings or 'issues' undertaken by business entities (such as ASX listed companies) to contribute to their capital requirements. When referring to debt listings on ASX, the term 'Interest Rate Securities' (IRS) is used to describe this group of listed investments.

Just as you would instruct your broker to buy shares in a company, you can instruct your broker to buy or sell Interest Rate Securities listed on the ASX.

The type of IRS listed on ASX can be broadly split into two categories:

- Corporate Bonds; and
- Hybrid Securities.

A number of other descriptions are sometimes used interchangeably when describing Interest Rate Securities. These include floating rate notes (FRNs), perpetual securities, convertible notes and convertible preference shares.

Generally, as with buying a share on-market, the minimum amount you can invest is \$500 but the usual transaction value recommended by brokers is \$5,000 or greater.

This booklet will help you understand what ASX Interest Rate Securities are, the risks associated with them and how they may be used within your investment portfolio.

It is important to remember that like shares, which are not all the same – even for companies operating within the same sector – Interest Rate Securities can also be very different from each other.

Why Invest in ASX IRS?

There are a variety of reasons investors may chose to invest in Interest Rate Securities, including the potential to:

- receive a steady and defined income stream. All Interest Rate Securities pay you income. Your income may be paid once, twice or four times a year;
- improve the return on your capital typically held as cash. Income from Interest Rate Securities is typically higher than interest paid on bank deposits;
- decrease the risk of your overall portfolio; and
- profit from expected movements in interest rates.

Differences Between ASX IRS and Term Deposits

Investors looking to receive a steady stream of income have often only considered bank term deposits. There are some significant differences between Interest Rate Securities and bank term deposits. The table below compares the two types of investments.

FEATURE	TERM DEPOSITS	INTEREST RATE SECURITIES
Interest rate return	Typically lower than IRS	Typically higher than term deposits.
Costs	Can be subject to bank fees and other charges (especially if the investment is accessed prior to the end of the term).	Brokerage is charged on transactions by the broker or advisor.
Ability to access funds	Typically funds are locked in for the term of the deposit.	Able to sell investment in the market and therefore access funds at any time the market is open.
Size of investment and interest rate	A lower rate typically applies for smaller dollar amounts.	The market sets a market price – no matter what size is invested.

It should be noted that while the ASX market provides liquidity – the measure of the price at which a buyer will buy for and a seller will sell – the liquidity of Interest Rate Securities may be lower than that of other ASX listed securities, for example shares which make up the S&P/ASX 200.

Differences between ASX IRS and Shares

Typically Interest Rate Securities have a higher face value than shares (e.g. \$100) and may have a limited life. Investors may also regard Interest Rate Securities as having limited capital growth potential.

When you invest in Interest Rate Securities, the entity issuing the securities effectively borrows money from you and has an obligation to repay you at the maturity of the investment¹. Interest rate securities generally rank higher than ordinary shares in terms of security. This means that if the issuing entity is wound up, IRS holders will be repaid before ordinary shareholders.

Capital structure – corporate



Source: FIGG Securities Limited (www.figg.com.au)

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By comparison, when you purchase shares, you become a part owner of the entity or company in which you hold those shares. There is no obligation on the company to repay your investment, however you may be able to sell your investment on-market for a market price.

When you buy Interest Rate Securities on ASX, your relationship to the issuer is that of a creditor. When you sell the IRS, you transfer this relationship to the buying investor. In a similar way, when you buy or sell shares your relationship as a part owner transfers.

The return on an Interest Rate Security can be largely defined if it is held until maturity. It will usually include a fixed rate or floating rate of interest paid regularly until maturity when the initial investment is repaid (perpetual notes are an exception). Floating rates of interest typically vary in line with a benchmark rate which is usually at a margin above the bank bill rate.

Shares have no fixed maturity and your return will fluctuate in line with the profitability of the company and other factors. It will include any dividends from the company plus any capital gain or loss when you later sell the shares.

¹ In some instances depending on the type of Interest Rate Security, the investment can be subject to a rate reset or other events occurring as set out in the terms of the security.

