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**Note to: The Commonwealth Debt Management Review  
C/o Dept of the Treasury  
Langton Crescent  
Parkes  
ACT 2600**

**Subject: RESPONSE TO COMMONWEALTH DEBT  
MANAGEMENT REVIEW – NOVEMBER 2002**

## **1. Background**

JANA Investment Advisers is one of the leading investment consulting firms in Australia. Principally JANA is an asset consulting business focused on the:

- Establishing the strategic assets allocation (that is the allocation between growth and defensive assets and the role they play within a balanced investment portfolio).
- The review and recommendation of the appropriate managers within each asset class so as to insure that the investor/Fund maximizes the potential to achieve its overall investment objectives.
- Portfolio construction.
- Investment Policy Implementation.
- Alternative Investments.
- Transition Management.
- Risk Management.
- Capital Markets Research.

As such, JANA has no vested interest in the outcome of the Commonwealth Government's current review of the Commonwealth debt position. Rather we are purely focused on providing high level strategic advice to a wide range of large investors so as to maximize the potential to meet these investors' performance requirements – without exceeding their risk tolerance. JANA is concerned only about efficient market outcomes.

A list of the current client base of JANA is attached as Appendix 1, however, in summary, the majority of the Funds we work for are large Superannuation funds, and as such the advice JANA provides is inextricably linked to the ability of those Funds to maximize the retirement incomes for individual members.

The size of the Australian Superannuation industry has been estimated by market practitioners at approximately \$750 billion<sup>1</sup>. JANA advises Funds with approximately \$50 billion and therefore represents approximately 7 per cent of the entire industry. Moreover many of JANA's largest clients are large scale industry Funds and public sector superannuation schemes with large numbers of members. It has been estimated that approximately one in ten working Australians holds their superannuation with a Fund advised by JANA.

JANA was founded in 1987 by John Nolan who recognised the growing size and complexity of superannuation required the provision of high level strategic financial advice. In December 2000, JANA was acquired by the National Australia Bank Limited, however it still operates as a stand alone boutique asset consultant. The views included in this memorandum are purely the views of the management at JANA and do not necessarily represent those of the National Australia Bank Limited.

## 2. Strategic Issues

The Commonwealth Debt Management Review Paper raises several strategic issues that need to be considered. Generally these can be summarized as follows:

- 2.1 *Increased risk to the Australian investors*** – Investors in the Australian financial markets currently have the ability to switch between the government (risk free) curve and corporate credits depending on their underlying view of the financial market conditions. The ability to switch between risky and risk free asset classes is fundamental to investment portfolio theory. The vast majority of the Funds JANA works for structure fixed interest mandates to provide for the ability for the underlying manager to switch between these two asset sectors based on underlying financial/economic/geopolitical views. Further some Australian superannuation funds limit their Australian fixed interest investments to the government and semi-government curve only. By removing the risk free government curve, the government is removing a key component of the fixed interest mandates resulting in the investor only having access to a far more limited and risky investment horizon.

The following chart shows the average allocation to Australian Fixed Interest amongst investment managers in Australia (source Rainmaker Analytics Data Base)

Government bonds play a significant role in both the Australian and global fixed interest markets, as can be seen by looking at the key benchmark indices for these markets.

Not only do Government bonds play an important role in investment management, they have been an important source of “value add” for investor returns. You

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<sup>1</sup> Source Rainmaker

only have to look at recent history to see the value that managers can add by switching between the risky and risk free asset classes. Over the last six months fixed interest markets have dramatically outperformed equity markets. However, the return amongst individual sectors of the fixed interest market have been quite different. The most attractive asset class for investors over the last six months has been government bonds.

Fixed interest managers who spread their exposure between government and corporate credits had underperformed. This is the result of a dramatic increase in corporate credit spreads over the last six months as investors took a flight to quality, out of equity into government bonds. It should be noted that these investors did not see a flight to quality into corporate credit as being appropriate. If domestic fixed interest managers were only able to invest in semi-government and corporate credit during this period the overall return to superannuation funds (as well as the entire investment industry) would have been materially reduced. Naturally any reduction to the returns to the superannuation funds has direct impact on either the size of individual members' retirement balances or the contribution rate that the employer must make during the years until the member retires.

