Damien Wood, Principal

Spectrum Insights

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Deposits – time for a re-think?

Australians have long liked bank deposits. Those in this $2 trillion market got a simple and safe investment. Today, though, it's a new world. Soon-to-be enforced bank regulations will mean you cannot break a bank term deposit at will. You will need to give 31 days notice. Even then, you may forgo interest. The regulations may also favour rates given to individuals and small businesses. All others, including Self Managed Superannuation Funds (SMSFs), may be worse off. For investors who want a degree of safety and access to funds, an A$ corporate bond fund now may make more sense. True, it's a little riskier. But you typically get better returns than deposits and ready access to your funds. In this yield starved world, this has the potential to make a big difference.

What's changed -1 - NSFR

Soon after the Global Financial Crisis (GFC) of 2008-9, the Basel Committee released a new set of guideline regulations for banks around the world. These rules, for the first time, included bank liquidity measures.

Specifically, the Net Stable Funding Ratio or NSFR encourages banks to keep a minimum level of stable funding. This is to help ensure that the banks can withstand a sudden outflow of funds. Australian banks will need to comply with the NSFR by 1 January 2018.

The rules encourage banks to take deposits from retail and small businesses as well as longer dated deposits. This should benefit those individual direct investors who want to deposit their money for a reasonably long period, and consequently, receive relatively higher interest rates for their deposits.

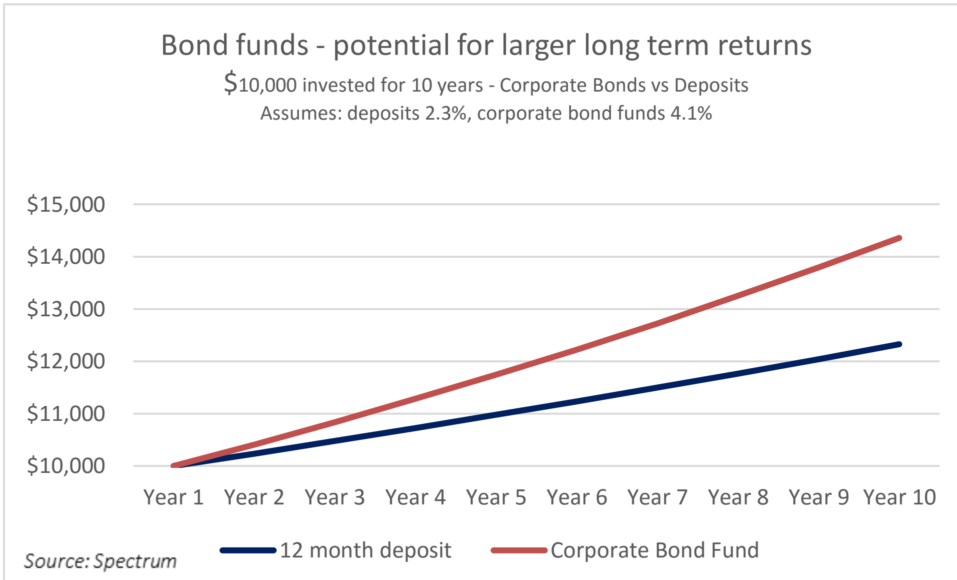
For everyone else, including SMSFs and larger businesses, it is net bad news for two reasons.

- First, their investments become relatively less attractive to banks. Hence, this could lower the interest rates received.
- Second, these deposits are now illiquid. Previously, you could call a bank, request the break and the bank would typically do so on the spot with full interest accrued. Now you need to give the bank 31 days notice and your interest earned to that date may evaporate.

What's changed -2- collapsing yields

In recent years, yields have fallen for deposits, bonds, equities and just about every asset class in Australia. In a higher yielding environment, a one or two per cent difference in returns did not make much difference to the relative long term returns. Nowadays, it makes a huge impact.

To demonstrate how a sustained small difference can now make a large impact in returns, see the graph below. Here we show the accumulated total returns of two types of investments - a 12 month deposit of 2.3% compared to the running yield of a corporate bond fund such as Spectrum's at 4.1%. To help illustrate the point, both are presumed to keep the same yields over the period.

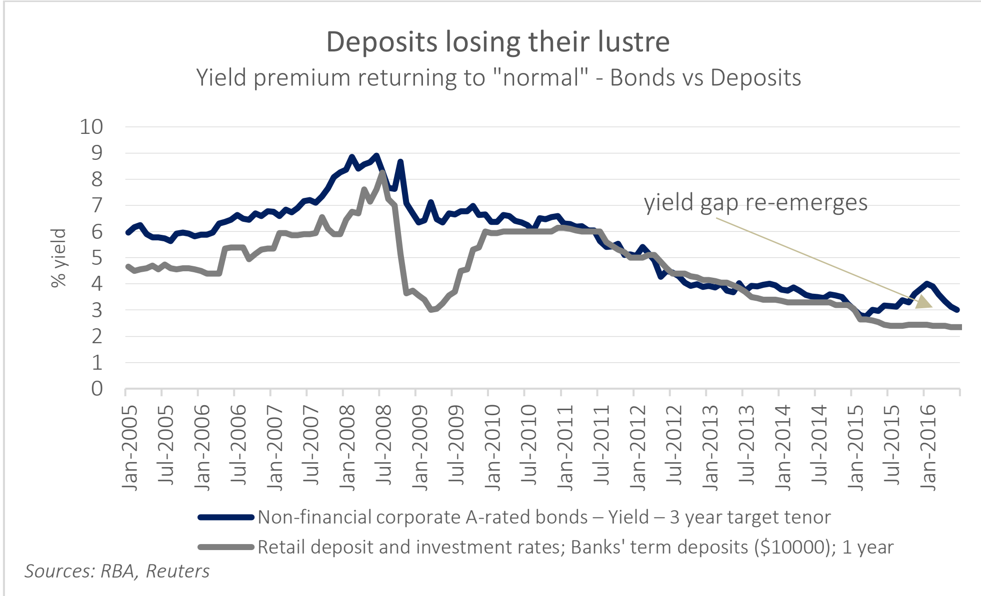


What we see here is that $10,000 invested in the bond would theorectically generate around $4,400 in income over 10 years whereas the deposits would generate around $2,300. That's nearing double the returns from the bond fund over the decade!