Using IRS to Diversify Your Portfolio

Diversifying your investment portfolio with a variety of ASX listed products can help reduce risk and protect returns over the longer term. Diversifying involves:

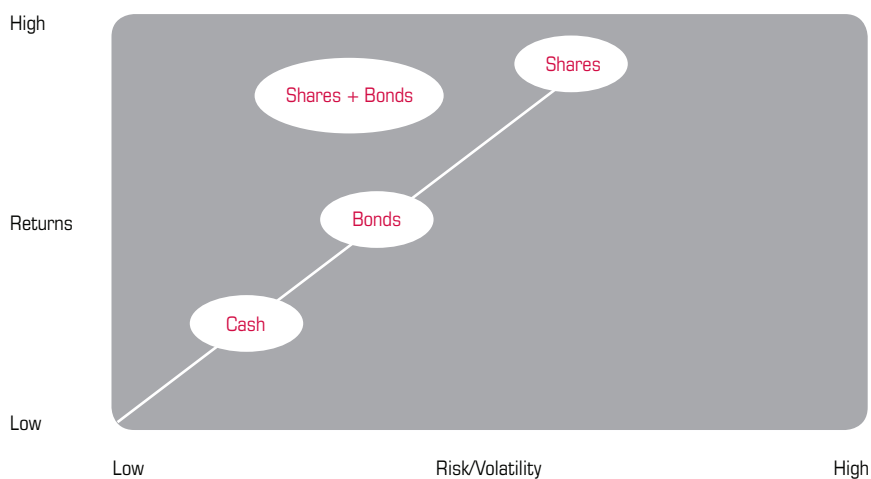
- spreading your investments across a mix of assets such as shares (equity ownership of domestic and/or international companies), REITs² (exposure to listed commercial property) and/or Interest Rate Securities;
- spreading your investments within each asset type so you would hold a range of shares across sectors and a spread of Interest Rate Securities across issuers and maturity dates; and
- spreading your investments across assets that have low correlation with each other as the value of investments in different asset classes can change through different cycles.

Risk and Return – the Trade Off

It is important to understand the degree of risk associated with different types of investments. Generally speaking there is a trade off between the returns of different investments and the risks associated with those investments. The risk level of a portfolio can be decreased by spreading your money across a range of 'asset classes'.

The diagram below is designed to illustrate how a portfolio that includes a balance of shares (equity) and Interest Rate Securities can have a lower risk profile, but with lower returns. This may suit investors with a desire for greater certainty of income rather than portfolio growth.

Risk versus Return



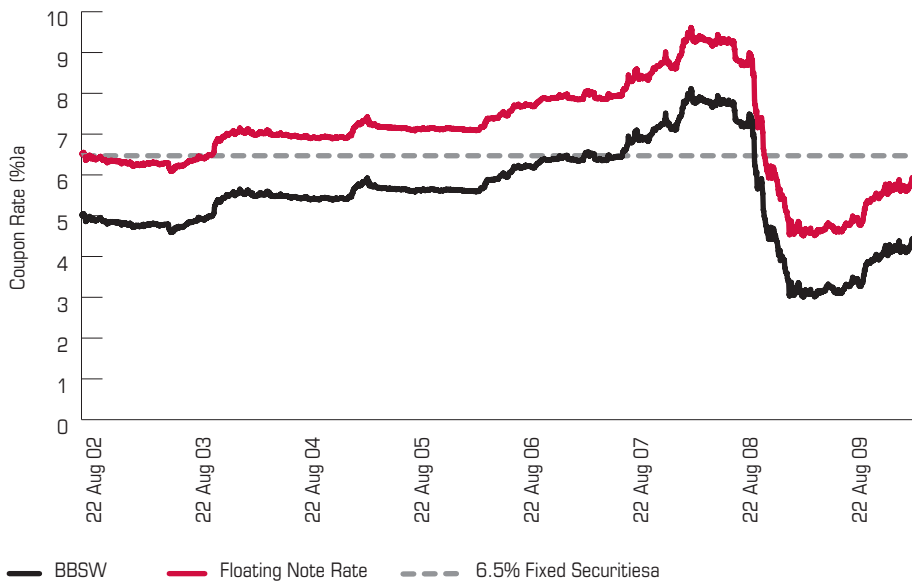
Common Characteristics of ASX IRS

The four most defining characteristics of an IRS are usually:

- 1 the **amount of interest** (coupon) you will receive over;
- 2 the **life of the security** (term to maturity) from;
- 3 the **company** (issuer) that borrowed the funds; and
- 4 the **face value** per unit.

The coupon payments and face value repaid at maturity are the two cash flows that determine the return on your investment, while default by the issuer is a potential risk. The potential for General interest rate movements over time can influence returns (up or down) depending on whether the investment has a fixed or floating coupon rate. and the relationship between the Interest Rate Security's rates – fixed or variable and market rate movements.

