Cover Letter

In 2024 we produced the second paper in our “Prepare for Change” series which focused on the need for Australian capital markets to adjust so as to provide the same, if not better, growth and wealth creation opportunities than those experienced by the Baby Boomer generation that came before them - the topic of our first research paper in 2023. This year I am pleased to share with you the coda to the series - “Prepare for Change: The Atomic Bond”. The reason this is a coda is because it follows our recent acquisition of FIIG Holdings Limited. FIIG is Australia’s largest specialist fixed income provider with over 6,000 clients and $4.5bn of funds under advice, providing investors with direct access to domestic and international bond markets and a range of term deposits and other cash solutions. We acquired FIIG because as part of Nomura Research Ltd (NRI) we are a research led organisation, and our research led us to seeing the opportunity to create value for Australian investors and our Wealth Management clients by acquiring FIIG and integrating their robust bond offering into our service platform for Financial Advisers.

We will continue to provide research as we look for more ways to add value to all our stakeholders in the future, but for this research paper we are pausing to reflect on the opportunities and issues of improving Australian Investor access to bonds in the near term. By sharing with you our analysis of the reasons as to why investors need bonds, how that led us to the FIIG acquisition, and by sharing what we think needs to be done to improve their adoption in Australian portfolios, we hope we can all work together to bring this important asset class to more Australian investors - because as you will see, they need them.

Patrick Salis
CEO, Ausiex

Prepare for Change: The Atomic Bond

Introduction

Australia has a retirement savings system that is the envy of the world. It is established, mature, and successful. However, like all systems, it has to adapt and mature. When compared to the rest of the world, the Australian superannuation system does not use bonds effectively, and we suggest that this is an area for improvement.

Notwithstanding this observation, the Australian financial services industry provides investors with a vast array of local and global investment products. The market is dynamic and able to meet Australian investors' appetite for innovation and quality. And yet, the numbers indicate there is little hunger in Australia for fixed income products (excluding cash and term deposits). Put simply, Australian superannuation funds are underweight bonds. The purpose of this paper is to discuss the need for - what we call the “Atomic Bond”. The reason we call it this is because bonds are one of the three core “atoms” of an investor’s portfolio along with equities and cash. We describe why bonds are an essential atom to be used in the construction of an investor’s portfolio, and we also discuss what we are doing, and what we believe others can do, to help improve this aspect of the Australian retirement system.

Australian Asset Allocation Observed

Table 1. Bond allocation in Australia vs OECD Averages

	Australian Super	OECD Pension Fund
Total	19% (Average)	30-40% (Average range)

This table shows that Australian superannuation portfolios hold, on average, half the number of bonds held in OECD pension funds. While there are good reasons for these differences, this raises the obvious research question: why is this so?

We believe there are two important reasons.

1. **A National Blind Spot.** Because our super funds are underweight bonds, a natural blind spot has appeared. Bonds are not explained often or well to Australian investors because they aren’t top-of-mind when we look at our portfolios.
2. **Structural Differences.** There are structural differences between the Australian bond market and the rest of the world that can be addressed to benefit investors.

Addressing the structural issues can create a virtuous cycle that also helps fix the blind spot.

Filling the Blind Spot: The Three Portfolio Atoms

At their basic level, bonds are not a complicated product. They are one of three fundamental products along with Shares and Cash. For this paper, we focus on these three fundamental "portfolio atoms". Other products like managed funds or ETFs are "molecules"—simply different ways of packaging these core atoms. We also exclude strategies like leverage or options, which are like the "electrons" that surround the atoms.

The Cash Atom

In Australia, “Cash” is the Australian dollar (AUD). In an investment portfolio, it is formally called “the risk-free asset”. The risk-free asset for an Australian investor is different from that of an American or British investor because it is the currency used to pay taxes. It’s risk-free because if you have a $100 Australian tax liability and $100 in Australian cash, you are free from any risk of being unable to pay. If you hold American dollars, you are not holding a risk-free asset because exchange rate changes put your ability to pay your $100 tax liability at risk. While cash in a bank account might earn a little interest, its face value never goes down unless you spend it. And so, Cash is the portfolio atom of the safest asset you can own.

The Equities Atom

“Equities” is the term for shares traded on a stock exchange like the ASX. The name comes from “shareholder equity,” which is the value of the remaining equity that shareholders own after any debts are paid off. An “equity” is a fungible (meaning identical and interchangeable) unit of ownership in a company. When you own an equity, you participate in the company's income, value growth (or decline), and governance through voting rights. If the company goes bust, the value of your equity can go to nothing, but your risk is capped to the value lost, as you are not liable for the company’s debts. And so, equities are the portfolio atom of ownership in a company.