## 2.2

***Flow on impact to the Corporate bond market*** – the problems outlined in 3.1 are so serious that investors may legitimately respond by changing their fixed interest mandates to global fixed interest mandates. In this way they will retain the ability to switch between the risky and risk free sectors of the fixed interest market. This is likely to have a dramatic impact on the viability and effectiveness of the Australian bond market. If the “buy” side interest is materially reduced this will have a direct impact on the ability of issuers to issue corporate bonds in the primary market. In turn these issuers may look to match what the investors are doing, that is concentrating on the off-shore capital markets. Obviously the flow-on impacts to the corporate bond market in Australia could be significant.

One only has to look at the early 1990's when the corporate bond market in Australia was near collapse as a result of lack of liquidity (there were very few suitable true corporates willing to commit to this market and the ability to accurately price new issuants was extremely limited). However the market was predominantly saved by the growth of the superannuation industry with its associated appetite for local currency fixed interest assets.

The transaction costs for corporations to borrow in international capital markets are significantly higher than in the domestic market. A new bond programme could cost over \$1M to document in the US market compared to under \$100,000 in the local market. Dealer fees are also often higher in the international markets. Additional transaction fees are incurred to bring the funds back to Australia (cross currency swaps etc).

**2.3 *Diversity of credit*** – All of the new issues referred to under Section 3.2 above relied on the government bond curve to facilitate the accurate pricing of where these new issues could be bought to market. In turn, this provided confidence to issuers that the bonds would successfully clear in the market place. At the same time, investors were assured that they were being appropriately compensated for the credit risk involved in the underlying transaction. JANA does not believe that the risk free curve could be appropriately or effectively replaced by a corporate credit curve due to the diversity of underlying corporate issuers in Australia. Even issuers of equivalent credit rating often trade in the primary and secondary capital markets at significant differences to each other based on underlying peculiarities of each issuers business. (Often the names with household appeal would trade well inside equally as strong rated entities with a lower level of “brand” recognition.)

**2.4**

***The risk free rate plays an important role in determining the revenue for many regulated businesses*** – a whole industry has sprung out of the application of the capital asset pricing model (and in particular the way that weighted average cost of capital is calculated), in determining the appropriate revenue to set for regulated/monopoly businesses. For instance the recently privatised electricity industry in Victoria has a revenue determination set once every five years which is predominately based on determining an acceptable weighted average cost of capital return to the asset owner. A key component of this calculation is the determination of the appropriate risk free rate.

Currently this rate is easily observable in the market place. This transparency of revenue determination also facilitates cost effective hedging activity by the underlying asset owner in order to remove interest rate volatility from its business operation. It is unclear how the appropriate revenue determinations would be made in the absence of a risk free rate. If the regulators were to apply some form of corporate swap curve, then this will be a materially higher number than the risk free rate currently used, and therefore, all other things being equal, will produce a higher revenue number for the asset owner. This of course represents a higher cost to those purchasing the services (the community at large). The regulator may respond by declaring that some margin below the corporate swap curve will apply, however it is unclear to JANA what would be the appropriate margin to apply to the corporate swap rate.

**2.5**

***If it's not broken don't fix it argument*** – Australia has benefited from having extremely effective and liquid financial markets.<sup>2</sup> Australian risk management expertise is recognised as equal to the best in the world. This has been born out of a commodity based economy dealing in international markets in mostly US dollar terms, and at the same time being subject to the volatility inherent in exchange rates linked to underlying commodity prices. JANA believes it is the obligation on those wishing to change what is a perfectly functioning market, and verify to the Australian community that the removal of the risk

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<sup>2</sup> It should be noted the corporate bond market in Australia is still small, illiquid, short dated and relies on “credit wrapped” insurance. It is the government bonds that provide the platform for the entire market to work effectively.

free government curve will have no material impact on the functioning of the Australian capital markets. JANA believes it is unreasonable for the government to place the onus on the Australian financial markets to verify that it still requires the issuance of government debt. The removal of the government debt is such a significant initiative that its flow-on impacts to the operation of those financial markets is most unclear and cannot be resolved with any degree of certainty now. One needs to move very cautiously and prudently when looking to alter the operation of a fundamentally sound system.