Fixed versus Floating Coupon Rate



However, like most investments, there are other characteristics and related jargon you should understand before you invest. Below is a list of features that can be common to Interest Rate Securities although do not necessarily apply to all.

Call provision

Some Interest Rate Securities, notably perpetual securities, have a call provision attached. This gives the issuer the right, but not the obligation, to buy back the securities from you at a particular point in time, typically at par or issue price.

Convertible

A security that is convertible gives the holder the option to convert the security into ordinary shares at specified times (usually reset or maturity dates). If the holder decides not to convert there are generally two other choices: receive the face value back, or continue for a new set term (these terms are set out in the prospectus to the issue).

Converting

A converting security does not give the holder a choice at maturity; the security in most instances must convert into the underlying shares at a specified date.

Coupon frequency

Coupon payments are made at regular intervals throughout the life of the IRS and are usually quarterly, semi-annual or annual payments.

Creditor status

In the event of winding up a company the repayment of capital of a hybrid (if in the form of a convertible preference share) ranks ahead of ordinary shareholders but behind all creditors. Convertible preference share holders do not have full shareholder voting rights. Convertible notes on the other hand generally rank above convertible preference shares.

Cumulative/Non-cumulative

This refers to what happens in the event of missed dividend or interest payments.

Cumulative: missed payments are added to the next payment.

Non-cumulative: missed payments are forgone.

Discount at Conversion date

This generally applies to hybrids that do not have fixed conversion terms. At conversion the allotment of ordinary shares (to the holder of the hybrid) is calculated on the current market share price. The holder of the hybrid may receive a discount off the current market share price, therefore the allotted number of shares increases per hybrid.

Face Value

The issue price or underlying value of the security is usually, but not always, \$100. This is the base value used to calculate dividend or interest payments e.g. 8% return is not calculated on the market price of \$102.50, it is calculated from the \$100 face value, therefore you receive \$8 p.a. per security.

Market price

The market price of an IRS includes two components:

- 1 Capital amount – the value of the security estimated by the market. It is based on a number of variables including current market interest rates relative to the coupon rate, time to maturity, ranking and credit quality. This value may remain stable from one day to the next, unless general 'market' interest rates move; and
- 2 Accrued interest – the amount of interest accumulated on a security since the last coupon payment. A security price increases daily by the amount of interest accrued, for example, a security with a \$100 face value and 6.5 per cent coupon rate accrues interest at \$6.50 per annum or 1.78 cents per day. The price should adjust immediately after the ex distribution/interest date.

Maturity

Maturity is the date the agreement or contract between the issuer and investors holding the securities ends. On this date the final coupon and the face value is paid to investors. The time to maturity can vary greatly from short term (up to four years) to medium term (five to 10 years) or long term (10 or more years). Convertible or hybrid securities may be converted into shares in the issuing company on maturity rather than paying you the face value. Perpetual Interest Rate Securities have no maturity date but you can recoup your investment by selling them on the ASX.

Redeemable/Non-redeemable

Redeemable: at certain times the holder may have the option to hand the securities back to the company in return for the face value/issue price. Similarly, the issue terms may give the company the ability to redeem in certain circumstances.

Non-redeemable: The securities cannot be redeemed under any circumstances.

Reset/Resettable

A resettable security means that after a certain period (usually 3-5 years) the current terms and rates are reviewed i.e. a new interest or dividend rate is set over a new term and reset by the issuer. At this reset date the holder may have several options available to them but generally the holder can either accept the new terms, redeem, or in relation to hybrid securities, convert into ordinary shares.

Returns

Like bonds, convertible notes pay a coupon, i.e. interest. Convertible preference shares pay dividends in a similar way to coupons, i.e. a set return on set dates. This dividend is often franked and therefore offers possible tax advantages to the holder. Unlike ordinary shares the dividend on hybrids is known and predictable. The dividend rate may be fixed or floating.

Yield

The yield is the expected return on your investment. It can be described as:

- Nominal yield – the return based on the annual coupon payments as a percentage of the face value of the security. Also referred to as the coupon rate, it does not change throughout the life of the security.
- Running yield – is calculated as the dividend or returns divided by the market price. It is a simple measure of the return the holder can receive at current market prices, excluding any discount or optionality.
- Yield to maturity (sometimes known as yield to reset or yield to call) – the annualised total return based on all the coupon payments plus the face value you would receive if you held the security to maturity. It includes any gain or loss if your purchase price was below or above the face value. Therefore it is the most useful indicator of the value because it enables comparisons between different securities and other interest rate based products.