The Bond Atom

Simply put, a bond is a share in a loan to an entity. It is a share in debt, not a share of ownership in a company. It’s called a “Bond” because it binds the borrower to the lender. In colloquial terms, it’s a company saying, "my word is my bond to pay the interest and pay the money back". Bonds are issued by nation-states, government entities, and companies to raise capital. Banks also issue bonds for corporate reasons and use a process called securitisation to package loans into new bond-like investments. A “bond” is also a fungible unit, but of loans, not companies.

The way bonds work is that the issuer creates certificates (now electronic) representing a share in the total loan, called the **principal**. They put a **term** on it (how long before they pay it back)

and a **coupon** value (the interest payments - or **yield** - the investor will receive). This is issued in the **primary market** which simply means - direct sales. After issuance, bonds can be bought and sold among investors in the **secondary market**. In this market, a bond's price can go up and down because of changes in prevailing interest rates or the issuer's creditworthiness. A key measure of a bond's sensitivity to these changes is its **duration**. The longer the bond's duration, the more its price is affected by interest rate and credit risk.

Bonds also have different **grades**. Sovereign bonds, or bonds issued by countries, have traditionally been the bonds of the highest grade and the US Bond the highest grade of all. However, even countries can **default** on their bonds (not repay them) like Russia did in 1998 when it defaulted on its bonds and sparked the “Russian Bond Crisis”. Municipal bonds issued by local authorities in the USA are rated at varying grades, but always at a lower grade than nation state bonds and hence they have to pay a higher coupon which means a higher yield to the investor.

Corporate Bonds also have different grades - a bond from Apple is lower risk than a bond from Ford Motor Company and so Apple can pay a lower coupon than Ford. Companies such as Standard and Poor's and Morningstar who specialise in doing research to rate bonds provide a scoring mechanism such as AA+ (S&P) for Apple and BBB for Ford (DBRS Morningstar). As the credit worthiness of companies change, so do their ratings and if their rating falls below a certain level it is considered a **junk bond** because it is not considered investment grade for the purposes of a bond investor because at a lower grade the economic profile of the bond becomes equivalent to equity.

Somewhat paradoxically a junk bond is not worthless; to the contrary there is a lot of high yield there to be found for investors who are comfortable with the risk of these lower grade bonds. The terminology of “investment grade” vs “junk” is more akin to the way we talk about “small cap” and “big cap” equities with all their opportunities and attendant risks. It should be noted that even though a bond can be called “junk”, it is still lower risk that an equity investment in the same company as bond holders are debt holders and are repaid from a restructure before remaining equity is determined and then returned to shareholders.

Why You Would Use the Bond Atom

Now that we have explained the Bond Atom we turn our attention as to why you would use them in your portfolio.

Managing Investor Risk and Return Preferences

Let's define Risk, Return and Rationality.

- **Risk** means an asset’s value can go up or down. More risk means you need more time to wait for a whole economic cycle to occur to get the average return for an atom type, less risk means you have to wait less.

- **Return** is what you get paid for taking on that risk over time.
- **Rationality** simply means making choices that fit your own personal goals and comfort with uncertainty. Importantly, it's not a value judgment, as everyone's goals are different.

Risk and Return allow us to describe how the different atoms and their combinations can work together to help manage an Investor's individual preferences.

- A portfolio of **Cash Atoms** has the lowest risk but also the lowest return.
- A portfolio of **Equity Atoms** is high risk meaning you need more time to get the highest potential return.
- A portfolio of **Bond Atoms** has a risk level between Cash and Equity Atoms alone meaning you need less time than Equity Atoms, but more time than Cash Atoms to get the potential return. The return of a Bond Atom portfolio is less than one made of Equity Atoms, but more than one made of Equity Atoms, which as you will see is why it is also an essential atom!
- A portfolio that blends all Atoms is called a **Balanced Portfolio** as it balances the ratio of all atoms to meet the Investor's particular needs at a given time in their investment journey.

By adding the Atomic Bond to your investment portfolio you can have a more nuanced and robust way to effectively manage your portfolio as your risk and return preferences change over time.

Meeting the needs of Demographic and Technological Change

We highlighted the importance of demographic changes in Australia in our first "Prepare for Change" paper. There are two important demographic trends that can be helped by better adoption of the bonds in Australian portfolios. First, as the Baby Boomer cohort retires the preservation of capital while still maintaining a return above inflation becomes an important need. The greater use of bonds in a portfolio is a better solution to this requirement for this cohort than what can be achieved by relying solely on cash and equities. And second, as the new generations enter into the system and they use new assets such as "crypto", bonds can be used to balance the high volatility of these new assets in this cohort's portfolios.