## 2.6

*The fundamental function of government debt* – the proposition that all government debt is bad is both naïve and simplistic. Whilst JANA does not recommend the issuance of government debt purely for issuance sake alone, it does believe that the issuance of government debt provides fundamental benefits to the community. For instance, when the government is engaged in major infrastructure projects (eg road systems or power stations) these assets will provide an economic benefit not just in the current year but in future years and in future generations. In these instances it is entirely appropriate for the government to spread the cost of providing this economic infrastructure across future years and future generations. The most appropriate form to spread this cost is via the issuance of government debt.

## 2.7

*Off shore investors may desert the Australian capital markets* – it has been estimated by market participants that approximately 35-40% of the Australian government bonds are held by foreign investors. These investors demand the ability to switch between the risky and risk free sectors of fixed interest in whatever currency they are invested in (refer arguments in section 3.1). If there is no risk free assets in Australia, these investors may bypass the Australian capital markets entirely as it should be recognised that the Australian capital markets represents a small fraction of the global capital markets, and therefore the removal of Australia as a source of investments would be of little consequence to global fixed interest managers). JANA believes it is difficult to see why the major global fixed interest managers would maintain any presence in the Australian capital markets, and this would further weaken the Australian capital markets.

Whilst JANA believes that other instruments may become more prominent in Australian capital markets, and in some cases may supplant some component of the risk free rate, it believes that the removal of the risk free curve in Australia will materially weaken the underlying effectiveness of the Australian capital markets from both the borrower and investor perspectives. Any decrease in the effectiveness of the market place can only be compensated by an increase in cost to the issuer and/or risk to the investor.

### **3. Specific Issues Raised in the Commonwealth Debt Management Review**

#### **Pricing other financial products**

*Question 1 – Whether CGS is used extensively as the primary benchmark for pricing the debt security of other issuers.*

All corporate securities are referenced off a margin to both the Commonwealth government curve and the swap curve. However the margins of the swap curve is derived simply as a mathematical calculation after starting from the margins of the Commonwealth bond and then taking into consideration the bond/swap spread. Many investors will only bid for new issuance based on a margin to Commonwealth bond as this represents the most meaningful calculation as to whether they are receiving a fair compensation for taking credit exposure. Issuers will often consider where similar rated entities' bonds are trading in the secondary market in order to determine an appropriate price for new issuants, however again these calculations originate as a margin to Commonwealth bond. As mentioned under Section 3.3 the great degree of diversity among Australian corporations means that it is simply impossible to derive a uniform corporate credit curve in Australia.

*Question 2. – Whether the interest swap curve is used widely for pricing debt securities. If not are there obstacles to using the swap curve?*

It should be noted that the interest rate swap curve is priced off a zero coupon interest rate curve which in itself utilises the commonwealth bond risk free curve to determine its key reference points. JANA is uncertain as to how the interest rate swap curve would be determined in the absence of a risk free government curve and believes that any substitute which may be used in the future would involve some degree of compromise and shortcuts, which in turn would lead to market inefficiencies. So whilst many corporate bond transactions are initially priced off the swap curve, as noted above, this is primarily a function of the margin to a commonwealth bond plus the bond swap spread.

*Question 3. – What other options are available for pricing debt securities and how effective are they.*

As mentioned under Section 3.5 the Australian financial market has evolved into a very effective risk management environment. It is highly likely under this type of environment that alternative instruments may arise to replace the government risk free curve, JANA notes that there is a great deal of uncertainty as to exactly what instruments will surface, and how effective they will be at insuring that interest rate swaps can be effectively priced. As noted above, the diversity of credits amongst the Australian corporations means that it would be impossible to foresee a corporate bond curve developing in Australia.