Risks Associated with ASX IRS

The same relationship that generally holds true in other investment types also applies to Interest Rate Securities: usually the greater the perceived risk, the higher the expected return required to compensate investors for that risk.

For example, you might be able to earn a 5% return on a six month term deposit. However, you might prefer to invest in a 10-year bond that, at the time of purchase, yields a 6.5% return. The yield is higher than the term deposit rate because you have to wait 10 years to get your investment back and in the meantime conditions such as interest rates may change affecting the price of the Interest Rate Securities if you do decide to sell it.

The effect of changing interest rates on yields (return on your investment) and prices

When interest rates in general rise or fall, investors look for a correspondingly higher or lower yield from an Interest Rate Security.

If the coupon rate is floating, the yield on the security may stay in line with market interest rates without any significant impact on its price. However, if the coupon rate is fixed, the yield on the security can only keep pace with changing interest rates if the price of the security changes.

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.

There is an inverse relationship between the capital price of a fixed-rate security and yield. A comparison can be made with what happens to the dividend yield on shares, that is, when the price of a share increases the dividend yield falls (assuming the dividend amount stays the same).

The table below shows the effect of different yields on the capital price of one bond with a fixed 5 per cent coupon and of another bond with a fixed 8 per cent coupon.

YIELD	5% FIXED-RATE BOND			8% FIXED-RATE BOND		
	2 years	4 years	10 years	2 years	4 years	10 years
4.00%	\$101.904	\$103.663	\$108.176	\$107.615	\$114.651	\$132.703
6.00%	\$98.141	\$96.490	\$92.561	\$103.717	\$107.02	\$114.377
8.00%	\$94.555	\$89.901	\$79.615	\$100.00	\$100.00	\$100.00

Other factors affecting the yield on Interest Rate Securities

In addition to the prevailing market interest rates, a range of factors can affect the yield that investors seek from any particular Interest Rate Security including the:

- Credit quality of the issuer
- Ranking of the issue
- Time to maturity
- Coupon frequency
- Liquidity or marketability.

Credit quality

An important element of risk in Interest Rate Securities is potential default by the issuer. Generally the higher the credit quality of the issuer, the lower the risk associated with the security and therefore the lower the yield required by investors.

Ranking

Ranking or status refers to the order in which liabilities will be paid should the issuer be wound up. The higher the ranking of a security, the safer the investment and the lower its yield.

Time to maturity

The longer you are required to hold an Interest Rate Security, the greater your exposure to the risk that market conditions or the issuer's credit rating might change and you should expect to receive a higher return as compensation for that additional risk.

The relationship between yield and maturity is represented by what is known as a yield curve. Yield curves reflect investors' view of the value of Interest Rate Securities of various maturities.

Liquidity or marketability

Whilst many investors may choose to hold their Interest Rate Securities until maturity, if you want to sell your investment before this point, you will need to do so on market.

Liquidity risk is the risk that you may not be able to sell your securities for a reasonable price due to lack of demand or the price offered is too low.

Types of ASX IRS

There is a range of terminologies used to describe the types of Interest Rate Securities, which may refer to a key feature of a particular type of ASX IRS. The table below provides an overview of the distinguishing characteristics of the two broad categories (corporate bonds and hybrid securities) and identifies a number of sub-types within each category.

1 CORPORATE BONDS

Corporate Bonds are like a loan whereby an amount is lent, interest as a percentage is paid at regular intervals and the amount borrowed is repaid in cash at a specified future date. A notable exception is perpetual securities (see below).

Vanilla style

Bonds issued by companies that can be either secured or unsecured. They have a fixed maturity and coupon rate meaning that cash flows are known throughout the life of the bond and the face value is repaid at a fixed date in the future.

Floating Rate Notes (FRNs)

Bonds that can be either secured or unsecured. FRNs pay a variable coupon amount, generally quarterly or semi-annually, which is referenced to a short-term benchmark rate such as the 90-day bank bill swap rate.

Perpetuals

Some FRNs are perpetual and have no specified maturity date. Without a fixed redemption date an investor may have to sell on-market (at a premium or discount to face value) to realise their investment. The issuer may have the right (but not an obligation) to redeem a perpetual; however, there can be no guarantee of this occurring.

