Navigating the Shifting Tides: Challenges and Opportunities in Australia's Fixed Income Investment Landscape

27 November 2025

Commonwealth Private

Introduction

Long a staple for fixed income investors, term deposits (TD) and their attractiveness compared to alternative fixed income investments is less compelling, partly driven by a multi-year global easing cycle. With domestic bank hybrids now being removed from the riskier end of the fixed income investment menu, clients in search of elevated yields and returns are searching for substitute investment options that meet their yield, risk/return profile parameters and overall investment objectives.

The following report aims to address this challenge by providing key investment-grade-based fixed income alternatives, and in doing so, outline their relative strengths and weaknesses and risks, to support our Commonwealth Private clients in making informed decisions.

The relative attractiveness of deposits is fading

Previously at 5%-plus yields, TDs played a significant role in the portfolios of wholesale investors, including as an anchor, low risk holding in a "barbell" investment strategy or as a shorter-term investment, following a liquidity event. At those previous mid-single digit yields, who could argue? Certainly not us. Especially given the minimal capital risk of TDs a feature that we flesh out further shortly.

However, with the fundamental interest rate market changes that have taken place in this decade so far, the investment paradigm has markedly evolved and in turn, causing high net worth (HNW) investors to re-evaluate.

So that clients are appropriately armed, we present two broad investment-grade-based alternatives in fixed income, as well as their relative strengths and weaknesses. As detailed in the table below, these two options are: (1) actively managed, diversified fixed income funds, and (2) financial, corporate and asset-backed bonds ("credit bonds"). Note that with sub-trend domestic economic growth and historically low global credit spread levels, especially in the US and European markets, we've focused on liquid, fixed income options that are largely investment-grade (IG)-based. Fleshing out the more pertinent factors and relative risks will assist clients in determining whether to seek alternative investments as their TDs approach maturity – commencing with the most important decision point – the respective yields on offer.

Differing yield premiums

With the material decline in TD rates, the relative attractiveness of IG credit bonds and fixed income portfolios has risen. Put simply, the 5%-plus TD rates that HNW investors could previously receive, are now materially below that.

At the same time, driven by the substantial increase in base interest rates since 2020, the yield and contracted coupon income levels derived by fixed income portfolios and bonds are now appreciably higher, thereby providing much higher return potential compared to five years ago. Elevated yields also perform another key role - by providing a higher defence mechanism/buffer against adverse fixed income market conditions and negative returns. This is important for Commonwealth Private given our guiding investment philosophy that fixed income should be a defensive asset class with capital-based objectives also a focus.

The change in portfolio yields and forward-looking return potential is best illustrated by the below chart, which highlights the portfolio yields of three of the approved funds that are in Commonwealth Private's core fixed income model. From a low 1% to 2% level in early-2021, the gross running yields for these three funds as at 31 October 2025 are not far from their cyclical peaks, noting that starting yields are now a dominant factor in expected bond returns[1].

Portfolio gross running yields (%) – KARIF, PPT DIF, Realm STIF as at 31 October 2025