### 3.1

#### **Referencing other financial products.**

*Question – whether the yield on CGS is commonly used as a reference benchmark for comparing the yields on other debt instruments.*

JANA believes that this question will be adequately covered by other market participants who are focussed on this sector of the industry. However it wishes to make the following additional point.

- As outlined in Section 3 there are now entire industries that have their revenue determinations set by independent regulators. These independent regulators utilise a weighted average cost of capital determination (as determined by the capital asset pricing model) which in turn relies on the agreement on a risk free rate. Further these regulated companies require the ability to hedge this exposure as it is the biggest component of their financial exposure.

### 3.2

#### **Managing financial risk**

*Question – whether there is scope for the Treasury bond futures market to be replaced by a futures market based on alternative instruments. What could hamper an alternative futures market from developing?*

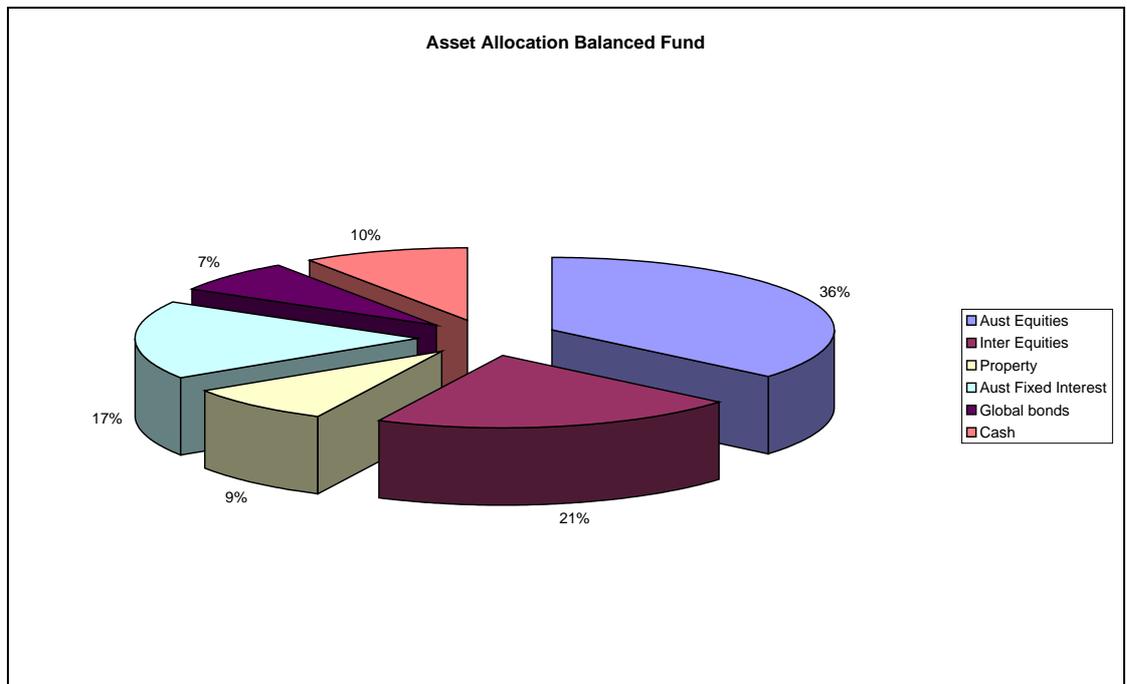
JANA is uncertain as to the effectiveness of some form of swap futures curve as this would involve a derivative instrument, which in turn was based on another derivative instrument – the pricing mechanism for this arrangement is uncertain.