2 HYBRID SECURITIES

Hybrid securities are an investment, interest may be paid at regular intervals as either a percentage amount or which may be fully franked with the repayment of the loan amount being either repaid in cash or converting to equity (ordinary shares in the issuer).

The manner in which the conversion to equity is calculated can vary. For example, some hybrids convert on a one for one basis – one hybrid for one ordinary share, while others convert on a dollar value – current or discounted share price divided into hybrid face value or a set dollar amount.

Convertible Notes

Pay a fixed coupon rate and can be converted into ordinary shares at a particular date or period of time in the future.

Convertible

Securities that have both debt and equity characteristics that convert into a dollar amount of the ordinary shares of a company at a future date at a set dollar amount or at a discount to the ordinary share price at that time.

Reset Preference Shares

Typically pay a fixed rate where the coupon is set for a defined term. At the end of the defined term, the securities are remarketed where they are either redeemed or a new fixed coupon rate is set. They are typically perpetual in nature.

Step up Preference Shares

Securities that have both debt and equity characteristics. These securities normally pay a floating rate coupon and have a call date after a set period. If these securities are not called at the first call date then the coupon 'steps-up'; to a higher rate to compensate investors for non-redemption. They are typically perpetual in nature.

Stepped up Preference Shares

Securities that have both debt and equity characteristics that have already passed the call/step-up date and pay an additional amount over and above the original coupon. They are typically perpetual in nature although the issuer has the option to redeem the securities on any future coupon payment date.

Convertible Notes

Converting Preference Shares

Distinguishing Characteristics of Interest Rate Securities

The following table highlights the differentiating characteristics between the two broad types of Interest Rate Securities

DISTINGUISHING FEATURES	CORPORATE BONDS	HYBRID SECURITIES	
	Vanilla Style Floating Rate Notes (FRNs) Perpetuals	Convertible Bonds/Notes	Converting Preference Shares
Call Provision	Issuer may have right not obligation to call or buy back at some time	Generally set for predetermined period	Generally set for predetermined period
Convertible	No	Holder has option to covert into shares or cash	Holder only has option to convert into shares
Converting	No	Holder has option to covert at maturity	Holder only has option to convert at maturity
Conversion value (what you receive at maturity)	N/A	Cash or shares which may be on a 1:1 basis	Allocation of shares that may be at a discount or allocated at set dollar value
Coupon Rate benchmark	Fixed or variable with a fixed margin over a known benchmark	Fixed or variable with a fixed margin over a known benchmark	Fixed or variable with a fixed margin over a known
Income	Coupon rate	Coupon rate but dividends cannot be franked	Can be coupon rate and may have franked dividends attached
Maturity	Known maturity or reset date though Perpetuals have no specific date and may require on-market trade to redeem unless issuer redeems	Fixed maturity or reset date	Fixed maturity or reset date
Redeemable	Holder may have option to hand back securities in return for face value	Generally not redeemable	Generally not redeemable
Resettable	After a set period, terms and rate may be reviewed. At reset holder may have option to accept or redeem	After a set period, terms and rate may be reviewed. At reset holder may have option to accept or redeem	After a set period, terms and rate may be reviewed. At reset holder may have option to accept or redeem
Step-Up	N/A	Coupon is typically increased by a 'step-up' margin as a result of a specific trigger	Typically not allowed

Corporate Bonds: An Example

On 10 May 2010, you buy 50 corporate bonds of a fixed-rate issue by XYZ Company of '6.50% 11 February 2012 bonds' at a price of \$103.50 with a yield of 5.39%.

Issuer	XYZ Company
Coupon	6.50% fixed
Coupon Frequency	Semi-annual: 11 February and 11 August
Maturity Date	11 February 2012
Face Value	\$100
Purchase Price	\$103.50
Yield to Maturity	5.39%

The 5.39% yield to maturity on your investment is based on the following:

Accrued interest and capital amount

You bought the bonds on the date of 10 May 2010. This is 88 days after the last coupon was paid on 11 February 2010 therefore there is accrued interest incorporated into the security's 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 $\$6.50/365 \text{ days} = 1.78 \text{ cents per day}$.

Therefore the accrued interest is for 88 days = $\$0.0178 \times 88 = \$ 1.57$

Leaving the capital amount of = $\$103.50 - \$1.57 = \$101.93$.