As the Australian population's needs deepen and change, the Advice industry is adaptive and it also changes with it. Artificial Intelligence (AI) is a new powerful tool that is making the mathematically intensive methods used in institutional investment advice available to Financial Planners to better help them serve their clients. These methods rely on having bonds available for the asset allocation process to construct what are called "optimal portfolios". We will now consider how increasing market access to bonds and fostering a deeper understanding of them will be an important step in helping the industry use AI led technology innovations to the benefit of clients.

Meeting the needs of Sophisticated Advisers and Rational Investors

This is a short technical discussion about the unique attributes and benefits of using the Atomic Bond in quantitative models. Quantitative models are mathematical models used by institutional investors to construct portfolios often using the theory of **The Efficient Frontier**. The non technical reader can choose to skip ahead to the next section called the "Structure of Australian Investment Markets".

The Efficient Frontier is a theory introduced by Harry Markowitz in 1952 for which he received a Nobel Laureate. What his theory achieved is that it found a way to put the risk and return concepts we defined earlier into a mathematical model that allows you to choose the "optimal" portfolio for an investor that matches their risk tolerance with the observed risk of all the assets that they can choose to put into their portfolio. It is a rigorous mathematical way for an investor to create a portfolio that is a **rational** model for achieving their goals according to their level of risk tolerance.

Figure 1. Illustrating the Efficient Frontier.

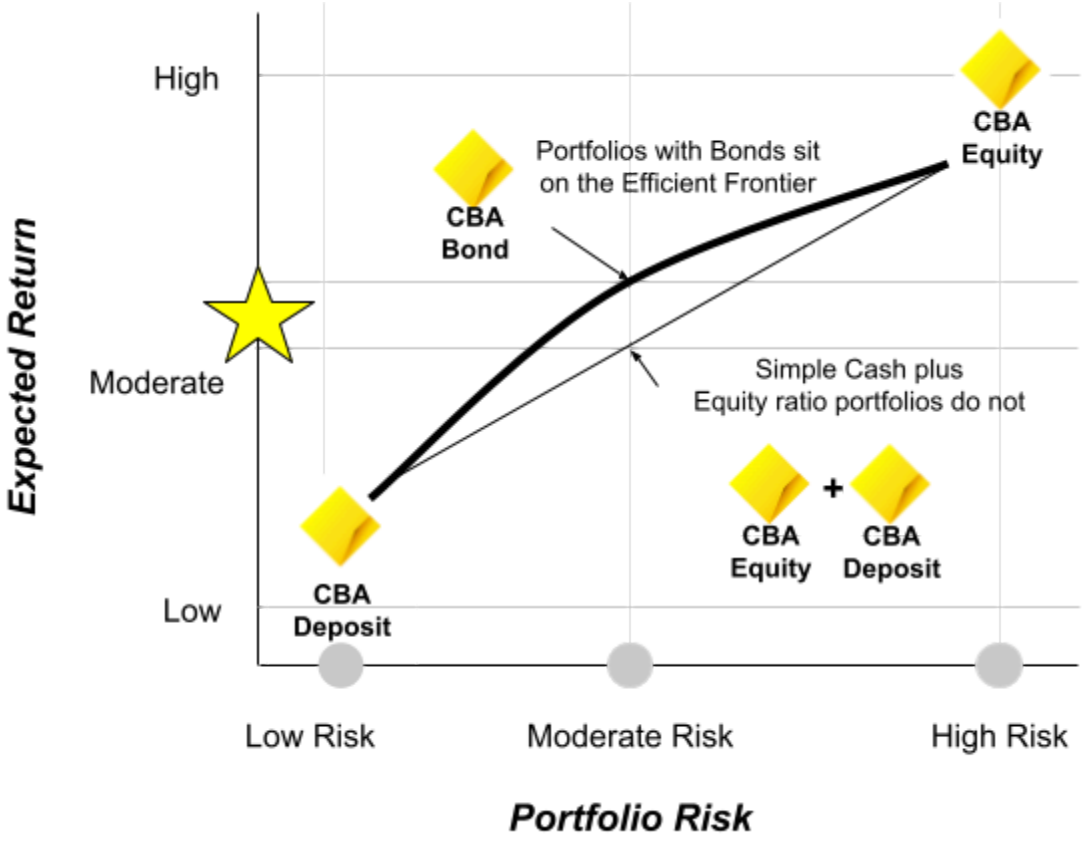

Figure 1. shows the reason why bonds are an atomic element, not just another molecule made from other elements. The diagram is highly stylised and only shows CBA products because it

provides all the atomic atoms and can be used to illustrate each of our data points. Of course in a real portfolio all atoms of all markets are available to the Markowitz model to create a properly diversified portfolio. The figure says that at high risk levels of - all equities - an investor will get the highest theoretical return over the longest run. At the lowest level of risk - a cash deposit - then the investor will get the lowest return for the lowest risk at any point in time. Now it is true that an investor can construct a moderate risk portfolio by creating a portfolio blended with equities and cash. BUT the addition of bonds moves the portfolio to the edge of a more **Efficient Frontier** providing more return at an equivalent level of risk. This is because the unique characteristics of bonds is **additive** to mathematical models and gives a better result than just combining equities and cash. The potential additional return achieved by using bonds for the same level of risk compared to only using cash plus equities is highlighted by the gold star.