Bonds vs Deposits – back to normal

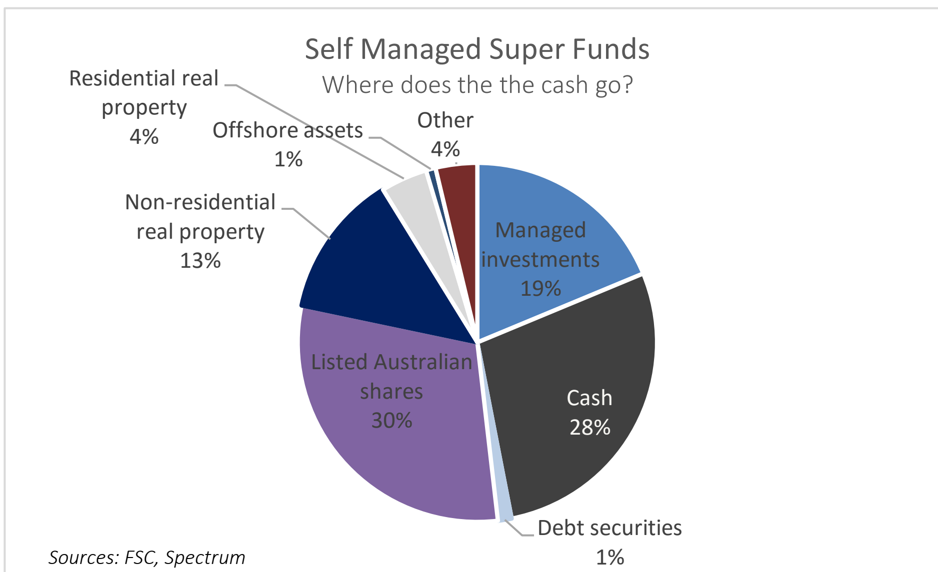
Post the GFC, Australian banks were told by regulators and rating agencies that they relied too much on international bond investors. Their balance sheets needed more local deposits. The banks responded by paying up on deposits to bring their yields near those of a 3 year "A" rated corporate bond.

As the graph below shows, there now is a more normal yield premium for corporate bonds over deposits. This reversal to "normal" helps investors, in general, get better returns from an A$ corporate bond fund when compared to bank deposits.



SMSFs – languishing in deposits

The growing $600b Self Managed Super Fund (SMSF) Industry has a around $160b in bank deposits. Hardly any SMSF invests in bonds. Many appear to use deposits as a proxy for bonds. This made sense in the past. Now it does not, particularly because SMSFs may now secure worse deposit rates than what an individual would earn.



Liquidity or return – there is a third way

For many bank depositors, it now looks like you can either have yield or liquidity but not both. For corporate bonds funds, you typically get the risk that one or more companies whose bonds they hold get into financial strife. But you also get higher returns and maintain the ability to sell at short notice*, **. In this world of vanishing yields, just a percent or two more in return can make a large impact on the performance of your portfolio. The investing environment has changed. It may be time for many to reconsider corporate bonds instead of just leaving excess cash in deposits.

* Most corporate bond funds can be sold with a days notice and funds generally arrive in 2-3 working days' time.

** We prefer an A$ corporate bond fund with a high degree of floating rate notes. This is typically more stable in price than a bond fund with a high proportion of fixed rate coupons. In addition, its helps shelter the investor from rising government bond yields.

NSFR Basics

Australian banks required to have a minimum 100% ratio by 1 Jan 2018 and to maintain this ratio thereafter. The major banks are a little vague on their current positions but comment they are just below or just above the required level.

This is not to say there will not be nuanced competition for deposits. The new regulations mean that not all deposits are equal in satisfting regulations. This means there is highly likely to be differential deposits pricing depending on who and for how long the deposits will be.

NSFR will only be applied to larger, more complex banks or Authorised deposit-taking institutions (ADIs). Smaller ADIs with balance sheets that comprise predominantly mortgage lending portfolios funded by retail deposits are likely to have stable funding in excess of that required by the NSFR. This means that regulators see limited value in applying NSFR standards to these entities.

The NSFR is defined as the ratio of:-

- the amount of available stable funding (ASF) to
- the amount of required stable funding (RSF).

The ASF is weighted from 0% to 100% to reflect the stability of likely stability of the funding. Retail and small business deposits are considered to be more stable than other sources.

For more information please go to:-
http://www.apra.gov.au/adi/PrudentialFramework/Documents/160329%20DP%20Liquidity%20NSFR%20FINAL%20CLEAN.pdf

Spectrum Asset Management manages the Spectrum Strategic Income Fund. This fund invests in A$ corporate securities of which the majority are floating rate notes. The intention is to make this portfolio relatively immune from the bond yield volatility which can, in turn, hit equity and fixed income markets. The fund is also designed to deliver an income stream while generating capital gains from time to time. For more information and how to invest please go to our website http://spectruminvest.com.au or contact your mFund broker http://www.asx.com.au/mfund/foundation-members.htm#tabs-218. Spectrum and the author have investments in either securities mentioned in this report or comparable securities

Dwood@spectruminvest.com.au – (02) 92992288