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The defensive bucket, audited.

The main Australian bond index sits inside the defensive part of most balanced super options. Between 1990 and 2020 it recorded two negative years. Across 2021 and 2022 it fell 12.7 per cent from peak to trough, its largest fall on record, during the same period as a global share market downturn. This paper sets out what the index holds, prices a one percentage point move in interest rates against it, and puts the result in dollars on an ordinary balance.

Q. II · DEFENSIVE
IN DRAFT · NO. 03

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SUMMARY

Australian super funds describe their fixed income holdings as defensive, and for thirty years the description fitted. The Bloomberg AusBond Composite, the standard index for the asset class, posted negative calendar years in 1994 and 1999, both small, and nothing else between 1990 and 2020.[1] Then it fell 12.7 per cent from its 2021 peak to its 2022 trough, at the same time as shares were falling, which is the one combination the defensive label exists to prevent.

PLAIN ENGLISH · WHAT THE INDEX IS

A bond is a loan to a government or company that pays fixed interest and repays on a set date. The AusBond Composite bundles several hundred of these loans into one index. When you read that a balanced option holds 25 per cent in fixed income, this index, or something close to it, is usually what that means.

The fall had a specific, checkable cause. The index's sensitivity to interest rates, its duration, had drifted up through the 2010s as governments and companies borrowed for longer at low rates, while the income the index paid drifted down toward 1 per cent. When the Reserve Bank and world markets lifted rates by roughly 3 percentage points, the prices of all those long, low interest loans adjusted downward together. Paper 01 walks the same mechanism through a single extreme bond; this paper covers the version most Australians actually own.

> **What this paper does not claim:** that 2022 will repeat. Duration cuts both ways, and at today's yields the cushion is real. The point is that the risk should be held knowingly.

2	-12.7%	~5 yrs	~4.4%
NEGATIVE YEARS, 1990 TO 2020	PEAK TO TROUGH, 2021 TO 2022	INDEX DURATION TODAY, APPROX	INDEX YIELD TODAY, THE CUSHION

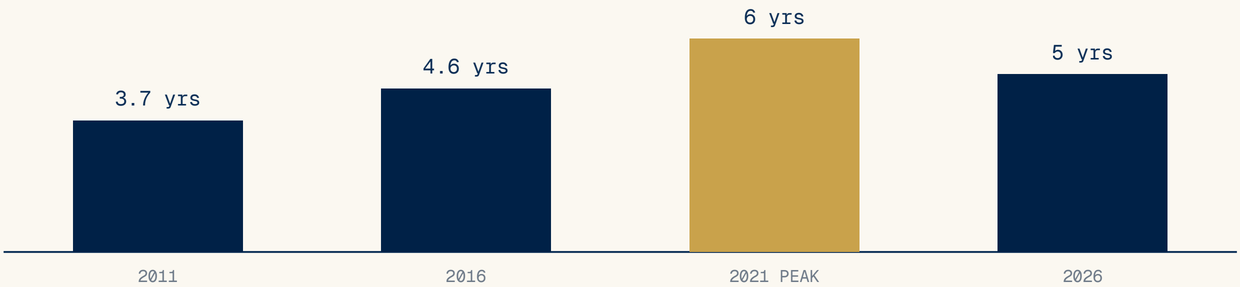
SECTION 01

What the bucket holds.

The index is mostly loans to Australian governments. A little over half is Commonwealth Government bonds, roughly another third is state government paper, and the remainder is high grade corporate and supranational debt.[2] Credit quality is strong across the board, and the 2022 fall involved no defaults. The sensitivity that mattered was to interest rates, and it built up gradually.

INDICATIVE COMPOSITION BY ISSUER, PER PUBLISHED INDEX BREAKDOWNS. SOURCE 2.

FIGURE 1. WHO THE INDEX HAS LENT TO. THE BORROWERS ARE ABOUT AS RELIABLE AS BORROWERS GET, WHICH IS WHY THE RISK THAT REMAINS IS THE INTEREST RATE KIND.



INDEX DURATION OVER TIME, YEARS, APPROXIMATE, FROM PUBLISHED INDEX CHARACTERISTICS.

FIGURE 2. THE QUIET DRIFT. EACH LONG, LOW COUPON BOND THAT ENTERED THE INDEX MADE IT MORE SENSITIVE TO RATES, AND HOLDERS TOOK ON THAT EXTRA SENSITIVITY WITHOUT MAKING A DECISION.

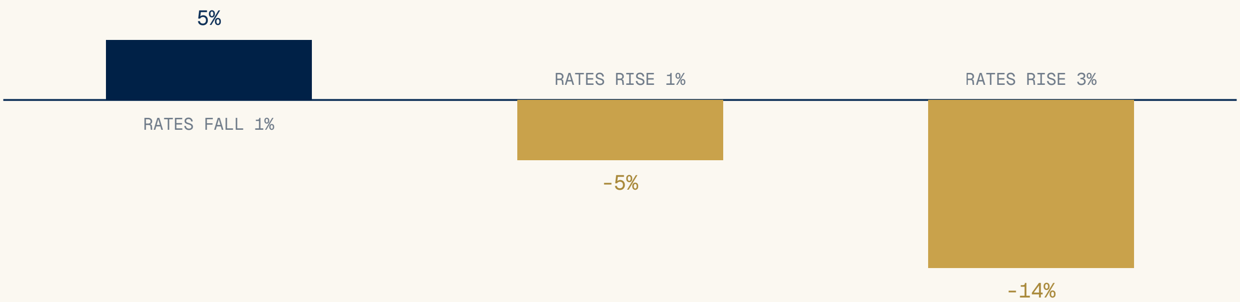
Duration near six years at the 2021 peak meant a portfolio that would fall roughly 6 per cent for each 1 percentage point rise in rates, at a moment when the income on offer to cushion any fall was about 1 per cent a year. Those two published numbers, read together in 2021, described the 2022 result in advance.