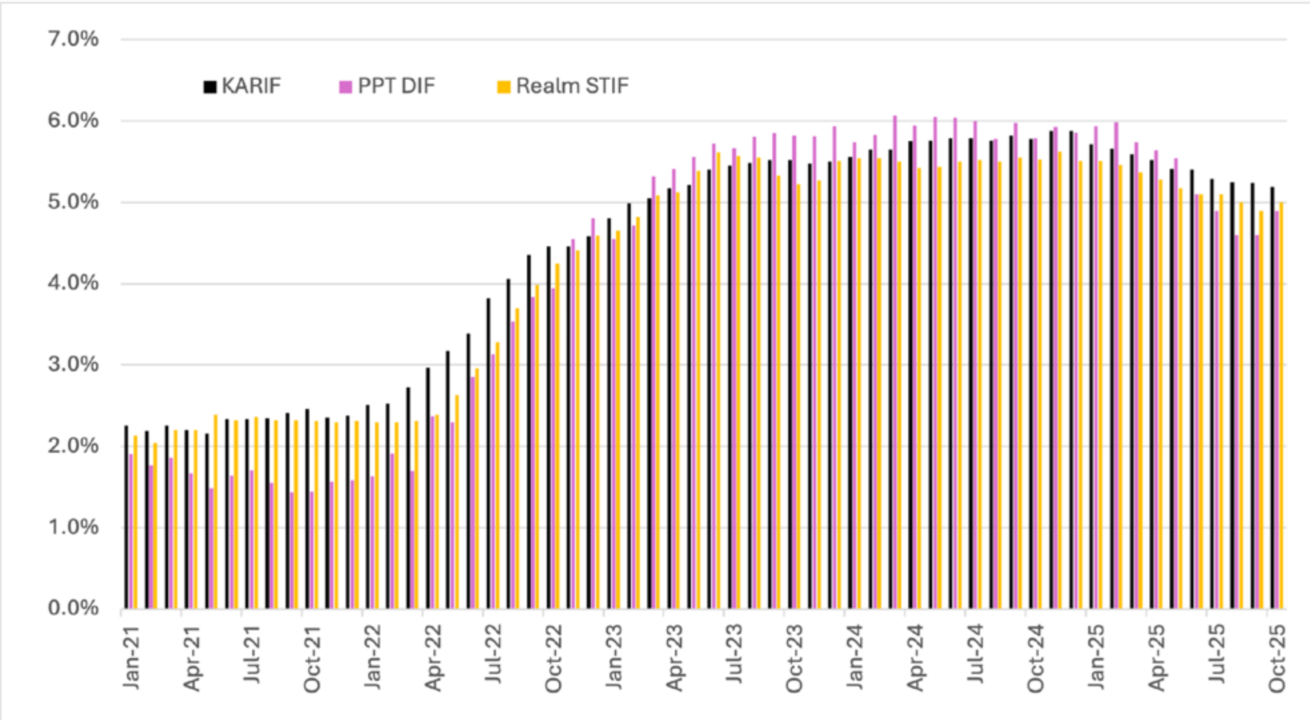

Figure 1

Source: Kapstream, Perpetual (PPT), Realm.

DIF denotes Diversified Income Fund. STIF denotes Short-Term Income Fund. KARIF denotes Kapstream Absolute Return Income Fund. Past performance is not a reliable indicator of future performance.

With Commonwealth Private's fixed income funds that are actively managed (such as those profiled in Figure 1), holding a dual focus to deliver total returns over and above their base portfolio yield and coupon levels (while also seeking to mitigate the downside on the portfolio when fixed income markets are adverse), the current total return potential of these funds is materially higher compared to contemporary TD rates – especially where capital growth is not available.

[1] Source: PIMCO: "Why Yield Matters" dated April 2024.

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Investment factors for select AUD investment-grade-based fixed income investments

Investment factor	Term deposits	Investment-grade bonds	Investment-grade-based fixed income portfolios
Representative investment	Six-month TDs	Major bank Tier 2 bond	Kapstream Absolute Return Income Fund
Yield	2.95% as at 31 October 2025*	~5.0% as at mid-November 2025**	5.2%^ as at 31 October 2025
Reinvestment risk?	Higher	Lower compared to TDs	Low compared to TDs
Interest/ distribution cashflows	At maturity	Quarterly or semi-annually	Quarterly
Flexibility and liquidity	Available at maturity. Funds locked until maturity or a typical 31-day notice period with break fees	Daily liquidity (subject to market conditions)	Daily liquidity (T + within 5 days to settlement)
Capital growth?	No	Yes - Potential for capital growth, especially since global interest rates are at cyclically higher levels, but also subject to capital decline	Yes - Potential for capital growth, especially since global interest rates are at cyclically higher levels, but also subject to capital decline
100% risk free?	Yes - for accounts up to $250k with ADIs via FCS are effectively government guaranteed. TDs >$250k are lower risk but not risk free	No, but long-term default rates are very low (please refer to the below)	No, but long-term default rates are very low (please refer to the below)

Source: Commonwealth Private, RBA, Bloomberg.

** Source: RBA: Retail deposit and investment rates; Banks' TDs ($10,000); 6 months.*
ADI denotes authorised deposit-taking institution.

*** Based on the AUD yield: calculated as the market rate for three-month BBSW plus the market credit spread as at mid-November 2025 for a major bank Tier 2 with a circa 5-year call date.*

^ Gross running yield.

Past performance is not a reliable indicator of future performance.

Credit risk status

One of the attractive features for investors in Australian TDs issued by authorised deposit-taking institutions (ADIs) is their minimal credit risk, with accounts up to a limit of $250,000 effectively backed by a Federal Government guarantee (as outlined here) under Australian Prudential Regulation Authority's (APRA) Financial Claims Scheme. Beyond this $250,000 level, the risk to investors' capital is still low but not 100% risk-free, as highlighted by Silicon Valley Bank in the US in 2023.