The total investment amount is $\$103.50 \times 50 = \$ 5,175.00$

Income stream

The coupon is 6.50 per cent. 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)

= $(50 \times \$100) \times (6.50\% \div 2)$

= \$162.50

Payment at maturity

The maturity date is 11 February 2012, at which point you will receive the face value of the bonds as well as the final coupon. Maturity payment

= $(50 \times \$100) + (50 \times \$100 \times (6.50\% \div 2)) = \$5,162.50$

Yield

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

Hybrid Securities

The term hybrid is given to a class of securities that have the characteristics of both an interest-bearing security and equity i.e. both bonds and shares. This classification covers securities such as convertible notes and convertible preference shares. These securities may pay a fixed return (like a corporate bond) but also have an option to convert into shares (sometimes at a discount) of the issuing company which may pay fully franked returns.

The option of conversion can be based on either:

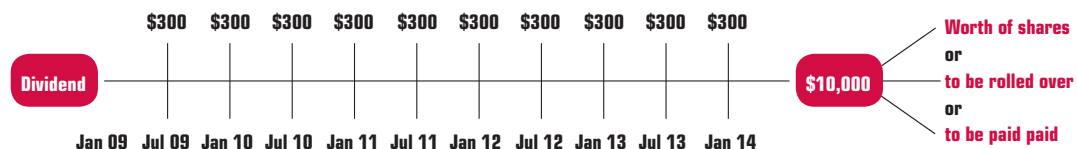
- Fixed Conversion; or
- Dollar Value Conversion.

There is a decision to make when investing in a hybrid security based on returns. This decision is whether to invest in a security that pays interest or one that pays a fully franked dividend. One aspect to consider when making this decision is whether the investor can utilise the franking credits.

Hybrids – A Simple Graphical Explanation

As an example consider XYZ Ltd which is a listed Company on the ASX. In January 2009 the Company issued hybrid securities – convertible preference share (expressed graphically below), which pays a semi-annual, fully franked dividend of 6% p.a. for 5 years. If an investor invested \$10,000 he or she would receive \$600 p.a. (\$300 every six months until the maturity date). At maturity, according to the terms set by the Company in the prospectus, the investor could choose to:

- 1 Convert the \$10,000 into ordinary shares (convertible); or
- 2 Rollover or reset the investment (resettable); or
- 3 Under certain circumstances, have capital in the form of cash returned (redeemable).



Fixed Conversion

With this type of hybrid the number of shares you are to receive is calculated and known at the issue date. The security usually reacts or behaves more like the underlying share than a bond, although each security with this type of conversion has individual characteristics, typically:

- They have a set rate of return until conversion;
- The conversion might occur at one or a number of dates;
- They are usually issued at a similar price to the underlying share; and
- They convert at a set ratio e.g. 1 hybrid converts into 1 underlying share.

Dollar Value Conversion

This style of hybrid security is where the conversion (or number of shares you receive) is determined at the maturity date not at issue. The face value, usually \$100, effectively buys you shares at the market price on the date of conversion, thereby reducing the correlation between share price and hybrid price. Therefore the characteristics of this type of security are very 'bond like'.

Although each security with this type of conversion has individual characteristics, typically:

- They have a set dividend rate over a fixed period ('reset' period), which at the end of that period can be reset for a new dividend rate and new fixed period;
- They are typically issued at \$100;
- The holder has the ability to take the new 'reset' terms, convert or, on rare occasions, redeem the face value;
- The holder can convert into the shares at a discount to the current ordinary share price e.g. 5%; and
- The conversion ratio is into a dollar amount of shares e.g. \$100 worth of the underlying equity.

Example: ABC Bank Preference Securities – Dollar Value Conversion

In March 2009, ABC Bank issued hybrid securities called ABC Bank Preferred Securities. The prospectus for this hybrid security did not state exactly how many shares the investor would receive on conversion. Rather it stated that the face value (issue price) of \$100.00 will convert into \$101.01 worth of shares on the conversion date.

So the number of shares received is confirmed at the maturity or conversion date. Lets take this example a little further.

A price of the ordinary shares is needed to work out how many shares the \$100 face value will buy. The conversion price is calculated by obtaining the average of the volume weighted average share price over the last 20 days of trading up to the conversion date (VWAP), to get a fair figure. Then (as in most cases with hybrid securities) a discount is applied to the conversion price, 1% in this case, effectively delivering more shares.

