



Best Bond ETFs for Australians

Jody McDonald

Contributor - Published: Jul 13, 2023, 3:18pm



While [bonds](#) are widely misunderstood by retail investors, they do have a deserved reputation for being a low-risk investment option. With the sharemarket expected to underperform due to unfavourable economic conditions, including a high cash rate and soaring [inflation](#), curious and cautious investors alike are rethinking the role of bonds in their portfolios.

[Exchange-traded funds \(ETFs\)](#) that offer exposure to bonds are particularly appealing due to their convenience and liquidity, reliable returns, and greater diversification compared to holding individual bonds.

However, while bonds can offer a way to protect capital and generate [passive income](#), in a rising rates environment a bond's market value falls. Read on to learn more about how to choose the best bond ETFs.



CENTAUR
FINANCIAL SERVICES

Related: [Best ETFs for Australians](#)

What Are Bond ETFs and How Do They Work?

Bonds are a fixed-income asset, often used defensively in turbulent markets, that deliver regular payments to investors based on a predefined interest rate. As well as reliable, low-risk income, bonds can be an attractive way to cushion against [falling share prices](#).

You can buy securities backed by underlying individual bonds issued by both companies and governments on the Australian Securities Exchange (ASX). Bond ETFs differ in that they are investment vehicles traded on the ASX where your money is combined with other people's funds and used to invest in a grouping of multiple bonds.

While the ETF provider maintains control of the bonds in the fund, you'll receive a proportional share of the interest payments. You can also make capital gains if the market value of your ETF units rise.

Certified financial planner and managing director of Centaur Financial Services, Hugh Robertson, said many investors favoured equities and dividends over bond ETFs when rates were low in the past 10 years, until the recent spike in the cash rate to 4.10%.

"Now, smart investors have pivoted over concerns on the global economy and recession fears, and adding bond ETFs into their portfolios to capture the higher yields on offer around 5%, as well as protection against share market volatility as bond ETFs historically have a low correlation to shares and offer broad diversification," he tells ForbesAdvisor.

"For a long time interest rates have been so low that bonds really weren't impactful to portfolio returns. Now there is the ability to really generate some great income from the defensive side of your portfolio which in turn takes pressure off the reliance on capital growth like investors needed in recent years."



How Bond ETFs Differ from Individual Bonds

In simple terms, when you buy an individual bond:

- It creates capital for the bond issuer—you basically become a credit provider and the government or company that issued the bond is in debt to you.
- They agree to repay your initial investment (known as face value) in full after a set time, known as the maturity date.
- Until maturity, the bond issuer commits to consistent interest payments on the face value.

Both governments and companies issue bonds as a way to access funds. Government bonds in particular are seen as safer than houses or even money in the bank, as it's highly unlikely the Australian Government will default on its payments (but not impossible).

Bond ETFs differ from bonds in the following ways:

- You aren't guaranteed to receive your initial investment back in full. You'll still receive interest payments from the underlying bonds held by the ETF provider, but the value of the ETF units you own will depend on market prices at the time you sell.
- Your investment doesn't 'mature'. The ETF provider rebalances the fund regularly with new bonds in pursuit of benchmark average maturity and yields.
- You'll typically receive returns more regularly. Interest payments on individual bonds may only be semi-annual while bond ETFs often pay quarterly or even monthly, which is great for income investors and retirees.

Key Bond ETF Terms To Understand

- **Credit Rating:** You might see an ETF's holdings described as 'investment-grade bonds'. This means the bonds held have high credit ratings with a lower default risk. Credit ratings start at AAA and beyond BBB- indicate a significant increase in default risk. Higher risk bonds may offer higher interest rates as a result.



- **Interest/Coupon Rate:** The interest rate offered on a bond is sometimes referred to as the coupon, with interest payments called coupon payments.
- **Running Yield:** Similar to dividend yield, this reflects the potential returns as a percentage, based on the annual coupon payment divided by the current market price of the bond ETF.
- **Maturity:** The bond's end date. While holdings in a bond ETF have different maturity dates, the ETF itself never matures—the provider will continually adjust bonds in the portfolio to provide a stable average maturity.
- **Duration:** Gives you a sense of how much the ETF's market price will change if interest rates change. Hugh Robertson offers the following example: "If you have a bond with a duration of six years it means that a 1% rise in interest rate will see a decline in value of 6%, so if your bond was worth \$1,000 paying you 5% you still get your \$50 per year, but the value of the bond on the secondary market is \$940."
- **Yield to Maturity (YTM):** A percentage value that represents the overall return you can expect if you hold a bond to maturity and reinvest coupon payments. For bond ETFs this is a weighted average of all the underlying bonds' YTM.

Keep in mind, the longer the duration the greater a capital gain or loss you'll make as cash rates fluctuate. If you're looking for short-term gains by potentially selling your ETF units for a profit if interest rates fall, you might prefer a fund with a shorter average bond duration.