IG corporate, financial and asset-backed bonds carry credit risk, but their historical long-term default rates are low. According to Fitch's Global Corporate Finance Default Rate Statistics for the period from 1990 to 2024, the cumulative average default rate for global bonds rated in the single-A and BBB categories at year five was 0.40% and 1.08% respectively (Figure 2). Furthermore, depending on the subsequent restructure and/or recovery, a bond default does not necessarily result in principal loss.

Consistent with Commonwealth Private's fixed income investment philosophy regarding capital, the constituent funds that are approved in our two fixed income managed accounts (core model and yield model), invest in securities that are mainly rated IG. By way of example, the weighted average[2] IG exposure of Commonwealth Private's core and yield models was 90% and 84% respectively as at 31 August 2025. With these fixed income funds also focused on mitigating the downside and actively managing their key risks, including credit risks, combined with the long-term default rates, the credit risks for the assets within these funds are considered to be relatively modest.

Fitch Global Corporate Finance Average Cumulative Default Rates for the period 1990 to 2024					
Rating category	Year One	Year Two	Year Three	Year Four	Year Five
A	0.05%	0.14%	0.22%	0.30%	0.40%
BBB	0.12%	0.31%	0.55%	0.81%	1.08%
Investment-grade	0.08%	0.21%	0.36%	0.51%	0.67%

Figure 2

Source: Fitch.

Past performance is not a reliable indicator of future performance

Phasing out of Australian bank hybrids

While this paper chiefly seeks to address the rising challenge for TD investors, it would be remiss of us not to discuss another important issue in Australian fixed income, albeit at the riskier end of the asset class spectrum. We speak, of course, of the decision by APRA in 2024 to phase out bank hybrid (or AT1) capital. This move, which was reconfirmed in July 2025 by APRA, will see the ~$40 billion ASX-listed financial hybrid market mostly disappear by 2032 with most of that capital being re-issued by domestic banks and funnelled into Tier 2 bonds.

[2] Figures are weighted averages according to the % allocations of the underlying funds and cash in the core model and yield model as at 31 August 2025.

This paper does not dwell on the context and factors behind APRA's move but recognises that bank hybrid investors will most likely need to source alternative investment options when these instruments come up for call or before. In this vein, we note that in 2025, 2026 and 2027, circa $15 billion of ASX-listed financial AT1s are due for call (Figure 3), with the overwhelming majority issued by domestic banks. Thus, the reinvestment task is significant for ASX-listed bank hybrid investors.