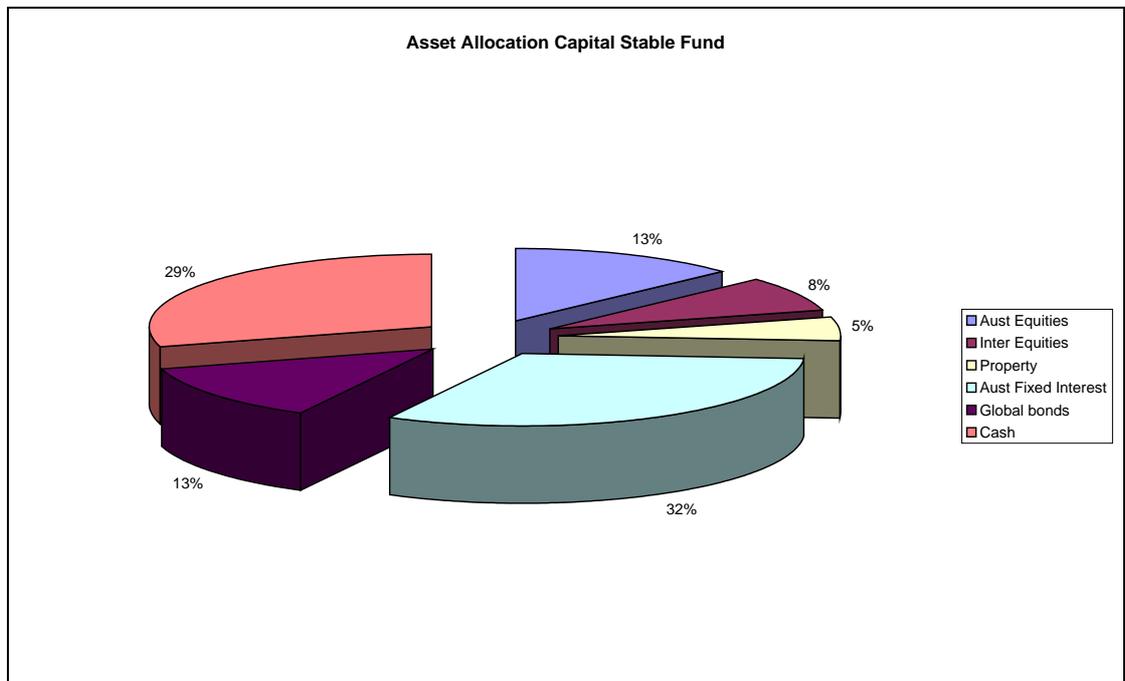
### 3.3

#### **Providing a long term investment vehicle**

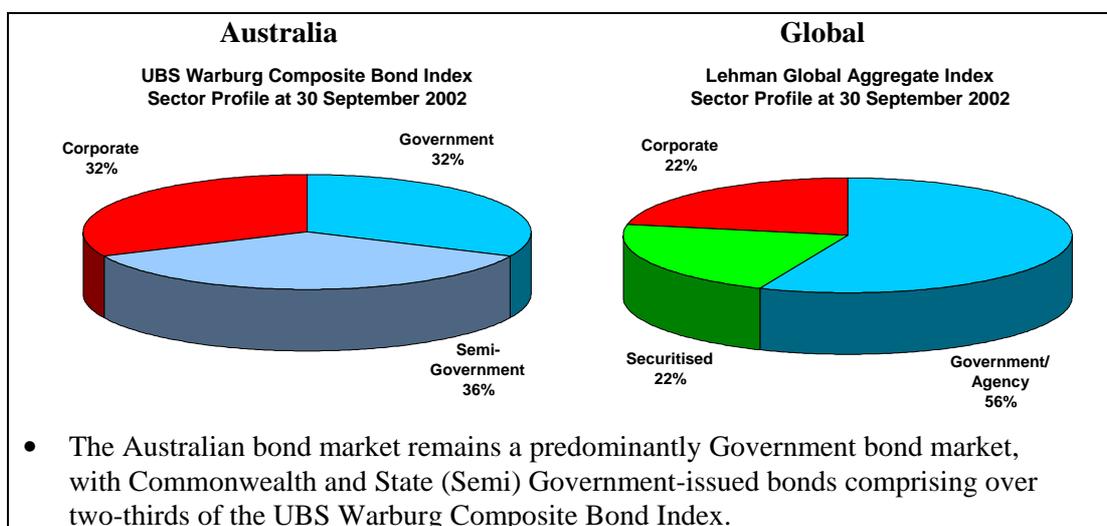
*Question – the significance of commonwealth government securities as a long term investment vehicle, particularly to the institutional investors such as superannuation funds and life officers.*