Related: [Best Dividend ETFs](#)

Types of Bond ETFs

Investment strategies vary across bond ETFs, primarily based on timeframe and bond type. For instance, one bond ETF might focus on longer duration Australian Government bonds while another might focus on higher-yielding corporate bonds—while some include a mix of both.

Most bond ETFs are index funds. Robertson adds: "The majority of bond ETFs track an index by nature and there are few active options."



He said the S&P Dow Jones Indices scorecard shows [active managers don't perform any better](#) than the index benchmark for Australian bond funds. "This makes it difficult to believe that investors on their own can find the managers that can consistently outperform over an economic cycle."

The main types of bonds that bond ETFs hold include:

- **Australian Government bonds:** Bonds issued by the Commonwealth Treasury, other government agencies and state governments.
- **Australian corporate bonds:** Issued by companies including Australian banks and large publicly-traded players like Qantas, Coles and Telstra.
- **International and supranational bonds:** Such as bonds issued by the US Treasury or corporations like Apple. Supranationals are organisations whose powers transcend a single government, like the European Investment Bank.

Top 5 Bond ETFs

The best bond ETF will depend on your investing goals and market conditions, but we've evaluated available products to provide a top five list based on low management fees and low-risk underlying assets.

[iShares Core Composite Bond ETF \(ASX: IAF\)](#)

- **Index tracked:** Bloomberg AusBond Composite 0+ Yr Index
- **MER/Annual fee:** 0.10%
- **Running yield:** 2.93%
- **Distribution frequency:** Quarterly
- **Credit rating:** 70% AAA
- **Average maturity:** 6.04 years
- **Duration:** 5.18



- **Why we chose it:** One of Australia's largest bond ETFs in terms of funds under management, with a high credit quality and reasonably short duration. Includes both government and corporate bonds.

[Vanguard Australian Fixed Interest Index ETF \(ASX:VAF\)](#)

- **Index tracked:** Bloomberg AusBond Composite 0+ Yr Index
- **MER/Annual fee:** 0.10%
- **Running yield:** 2.89%
- **Distribution frequency:** Quarterly
- **Average credit rating:** AA+
- **Average maturity:** 6.1 years
- **Duration:** 5.3
- **Why we chose it:** A low-cost option for investing in predominantly high-quality Australian government bonds to generate steady income.

[SPDR® S&P®/ASX Australian Government Bond Fund \(ASX: GOVT\)](#)

- **Index tracked:** S&P/ASX Government Bond Index
- **MER/Annual fee:** 0.22%
- **Yield:** 2.91%
- **Distribution frequency:** Quarterly
- **Credit rating:** 68.50% AAA
- **Average maturity:** 7.43 years
- **Duration:** 6.29
- **Why we chose it:** A diversified portfolio of high quality bonds that only includes Australian government and government-related bonds.

[Betashares Australian Investment Grade Corporate Bond ETF \(ASX: CRED\)](#)

- **Index tracked:** Solactive Australian Investment Grade Corporate Bond Select TR Index
- **MER/Annual fee:** 0.25%



- **Running yield:** 4.06%
- **Distribution frequency:** Monthly
- **Average credit rating:** BBB+
- **Average maturity:** 7.16 years
- **Duration:** 6.03
- **Why we chose it:** Aims to provide higher returns than Australian Government bonds through investment grade corporate bonds with a slightly lower average credit rating.

[Betashares Australian Bank Senior Floating Rate Bond ETF \(ASX: QPON\)](#)

- **Index tracked:** Solactive Australian Bank Senior Floating Rate Bond Index
- **MER/Annual fee:** 0.22%
- **Running yield:** 4.99%
- **Distribution frequency:** Monthly
- **Average credit rating:** AA-
- **Average maturity:** 4.28 years
- **Duration:** 3.7
- **Why we chose it:** Floating rates have shown a low correlation to equities and up to 80% of this ETFs' portfolio is allocated to bonds issued by the 'big four' Australian banks, which should be a stable option.

How do Interest Rates Impact Bond ETFs?

There are two concepts to grasp when it comes to how the cash rate set by the Reserve Bank of Australia influences bonds:

- The cash rate affects the interest offered when you initially buy a bond. In a high interest rate environment, bond issuers will offer higher interest on bonds being issued. For instance, back in January 2021 when the cash rate was 0.1%, a [three-year government bond](#) offered an interest rate of 0.10%, whereas after a record-breaking run of rate rises this year, a three-year government bond comes with 3.84% interest.



- The cash rate affects the resale value of a bond on the secondary market. “Interest rates and bond values have what is called an inverse relationship. When interest rates rise, bond values tend to fall,” explains Hugh Robertson. As rates drop, a bond ETF’s units tend to be worth more on the ASX.

