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02.06.2011

Cash vs bonds vs shares - can you beat 7% pa in 2011?

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What a difference a few months can make to capital markets: As recently as January, economists and analysts alike were expecting two, possibly three hikes to the Reserve Bank of Australia's (RBA) current interest rate of 4.75 per cent later this year. Fast forward to early May and there was no one holding their breath for a rate increase any time soon.

A few brave souls have even speculated that the RBA could be in rate-cutting mode by mid-year, especially if sluggish economic data outside the mining sector continues. But the consensus view is for the RBA to resume rate hikes – albeit later than expected – with the next increase due around August.

Victor Rodriguez head of Aberdeen's Australian Asset Management Fixed Income team expects another two RBA rates hikes to take the official rate to 5.25 per cent by year's end. So if he's right, where does that leave cash/fixed interest as an asset class, compared with bonds and equities?

With the market pricing in another two rate hikes, Rodriguez expects cash to marginally outperform bonds by around 1 per cent. But he reminds investors that while cash won't rally if share markets fall, bonds will.

Given the strongish outlook for corporate earnings, coupled with an increase in dividend growth by an average 6.4 per cent over the last six months, shares are looking increasingly more favourable against cash. The average term deposit currently yields 6.1 per cent while the 90 day bill rate is 4.9 per cent.

By comparison, the average dividend yield across the ASX is currently 5.8 per cent grossed up for franking credits – with the index yielding 7.3 per cent grossed up for franking credits. Adding to the attractiveness of shares is the prospect of an additional premium from capital growth, although as all investors know all too well, this works both ways – both up, and down.

The only drivers of an unlikely kicker for bonds, says Steven Wright director of fixed-interest with RBS Morgans would be either a changing inflationary outlook or the direct impacts of global shocks on domestic growth. "Given that the RBA has proactively kept underlying inflation within its mandated 3 per cent range, any short-term kicker for bonds looks unlikely," says Wright.

While bonds currently appear 'out of the money', Wright also expects 2011 to be a relatively bearish, yet stable year for interest rates. He expects the current 1 per cent margin of cash over bonds to contract to

around 75 basis points (BPS) as banks fail to fully reflect two 25 bps rate adjustments in term deposit rates.

Wright says this partly reflects the fact that banks aren't as desperate for retail term deposits as they were last year. He says it also reflects their limited success in 2010 locking in longer-term funding from the retail sector. While interest rates will remain attractive, he doubts they'll again nudge the 8 per cent level offered on some five year term deposits last year.

"So there's an argument for investors locking in some of their money on longer term deposit – over one to three years – with rates of 6.5 per cent or better," advises Wright. "And if you can get a floating rate of mid to high 6 per cent, even better – this doesn't look bad when underlying inflation is at 3 per cent."

Wright expects to see more companies follow the lead of Tabcorp, CBA, Bendigo Bank - and Primary Health Care which offered an 11 per cent yield - that recently entered the retail listed bond market. Market whispers suggest one major is about to launch a new retail listed bond.

Last November CBA raised \$570 million through a five-year bond - with a margin of 100 to 115 basis points over 90-day bank bill swap – with a coupon of 6.85 per cent. Bendigo Bank also raised \$90 million through a three year bond paying a coupon of 6.8 per cent.

Rodriguez also expects to see the re-emergence of residential mortgage backed securities (RMBS) which typically form part of a bank's funding base. Included among the myriad 'Prime' RMBS deals - with subordinated issues offering an effective return of around 9 per cent - is the \$1 billion RMBS deal recently issued by Members Equity Bank. He urges investors to keep a close eye on greater liquidity of RMBS deals returning to the market, possibly later this year.

"Representing 'pockets of value', RMBS are structured such that investors are protected from falling house prices," says Rodriguez.

Admittedly, shares are expected to outperform cash by up to 6 per cent this year. Nevertheless, investors still love banks - so much so that \$153 billion dollars of their cash remains in low or no-interest transaction accounts. They also prefer the name recognition associated with major banks, especially the local 'big-four'.

With fixed interest investments being easy to understand, offering relatively attractive rates - while offering a risk-free haven from the volatility of shares - Rodriguez doesn't expect investor appetite for term deposits to fade any time soon. Adding to investor comfort with term deposits is the government's undertaking to guarantee up to \$1 million per 'authorised deposit-taking institution' (ADI). While this guarantee may be reduced subject to a review in October, Andrew Murray director with Curve Securities says it's unlikely to disappear altogether.

However, given investor appetite for name recognition, he says it could trigger potential outflow from unrated organisations into banks. As a result, he says unrated credit unions and similar may have to offer higher yields to continue attracting investors. "There's a wide range of compelling options for investors to choose from, and nothing comes close to term deposits for risk/reward" says Murray. "It's time for investors to capitalise on the ongoing battle for domestic deposits, and lock in good returns."