Fixed interest portfolios represent a crucial component of all superannuation fund defensive asset class. Australian fixed interest assets represent approx. 17% of the average “Balanced” Fund total portfolio of assets. In a more conservative fund, the fixed interest assets comprise approx 32% of the total portfolio (refer charts below – source – Rainmaker Analytics)





The key Australian bond market index is the UBSWA Composite bond index which has approx 32% allocation to Government bonds. JANA estimates that across all the Funds we advise, the average allocation to Commonwealth Government Securities is in the order of 7% of the entire asset portfolio. This is a significant component of their total asset allocation.



Investment managers if they are benchmarked against the UBSW composite bond index will strategically reallocate between the risky asset class (corporate bonds and the risk less asset class government bonds) based on their underlying views on sector performance. This ability is of fundamental importance to the manager when managing a large pool of investments and is a significance source of additional value added to the underlying investor (e.g. the superannuation fund).

If the government removes the ability for investment managers to allocate assets into the risk-less asset class then, by definition, the pool of remaining investments is becoming more risky and will have important implications for the risk profile faced by underlying superannuation fund members. A logical response by superannuation funds to this increase in risk, would be to reallocate funds from their Australian fixed interest portfolio to a global fixed interest portfolio.

This would involve a significant outflow of funds from Australia to the major world's capital markets and would require extensive interest rate cross currency hedging instruments in order for the fund to transfer underlying exposures back to Australian dollars. These cross currency interest rate swaps are credit intensive and therefore expensive to put into place. These

additional costs will be born by underlying superannuation fund members by way of a reduced earnings on the underlying portfolio of investments.

Superannuation funds also require fixed interest instruments with long term maturities in order to better match interest rate risk (as measured by duration) between their underlying liabilities to members and the assets in which the fund can invest. Traditionally Australian corporations have issued debt in the three to five year part of the curve, which is well below the tenure of many of their longer-term government bond issues (e.g. ten to fifteen years). The market experience in the Australian capital markets over the last ten years is that is very difficult for Australian corporations to issue long term debt (e.g. longer than five years) even if they have a reasonably high credit rating (e.g. single A). JANA is not confident that corporate Australia could step into the void created if there were no long-term government bonds on issue.

Finally, certain investors (many of which are advised by JANA) have a nil tolerance for capital loss. These funds may be endowment type funds that support ongoing medical research, religious organisations and special legal funds created to hold assets of individuals who have received court payments (eg via injury claims etc). These Funds require the utmost secure investment profile and often hold a large amount of their assets in government bonds.

### 3.4

#### **Attracting foreign capital in flow.**

*Question – whether the absence of commonwealth government securities market would affect Australia’s attractiveness to foreign investors.*

As indicated in Sections 3 and 4.4 above, JANA believe that the absence of a risk free commonwealth government bond curve would be highly likely to result in a change to mandates at superannuation fund level to move fixed interest mandates offshore. For the same reasons it is highly likely that offshore investors would avoid the Australian capital markets because of their inability to switch between the risk free and risky sectors of the fixed interest market. JANA believes that these initiatives are inconsistent with the governments stated objective of encouraging global investors to see Australia as the preferred financial centre within this time zone.<sup>3</sup>

## 4 Review Of Options Raised

JANA believes that the winding down of government bonds will have important and materially adverse impacts on the effectiveness of the overall financial markets in Australia. In particular, it will have increased risk implications for all Australian superannuation funds (assuming that those superannuation funds do not reallocate funds away from the Australian capital markets to the global capital markets – in which case this in turn has serious implications for the Australian financial markets).