This class of sophisticated asset allocation was once only available to institutional investors who could justify the cost of such sophisticated mathematics and computing. But in the age of AI this process is now becoming accessible to your Adviser and that is why we explain it as an important part of why bonds are becoming an important atom in AI managed portfolios. The age of AI means the ability to make mathematically **rational** investment decisions is becoming available to all of us.

Structure of Australian Investment Markets

We will now discuss the structural differences we see between the Australian bond market and the rest of the world that can be addressed to the benefit of investors. This section is about the supply and delivery of bonds to Australian Investors and the legislative environment in which they invest.

Financial Planners

Australia has a mature financial planning industry with world-class wrap platforms. While bond funds and ETFs are available on platform, the more natural way to deliver bonds is to enable direct investment in bond products on these platforms. FIIG already provides a primary market and a secondary market to investors and Advisers via the internet. We see this as being the equivalent of bonds being in the “ETrade” phase of early internet adoption where equities were made directly available to retail investors over the internet.

The ability to access stocks directly for clients evolved into Adviser Wrap Platforms which enabled the creation of **Separately Managed Accounts (SMAs).** SMAs meant Financial Advisers could begin to provide better service and post tax returns by having access to the underlying product, not just a collective fund, via internet enabled platform services. We see the same innovation happening for bonds. In the same way that managed fund equity products were disaggregated into model portfolios inside SMAs, we believe this same dynamic should occur for bonds so that bond funds are disaggregated and made available to SMAs to allow for better service and post tax returns. We will make individual FIIG created bond issues available

on our Wrap administration service so that our Adviser clients can improve the sophisticated asset allocation and services they provide to their investor clients.

The ASX as a Secondary Bond Market

The Bond market in Australia is already established and evolving at a rapid pace. Bonds can be issued by Australian companies, Australian institutional and retail investors have access to them and are taking advantage of that access in the existing primary and secondary markets as the blind spot recedes, and the infrastructure is stable, secure, transparent, and backed by large and committed organisations such as Ausiex. The ASX is the major provider of the equities secondary market in Australia, provides economies of scale to equity focused participants via CHESS, is the backbone of equity SMAs, and is endowed with a natural affinity for new products as the market evolves. We believe it is desirable that they add a **secondary bond market** capability to their platform and will work to help them with this initiative.

Regulatory and Tax

One regulatory barrier to bond adoption in Australia is the **franking credit system**. As the RBA highlighted in 2014, retirees may rationally eschew the safety of bonds to hold higher-risk, franked-dividend-paying equities to maximize income in retirement stream accounts created to fund their retirement. This impacts the economics for corporations, as it reduces domestic demand and the attractiveness of issuing bonds. There is a trade-off to be found, as more corporate access to bonds leads to a more dynamic economy, which also benefits investors. There is a win-win here, and we will work with others to find it.

Conclusion: Activating the Atomic Bond

Australia's retirement system is world-class, but its effectiveness can be improved. As we have shown, Australian superannuation portfolios are significantly underweight bonds when compared to their global peers, holding around half the allocation of the OECD average.

We argue this stems from two core issues: a cultural **"blind spot"** where the benefits of bonds are rarely discussed, and **structural inefficiencies** in the Australian market that make them harder to access and less attractive to issue.

The solution is not to simply abandon our successful growth-oriented approach, but to enhance it by activating the **Atomic Bond**. By embracing bonds, investors gain access to a third portfolio atom that acts as a vital "shock absorber" against market volatility and timing risk—the "lucky dip called 'real life'". This allows for a more nuanced and effective journey through the different stages of saving, from accumulation to retirement.

Achieving this requires tangible change. We must work to:

1. Grow and develop Australia’s existing bond capabilities.

2. Enable **direct bond access** on the platforms financial planners use every day.
3. Foster the establishment of a **public secondary market** for bonds on the ASX, with disclosure requirements appropriate for the asset class.
4. Address the **regulatory hurdles**, like the franking credit system, that structurally discourage bond issuance and investment.

By filling the blind spot with education and fixing the structural plumbing of our market, we can build a more resilient and dynamic investment landscape in Australia. We are committed to working with all stakeholders to make this happen, ensuring the Australian retirement system is not just successful, but robust enough to prepare all Australians for the changes ahead.