Schedule of call dates for ASX-listed financial AT1s

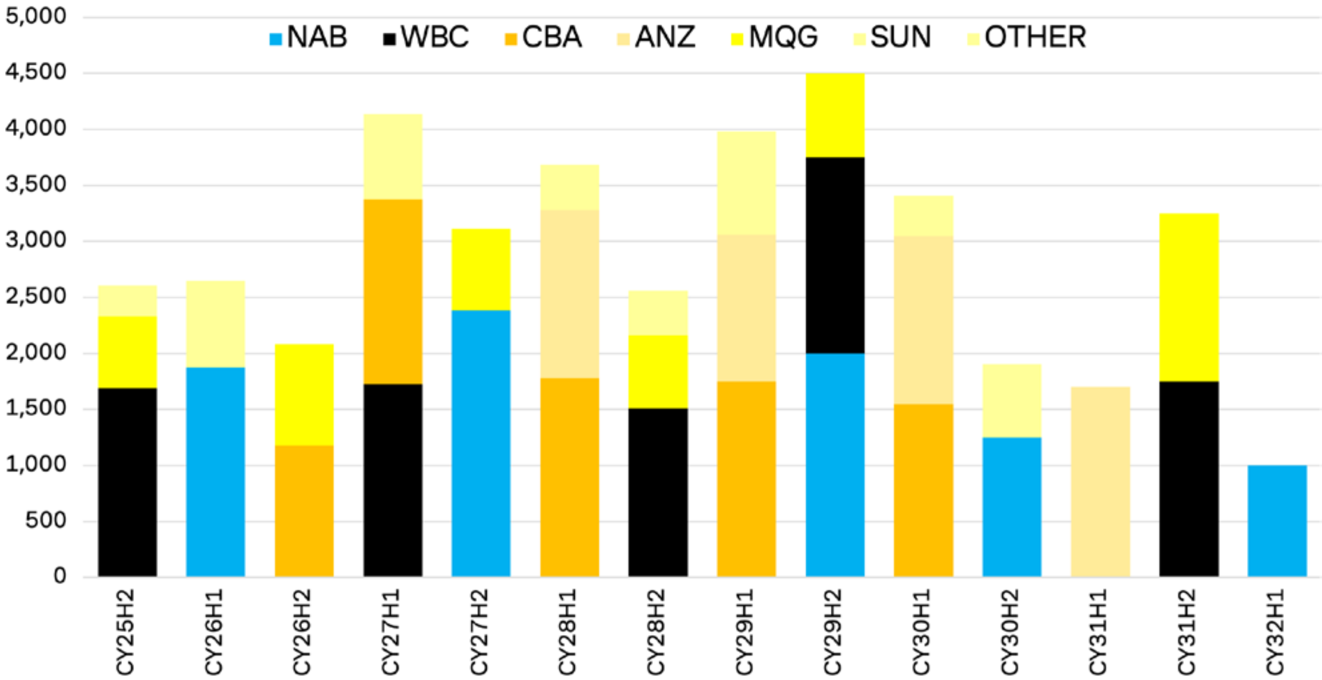

Figure 3

Source: Commonwealth Bank of Australia

Alternative investment options

Noting the above, and in particular, the elevated yields currently on offer in fixed income (driven by the markedly higher base interest rates, especially in the US and Australia), and depending on investors' individual risk/return parameters, the Commonwealth Private Investment Research Team believes there's merit in moving from short-term cash products, such as TDs, into alternative, liquid, fixed income investments that provide moderately higher yield potential and are mainly IG-based.

With reference to the investment continuum chart below (Figure 4) which plots the medium-term return target or yield, against the volatility for select investments across Australian fixed income and equities, we present key options for consideration for investors.

[3] As at 31 August 2025, the weighted average exposure of the Core Model to investment-grade assets was 90%.