For example, you purchase 50 ABC Bank Preferred Securities at the issue date for \$5,000. If the VWAP was \$25.00, then you would receive at conversion:

Face Value = 100

$VWAP \times (1 - \text{Discount})$ so $\$25.00 \times (0.99) = 4.04$ shares per security

Thus you would receive 202 ABC Bank shares at the conversion date.

Resettable

Resettable refers to the option the hybrid security offers at maturity. The choices can include:

- converting into ordinary shares;
- rolling over into a new set of terms offered by the issuer; or
- submitting a bid to the issuer for the margin at which you would like to continue to hold the hybrid. Agreement to this bid is usually at the issuer's discretion.

Valuing Hybrid Securities

Considering that each hybrid is constructed differently, comparing them is no easy task. There are many formulas and formats to measure value, two of the most popular are explained below.

Running Yield

Running yield is calculated as the dividend or returns divided by the market price. It is a simple measure of the return the holder can receive at current market prices, excluding any discount or optionality.

Yield To Maturity (YTM)

One method of comparison is to use a common indicator of value like YTM. The YTM is the return you will receive if you buy the security today and hold it until maturity. The YTM takes into account all future coupon or dividend payments due to the holder, current price if purchased today and the face value returned to the holder at maturity. YTM enables comparisons to be made between hybrid securities but only on its bond content.

Trading Margin

When comparing hybrids, it is important to have a standard by which to measure their relative value. One way to do this is to calculate a trading margin, or the implied margin that a hybrid is trading at given its current price.

For example, consider a hybrid that has a floating rate coupon with a margin of 3% (unfranked) over bank bills, which may be currently at 4%. The issue still has 5 years to maturity. However, the hybrid is currently trading at \$97, so has a current YTM of approximately 7.6%.

To calculate a trading margin, we subtract the bank bill rate to derive 3.6% as a trading margin, or the margin the market would require should they wish to issue another hybrid today.

Repeat the calculation for all hybrids you wish to compare their relative value.

Buying and Selling ASX IRS

There are two main ways in which you can buy Interest Rate Securities. They are:

- Primary market; and/or
- Secondary market.

When you buy on the primary market, you are lending money directly to the company that issues the security. Once the primary issue period is finished, the Interest Rate Security starts trading on ASX (the secondary market).

If you buy the Interest Rate Security on ASX, you are buying from another investor and not from the issuing company. By buying the Interest Rate Security on ASX and not through the issuer, you still have the rights to income paid on the security and the repayment of face value.

In order to buy or sell ASX Interest Rate Securities you will need to use a broker. The ASX website can assist in locating a broker or adviser in your area that may assist. Visit www.asx.com.au/findabroker

ASX Codes

ASX Interest Rate Securities trade in the same way as shares listed on the ASX. Each security is identified by an ASX code that is four to five alpha-characters long.

The first three characters identify the issuer, for example, WOW for Woolworths Limited.

The fourth character identifies the type of security. For example:

- H indicates an unsecured note
- G indicates a convertible note
- P indicates a preference share.

The fifth character, if any, is known as the sequence code. It indicates the number of that particular security within a series of securities on issue by the company. For example, WOWHA indicates the first unsecured note on issue by Woolworths Limited or CBAPB indicates the second preference share on issue by Commonwealth Bank of Australia.

Settlement

Settlement of ASX Interest Rate Securities takes place in CHESS (Clearing House Electronic Sub-registry System). As with shares you may hold your Interest Rate Securities in CHESS either as broker sponsored holdings or on the issuer's register as issuer sponsored holdings.

CHESS settlements normally occur on a trade day plus three (T+3) basis and the quoted prices for Interest Rate Securities reflect this.

Price information

You can get information about current trading prices through a number of channels including:

- Your broker who should be able to provide the current market price for any ASX security.
- Financial websites such as the ASX website www.asx.com.au
- The financial press which carry a list of the previous day's market action and closing prices.