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<sup>3</sup> JANA notes that Singapore, South Korea and Hong Kong have all faced a similar dilemma – and decided to maintain a liquid government bond market

However JANA does not believe that the Australian government should simply maintain a liquid government bond curve for the sake of simply issuing debt into the market place. There needs to be an underlying fundamental use for the funds so raised.

JANA believes that simply playing down existing government debt would not be in Australia's best interests due to the implications outlined in Sections 3 and 4 above. Further, JANA believes that it is highly likely that future Australian governments will be required to raise debt in the future. This would involve a significant increase in cost due to the removal of the infrastructure that supports the existing government bond issuance in Australia. JANA makes this statement based on observations world wide and in particular in the US instance where many market forecasters were indicating that the US government bond would be fully repaid during the 1990's. Certain unpredictable world events have since occurred that have resulted in the US Treasury again being a heavy issuer of government bonds and the US financial system has benefited by the quick and effective issuance of government bonds. If the existing stock of government bonds had been fully repaid, new government issuance would not have been able to be completed anywhere near as effectively.<sup>4</sup>

The government's debt management review paper also considers an option of consolidating commonwealth and state government debt and effectively dismisses this as not being politically achievable. JANA is not in a position to comment on the political implications of such a move but does wish to make the point that a compromise solution could be for the commonwealth government to credit wrap debt issuance by the states. Under this scenario the state governments would benefit from the pricing achieved by the commonwealth government debt issuance and yet still maintain its own responsibility and accountability for the state financiers. Under this scenario state government debt issuance would be seen as representing the risk free asset class.

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<sup>4</sup> Even in the Australian context, the government forecast a net surplus in 2001/02, however due to several factors a net deficit occurred.



<b>Funds We Work For</b>		
<b>Fund Name</b>	<b>Employed</b>	<b>Assets at 30/09/2002</b>
<b>Corporate Superannuation Funds</b>		<b>Millions</b>
Ancor	Mar 2002	495
Bank West	Jul 1996	165
Commonwealth Bank Officers Superannuation Fund	Nov 1995	4,929
Mayne Group Limited Superannuation Fund	Dec 1990	122
MM Superannuation Plan	Mar 1997	293
National Australia Bank Group Superannuation Fund	Sep 1997	1,749
Orica	Dec 1992	564
Southcorp	Mar 1992	130
Uniting Church Beneficiary Fund	Aug 1996	262
Wesfarmers Group	Nov 1988	271
<b>Public Sector Superannuation Funds</b>		
Government Superannuation Office (GSO)	Feb 2001	7,969
Emergency Services Super Scheme (ESSS)	Mar 2002	3,144
Launceston City Council	Mar 2002	27
PSS/CSS	Dec 2001	9,339
Retirement Benefits Fund (RBF)	Feb 1995	1,443
<b>Industry Superannuation Funds</b>		
Allied Unions Superannuation Trust (AUSTQ)	Jan 2001	60
Australian Retirement Fund (ARF)	Jun 1989	4,033
CARE	Jan 2000	1,163
Club Plus Qld	Aug 1999	86
Electricity Industry Superannuation Scheme (EISS)		185
equipsuper	Jun 1988	1,521
Finance Industry Superannuation Fund (FINSUPER)	Jun 1990	250
Host Super	Jan 2000	292
Host-Plus	Mar 2001	1,810
Quadrant Superannuation Pty Ltd	Jul 1998	153
Retail Employees Superannuation Trust (REST)	Jun 1990	4,334
<b>Charitable Trusts / Foundations</b>		
Garnett Passe & Rodney Williams Memorial Foundation	Apr 1993	29
Melbourne Grammar School	Mar 1995	74
Trinity	May 2001	22
<b>Other Funds</b>		
Anglican Diocese of Melbourne	Aug 2000	69
Insurance Commission of Western Australia	Jul 2001	1,440
Legal Practitioners Liability Fund	May 1998	106
Victorian Barfund	Aug 2000	89
Victorian Supreme Court - Funds in Court	Aug 1990	480
Victorian Automobile Chamber of Commerce	Dec 1997	95
<b>TOTAL</b>		<b>47,193</b>