Investment continuum for select AUD fixed income and equity investments

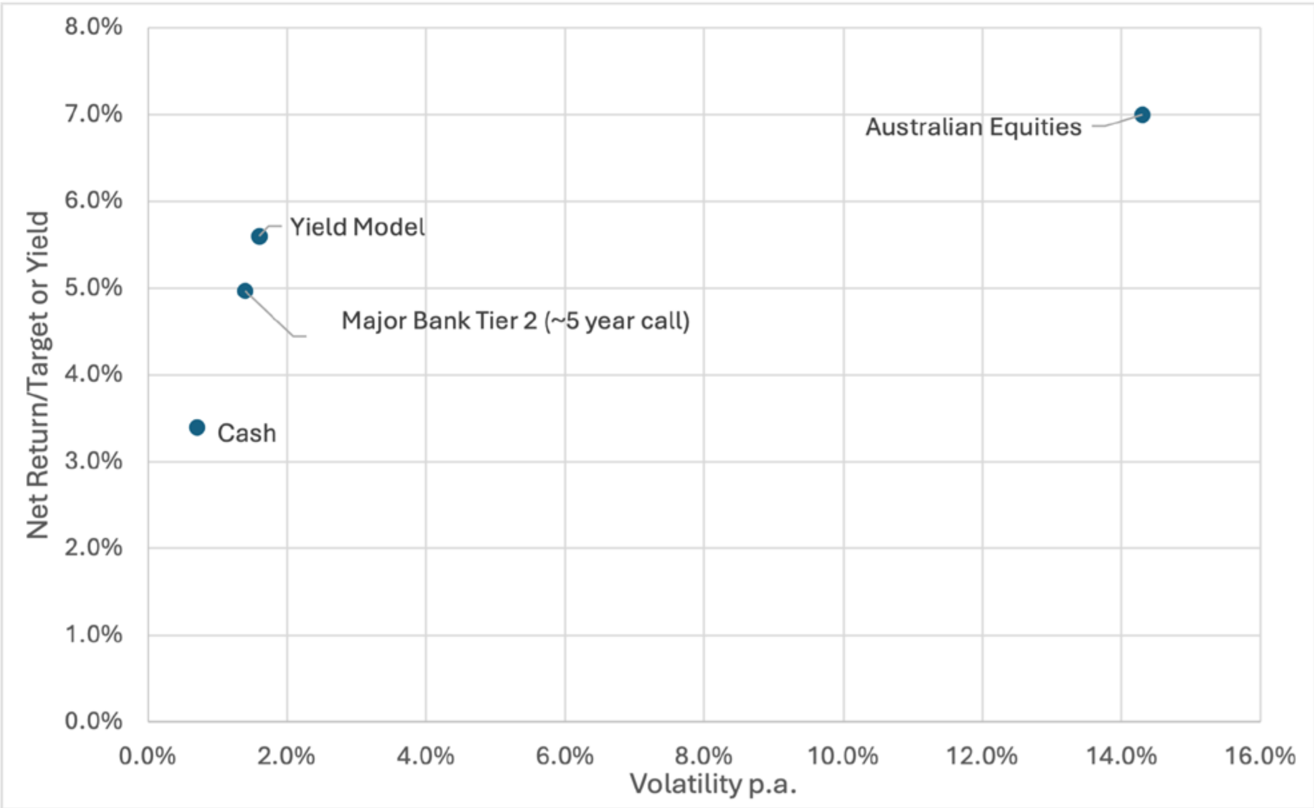

Figure 4

Source: Bloomberg, JPM, CBA, Commonwealth Private, Various managers.

The above return/yield and volatility data for the Cash, Major Bank Tier 2, Yield Model and Australian Equities investments listed above have been calculated as follows. Cash: the return and volatility data for the Cash investment has been calculated using JPM's long-term capital market assumptions, or LTCMAs (as noted below). Yield Model: The net return target for the Yield Model is calculated using the addition of JPM's LTCMA for Cash of 3.4% and the 2.2% net excess return target (as outlined below). The volatility data for the Yield Model has been calculated as the weighted average of the % volatility for the last 5 years to 31 August 2025 as obtained for each of the constituent funds in the Yield Model. Major Bank Tier 2: The yield for the Major Bank Tier 2 investment has been calculated using the AUD yield (calculated as the market rate for three-month BBSW plus the market credit spread as at mid-November 2025). The volatility data for the Major Bank Tier 2 investment has been calculated using the average of the daily implied 90 days annualised market volatility in bond price terms over the last 10 years as at July 2025. The LTCMAs from JPM are not designed to inform short-term tactical allocation decisions. JPM's assumptions are carefully built and calibrated to aid investors with strategic asset allocation or policy level decisions over a 10-year investment horizon.

Past performance is not a reliable indicator of future performance.

Actively managed, diversified fixed income portfolios

Commonwealth Private continues to advocate for diversified fixed income managers/funds that actively manage their interest rate and credit exposures, especially in this environment of structurally higher bond market volatility and historically low global credit spreads. These active managers have key defence tools that can be utilised to help mitigate the portfolio and return impact of any future adverse interest rate and/or credit market conditions.

[4] The Fund either has an absolute return approach or also has a specific focus on capital and/or drawdowns, in addition to a medium-term return target.

In this regard, Commonwealth Private has made available a core fixed income model comprising six constituent funds. Seeking to deliver a return above the model's benchmark, this predominantly IG portfolio, exhibits a portfolio yield that is moderately above current Australian cash rates. This managed account has a 70% weighting to funds that take an absolute return approach to fixed income investing (or similar) and thus also retain a key focus on capital-based objectives, in addition to seeking to deliver a return target over the medium-term.

To complement the existing core fixed income managed account, and thus, further along the fixed income risk/return continuum, and to address the dual challenges of lower TD rates and the phased removal of domestic bank hybrids, in July 2025, Commonwealth Private made available to clients, a yield model. Specifically, this largely IG[5] funds of funds portfolio will seek to deliver, over the medium-term, a return target (net of fund management fees) of RBA Cash + 2.7% or + 2.2% (net of fund management fees and investment management fees), while maintaining a focus on capital stability and/or drawdowns. Taking account of the risks for this yield model managed account (as noted below)[6], and depending on their risk tolerance and return objectives, investors may find this yield model of interest. This includes bank hybrid holders noting that the medium-term net return target for the yield model (as outlined in the table below) is on a par with the current yields to call[7] for mid-curve ASX-listed major bank hybrids.

The risks in this yield model include: (1) interest rate risk (which is the risk of increasing interest rates given the capital value of a bond tends to fall when interest rates rise), (2) credit spread risk (which is the risk of increasing credit spreads given the capital value of a bond tends to fall when credit spreads increase) noting that global credit spreads are at historically low levels, especially in the USD and EUR credit markets, and (3) credit risk (which is the risk that the issuer cannot make its interest and/or capital repayments).