Here’s an example from Robertson to illustrate the inverse relationship between the cash rate and a bond’s market value:

“Say you have a \$1,000 bond paying 5%. You will get \$50 every year until the bond expires. Suppose one month later interest rates go up to 6%. Now anyone who wants to own a fixed rate bond will get 6%, or \$60 per year, for the same \$1,000 investment. This presents the dilemma, if you want your money back prior to bond maturity you would sell it in the secondary market, and no one is going to give you \$1,000 for a vehicle that pays \$50 when for the same \$1,000 I can get \$60 on the new investment. Therefore, your capital value goes down and I offer you less for your bond.”

Difference Between Fixed and Floating Rate Bonds

It’s also important to highlight that interest paid by bond issuers may be paid at a fixed rate that doesn’t change until maturity, or a rate that is adjusted as economic conditions change.

For instance, the interest on Treasury Indexed Bonds are adjusted against the CPI, which protects your returns if inflation increases. Also, it’s worth noting that floating rate bonds offer a variable baseline rate plus a set margin on top. For example, the cash rate plus 2%. That means your coupon payments increase or decrease in line with the underlying benchmark rate.

Managing a Fixed Income Portfolio

One bond ETF is not a silver bullet for protecting your portfolio, Robertson warns.

“Understanding where the bond ETF will sit in the context of your total portfolio is essential. Ideally the bond ETF would have a low correlation to other parts of your portfolio. And don’t get greedy and over allocate your portfolio to any one asset class,” he says.



“If you want to have a long duration bond thinking (that) rates next move is down, you would get good income and some capital growth, but rates could go up and you could be wrong, so the key is to not over allocate to the strategy. A 5% or 10% would be satisfactory and you could handle short term underperformance and still collect a reasonable yield.

“Investors would be wise to hold floating rate bonds while rates are rising, and look to transition to longer maturity bonds when rates peak and start to fall. Investors should also consider how much they want to hold in government debt versus corporate debt. Right now my view is to gradually move any floating rate bond exposure across to fixed rate bond exposure as interest rates are near the peak of the cycle it would seem based off current economic news.”

Robertson says investors also shouldn't rule out other asset classes with defensive characteristics or low correlation to share markets.

“To diversify risk from equity markets investors should, if they have the risk appetite, look at private equity and infrastructure, asset classes that have a low correlation to equity markets traditionally.”

Advantages of Bond ETFs

Previously, these fixed income assets required hefty initial investments and were complicated to purchase, making them exclusive to wholesale and institutional investors. Bond ETFs have reduced the barrier to entry for retail investors, making it possible to benefit from bonds with an affordable minimum investment.

- **Inexpensive and easy:** In addition to being cost-effective, bond ETFs make it easy to invest in multiple assets that are managed for you—but usually with a lower annual fee than a managed fund. Although you'll also pay brokerage fees on trades, the convenience of a listed product is a draw for many investors.
- **Diversification:** The way ETFs bundle assets offers diversification. Allocating capital to bond ETFs can also diversify your portfolio as a whole, to lower overall risks.



CENTAUR
FINANCIAL SERVICES

Robertson says the benefits of diversifying with bond ETFs has previously been illustrated during the devastating global financial crisis—although the ASX200 fell 37% peak to trough between August 2007 to March 2010, bonds exhibited a negative correlation and provided positive returns.

“A portfolio that was 50% invested in shares and 50% invested in fixed interest returned 3% over the time period. This shows the extraordinary benefit of diversification,” he notes.

Disadvantages of Bond ETFs

Despite their many strengths, Bond ETFs are not without their flaws.

“Fixed interest investment still sees people fall victim to a yield trap chasing higher returns. That is the biggest risk in thinking that it is guaranteed and chasing yield,” according to Robertson.

“Investors need to understand the dynamics that affect bond pricing, namely maturity date, the coupon rate, and the current price. Education is key and don’t just rely on historical returns as that was in a historically low interest rate environment and looking at returns alone will not tell you the full story.”

Understanding the risks associated with the underlying bonds the ETF holds is critical.

“Compare apples with apples—bond ETFs range from super safe Treasury Bills to somewhat speculative high yield corporate debt. So you need to do some due diligence before allocating your hard earned money into this asset class.”

How to Invest in Bond ETFs

Bond ETFs are bought and sold on the ASX via a broker—whether that’s through your stockbroker or [financial advisor](#), or by using a stock trading app.



CENTAUR
FINANCIAL SERVICES

Follow these steps to self-manage your investment in bond ETFs using an app:

1. Select and sign-up to a share trading app, prioritising a platform with low brokerage fees and a helpful user interface. You can read more in our guide to the [best share trading platforms](#).
2. Deposit funds into your share trading account and use the app's features to search for your chosen bond ETF's ticker symbol, e.g., QPON.
3. Purchase your desired amount of ETF units. You can use the app's features to control your spending, such as stop orders, limit orders and margin purchases.

It pays to monitor RBA interest rates and bond ETF yields by staying abreast of the news and reviewing the information provided by ETF providers on their websites.

SOURCE:

<https://www.forbes.com/advisor/au/investing/best-bond-etfs-for-australians/>

Forbes ADVISOR