SECTION 02

Pricing a move, in percentages and in dollars.

PLAIN ENGLISH · THE RULE OF THUMB

Price change equals duration multiplied by the rate change, in the opposite direction. A five year duration and a 1 percentage point rise gives roughly a 5 per cent price fall. A 1 point fall in rates gives roughly a 5 per cent gain. Income earned along the way offsets either result.



PRICE EFFECT ON THE INDEX AT FIVE YEAR DURATION, BEFORE INTEREST INCOME. THE THIRD BAR IS ROUGHLY THE 2021-22 MOVE. METHOD NOTES.

FIGURE 3. THE INDEX'S PRICE RESPONSE TO RATE MOVES, USING THE RULE OF THUMB.

SCENARIO OVER ONE YEAR	PRICE EFFECT	INTEREST INCOME	APPROX TOTAL	ON $125,000 OF INDEX EXPOSURE
Rates unchanged	0%	+4.4%	+4.4%	+$5,500
Rates fall 1 point	+5%	+4.4%	+9.4%	+$11,750
Rates rise 1 point	-5%	+4.4%	-0.6%	-$750
Rates rise 3 points	-14%	+4.4%	-9.6%	-$12,000

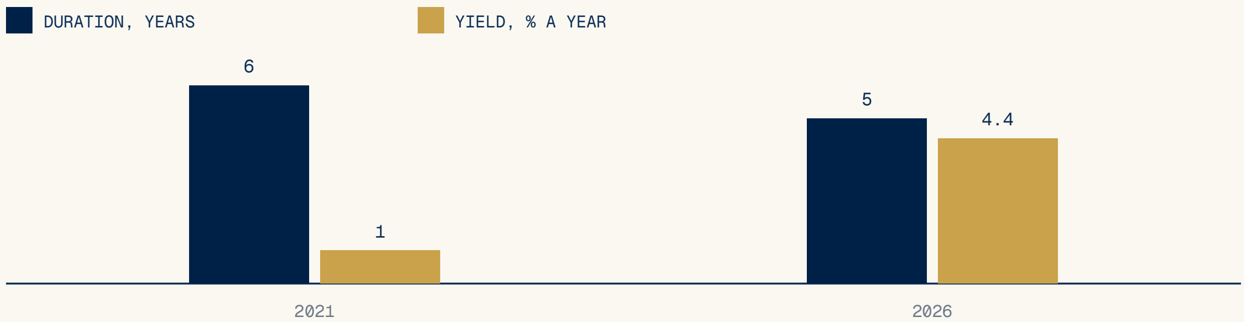
$125,000 represents a 25% fixed income allocation on a $500,000 balanced balance. Income uses today's index yield of about 4.4%. Method notes.

The third row is the important one for today's holder. At current yields, the income roughly cancels the price damage of a full 1 point rise over a year. In 2021 the same row computed to about minus 5 per cent, because the income line was close to zero. Today's index is a much better cushioned version of the same position, and the table is the honest way to show it.

SECTION 03

The position, stated out loud.

A member holding the index owns a position that gains about 5 per cent if long term rates fall 1 point, loses about 5 per cent if they rise 1 point, and earns about 4.4 per cent a year while waiting. Written out like that, it is a reasonable holding, and at today's yields a genuinely useful one. The audit's finding is about how the position was acquired: it accumulated through index drift over a decade, and most of its holders learned its size from their 2022 statement.



THE TWO NUMBERS THAT DESCRIBE THE POSITION, THEN AND NOW. PUBLISHED INDEX CHARACTERISTICS, APPROXIMATE.

FIGURE 4. 2021 COMBINED HIGH SENSITIVITY WITH ALMOST NO INCOME. 2026 CARRIES SLIGHTLY LESS SENSITIVITY AND ROUGHLY FOUR TIMES THE INCOME.

THE THREE NUMBERS TO CHECK YEARLY	TODAY'S ANSWER FOR THE INDEX	WHAT TO DO WITH IT
Duration, in years	About 5	Multiply by 1 point to know your downside from a rate rise.
Running yield	About 4.4% a year	This is the cushion that offsets price falls while you hold.
Your allocation, in dollars	Your statement	Converts both percentages into money on your own balance.

Our position in this discussion should be stated plainly. Oxford lends money against property; a held to term first mortgage carries repayment risk instead of repricing risk, and Paper 01 prices that trade in both directions. We are a participant in the comparison, and the same standard applies to us: name the risk, size it in dollars, and hold it on purpose. This paper is the bond side of that standard.

SOURCES

Sources and method.

1 Bloomberg AusBond Composite 0+ Yr Index, total return series: negative calendar years 1994 and 1999; peak to trough fall of 12.7 per cent across 2021 to 2022.

2 Published index characteristics and provider factsheets: issuer composition, duration and yield, approximate, as charted.

3 RBA statistical tables: the rise in Australian yields of roughly 3 percentage points across 2021 and 2022.

Method notes.

Composition and duration figures are rounded and indicative; they move month to month. Price effects use the linear rule of thumb, duration times rate change; the minus 14 per cent figure for a 3 point rise slightly overstates the pure price effect because the rule of thumb is pessimistic for large moves, and 2022's realised result also included income. The dollar table applies percentages to a $125,000 exposure, being 25 per cent of a $500,000 balance, and rounds to the nearest $250. The 12.7 per cent drawdown figure should be re-verified against terminal data before public release. Figures may not sum exactly due to rounding.

Disclosure.

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