Key portfolio metrics: yield model as at 31 August 2025

Investment Objective	Outperform RBA Cash + 2.7% (after fund management fees), or 2.2% (after fund management fees and investment management fees) **over rolling 3-year periods**
Gross Running Yield	5.8%
Distribution % pa (30 June 2024 fiscal year / 30 June 2025 fiscal year)	5.5% / 6.2%
Interest rate duration	1.0 year
Credit spread duration	2.8 years
Average maturity	3.3 years
Total investment-grade exposure	84%
Volatility (last 5-years)	1.6%

Source: Commonwealth Private, Various managers.

Figures/data above (except for the investment objective) are weighted averages according to the % allocations of the underlying constituent funds and cash in the yield model. Data as at 31 August 2025. Past performance is not a reliable indicator of future performance.

[5] As at 31 August 2025, the weighted average exposure of the Yield Model to investment-grade assets was 84%.
[6] Please refer to all the associated investment documents for an overview of the key risks relevant to this investment.
[7] Excluding the impact of franking credits for major bank hybrid holders. Data as at mid-November 2025.

Wholesale credit bonds

Driven by cyclically higher yields, considering the risks, Commonwealth Private views IG credit bonds as currently providing a healthy yield premium and return potential over TDs, given their contracted, regular income and long-term default rates (as discussed above).

Within the wholesale credit bond market sphere, Commonwealth Private views the opportunity and return potential in Tier 2 debt, including those medium-dated subordinated bonds issued by the well-capitalised domestic major banks, as constructive on a risk-adjusted basis. This partly reflects the 'A' band credit ratings for major bank Tier 2 bonds which are currently rated A-/A3 by S&P and Moody's.

This is in the context of the significant growth in AUD Tier 2 issuance and the size of the domestic subordinated debt market generally in recent years.

As subordinated debt instruments (Figure 5), these risks include the higher credit spread sensitivity of financial Tier 2 bonds compared to their senior counterparts (and as such, in periods of risk aversion, credit spreads for financial Tier 2 bonds would usually increase more compared to that for financial senior bonds), and call (or extension) risk – this is the risk that the financial issuer doesn't redeem and repay its Tier 2 bond at the issuer's optional early call date.

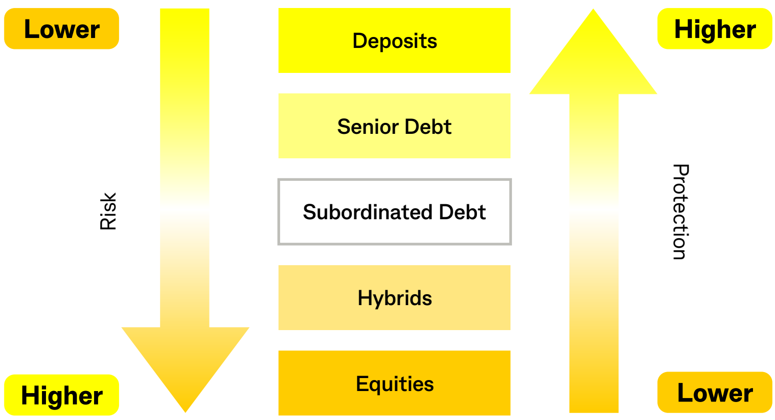

Figure 5

Source: VanEck

Other options

Other notable options that are available include Exchange-traded Funds (ETFs) and listed investment trusts (LITs) that are more liquid and IG-based. Further up the risk scale, are corporate hybrids, LITs and listed notes. Designed to fill the vacuum from the receding ASX-listed hybrid market, these latter two listed structures can provide a similar return profile to major bank AT1s by investing in a portfolio of largely private credit assets that are not liquid. Noting that the above alternatives are all yield-based options, Commonwealth Private also offers diversified model portfolios that provide income streams to clients.

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Conclusion

While TDs are likely to have a continued key role to play for HNW investors, depending on their investment strategy, timeframe and risk/return parameters, it is clear the long-held investment paradigm of fixed income investors holding significant allocations to TDs (and now, domestic bank hybrids) has evolved. Overall, Commonwealth Private believes there are more active and higher yielding approaches which investors can take, which balances the triumvirate of capital appreciation, capital stability, and liquidity.

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