Glossary

accrued interest

The amount of interest that has been accumulated from the last coupon date to the date when a bond is bought or sold.

annual coupon

A coupon that is paid once a year.

bank bill swap rate (BBSW)

A compilation and average of market rates supplied by domestic banks in regard to the specific maturities of bank bills. The purpose of BBSW is to provide independent and transparent reference rates for the pricing and revaluation of Australian dollar derivatives and securities.

bid price

Price a buyer is offering.

call date

The date prior to maturity on which a callable bond may be redeemed by the issuer.

call provision

Gives the issuer the right, but not the obligation, to buy back the securities from you at a particular point in time in the future at a certain price.

capital price

Gross price less accrued interest.

clean price

The price of a coupon bond that does not include any accrued interest. See also 'dirty price'.

corporate bonds

Bonds issued by a company.

convertible

A security that is convertible gives the holder the option to convert the security into ordinary shares at specified times in the future usually at reset or maturity dates.

converting

A converting security does not give the holder a choice at maturity; the security must in most instances convert into the underlying shares at a specified date.

convertible notes

A type of coupon-paying debt security that converts to the issuer's ordinary shares (equity) at maturity.

convertible preference shares

A type of dividend-paying preference share that converts to the issuer's shares (equity) at maturity.

coupon

The interest amount paid on the specified date to an investor in a bond. It is commonly expressed as the amount per \$100 as a percentage rate. Coupons can be paid annually, semi-annually or quarterly or as agreed in the terms of the security.

coupon date

The date on which the coupon interest is paid to an investor of a bond.

credit risk

The risk that an issuer may be unable to meet the interest or capital repayments on the loan when they fall due. Generally, the higher the credit risk of the issuer, the higher the interest rate that investors will expect in order to risk lending funds to the issuer.

cumulative/non-cumulative

cumulative

Missed dividend payments are added to the next dividend payment.

non-cumulative

Missed dividend payments are forgone. The issuer of the security is not obliged to pay the unpaid amount to the holder.

debenture

A type of fixed interest security issued by companies. It is usually backed by a specific or floating charge over the issuer's assets.

default

When an issuer cannot meet the payment obligations.

dirty price

Is the price of a bond that includes interest accruing and is due for payment on the next coupon payment. Dirty price is also known as gross price. See also 'clean price'.

discount

When the capital price of a bond is less than its face value.

exchange traded

A security traded on an exchange.

face value

The amount that an investor will receive at maturity.

Fixed/floating interest rates

Rates on bonds can be fixed (set at the time of issue) or floating. If they are floating then they will be set as a constant margin to a variable benchmark such as the 90 day bank bill rate.

floating rate note (FRN)

A floating rate note (FRN) is a security that pays a coupon linked to a variable benchmark.

government bonds

Bonds issued by a government.

gross price

The price an investor pays to buy bonds is made up of capital price plus accrued interest.

hybrid debt securities

A term or classification encompassing securities that have both debt and equity characteristics.

issuer

The entity (or borrower) that issues the debt security to raise money from investors.

liquidity

Liquidity refers to the ease with which a security can be readily converted into cash.

maturity date

The date on which a bond matures.

nominal yield

The return based on the annual coupon payments as a percentage of the face value of the security. Also referred to as the coupon rate.

offer price

Price a seller is asking.

over the counter

A security that is not traded on an exchange such as ASX but transacted over the phone between professional investors and brokers.

par

The face value of the security.

Perpetual security

A security with no maturity date.

premium

When a bond's capital price exceeds its face value.

purchase price

The dollar amount paid for the security.

Principal

The face value of the debt security on which interest is calculated.

quarterly coupon

Coupon interest that is paid four times a year.

redeemable/non redeemable:

redeemable – A bond which the issuer has the right to redeem prior to its maturity date, under certain conditions.

non redeemable – A bond which the issuer does not have the right to redeem prior to its maturity date.

running yield

The interest rate on an investment expressed as a percentage of the capital invested. It takes no account of the future capital gain or loss.

secured note

A note backed by a charge over an asset of the borrower.

senior debt

Senior debt is a class of corporate debt that has priority with respect to interest and principal over other classes of debt (except senior secured debt) and over all classes of equity by the same issuer. A company has no ability to defer coupon payment to senior or subordinated debt holders.

senior note

A note (evidence of debt) that ranks ahead of other debt and equity.

semi-government bonds

Bonds issued by a state-owned government authority.

semi-annual coupon

Coupon interest that is paid twice a year.

step-up securities

Where the coupon is typically increased by a step-up margin, subject to a specific trigger.

subordinated debt

A bond or loan that ranks below senior debt, loans and creditors.

time to maturity

The number of days until a bond matures.

unsecured note

A bond (note) that is not backed by an asset or charge over an asset.

yield

The annual return on an investment (bond, shares, property) expressed as a percentage.

yield to maturity

The return an investor will receive if they buy a bond and hold the bond to maturity.

yield curve

Graph showing the relationship between yield to maturity and time to maturity.

Further glossary terms are available from www.asx.com.au or www.fiig.com.au



ASX

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