BankWest has a 5-year rate of 7.10 per cent and RaboDirect offers a rate of 7.05 per cent, with the bank also offering a one-year term deposit paying 6.5 per cent. Even though Rabobank is a AAA credit-rated bank, Murray suspects they're having to offer higher rates in order to attract investors unfamiliar with the brand.

Other organisations offering attractive rates on five years include: Bank of Cyprus and SGE Credit Union with 7.30 per cent and 7.10 per cent respectively, while the best rates on three years are Bank of Cyprus's 6.80 per cent, and RaboDirect's and Victoria Teachers Credit Union's 6.75 per cent.

"Investors can find good specials in the one to two year part of the curve, where a rate of 6.6 per cent still offers 135 bps over the cash rate," says Murray.

He reminds investors that while the majors don't always have the best headline rates, they will 'pay up' when push comes to shove, particularly if you've got a bit to invest. "So shop around at the branch level for the best deal, especially on larger amounts," advises Murray. "Some banks will pay more for \$500,000 to \$1 million than say \$5 million on the pretext that 'institutional money' is less sticky than the retail variety."

By comparison, government bonds are only being viewed as offering protection against another GFC style downturn. Inflation linked bonds, like those offered by Rabobank or CBA - that are paying around 4 per cent over inflation - take their current returns close to 7 per cent.

Then there's long dated senior bank paper that's paying more attractive returns, with Barclays having released a four year senior note paying around 7 per cent, while Morgan Stanley has a 2017 floating rate note (FRN) yielding over 8 percent.

By extending the maturity, solid returns can also be found in the corporate and infrastructure space with a 2020 fixed rate bond issued by Stockland, and the long dated Southbank TAFE public-private-partnership (PPP) bond both yielding between 8 and 9 per cent.

Meantime, further along the risk curve, returns approaching 9 to 10 per cent can be achieved from some solid banking and insurance company debt securities. As a case in point, Swiss Re the world's second largest reinsurer has a Tier 1 security - with expected maturity at first call in May 2017 - with a yield just over 10 per cent. Local tier 1 securities from NAB Capital Securities or dated subordinated debt for Suncorp-Metway Insurance/Vero Insurance are expected to offer returns of 8 per cent-plus.

Relative to the underlying risk, Wright says a yield of 8 per cent for ASX-listed hybrids offered by major banks is also worth a look. "The risk of major banks not being able to pay these returns is low, so a 250 bps margin over the swap, makes hybrids look attractive compared with cash," says Wright.

Colin Campbell client adviser with Wilson HTM urges investors to do their homework to ensure term deposits aren't rolled over at lower rates once they've matured. He says investors who rely on financial institutions to advise them on options, may risk their funds being rolled-over by default into significantly lower-yielding investment. "Remember, that if the rate you're being offered isn't competitive, there's likely to be a more attractive one on offer for a different term.

and if not - check out the opposition.”

Fixed term Deposits – snap shot of 1 year fixed rates

	Teachers Credit Union Long Term Deposit (\$20000 to \$49999)	8.6	6.65%	Monthly, Yearly, Maturity	reduced interest - 2.00%
	Beirut Hellenic Bank Long Term Deposit (\$25000 to \$49999)	8.0	6.60%	maturity	Not allowed
	ING DIRECT Long Term Deposit (\$10000 to \$5000000)	9.1	6.50%	yearly	Not allowed. Must withdraw full deposit; reduced interest.
	RaboDirect Term Deposit (\$1000 to \$1000000)	9.0	6.50%	monthly, quarterly, yearly, maturity	Not allowed. Must withdraw full deposit; fee and reduced interest.
	ME Bank Super Members Term Deposit (\$1000 to \$499999)	8.2	6.50%	yearly	Not allowed. Must take full deposit; reduced interest.
	Citibank Citibank Long Term Deposit Special (\$25000 to \$1000000)	4.3	6.50%	yearly, maturity	Fee & reduced interest
	Defcredit Premium Term Deposit (\$5000 to \$1000000)		6.50%	maturity	Reduced Interest
	Bank of Cyprus Australia Long Term (\$25000 to \$49999)	10.0	6.45%	monthly, quarterly, annually, maturity	\$20 and reduced interest
	Investec Term Deposit (above \$25000)		6.44%	Maturity	Fee and reduced interest
	BCU Long Term Deposit (\$20000 to \$49999)	8.5	6.40%	Monthly, Quarterly, Six Monthly, Annually	Reduced interest
	Victoria Teachers Credit Union Long Term Deposit (\$20000 to \$49999)	7.5	6.40%	yearly	reduced interest
	ADCU Australian Defence Credit Union Investment Plus Special (above \$1000)		6.40%		reduced interest
	wide bay Long Term (\$20000 to \$49999)	9.5	6.35%	half yearly, yearly, maturity	reduced interest
	Heritage Building Society Long Term Deposit (\$20000 to \$99999)	9.1	6.35%	yearly	reduced interest
	Police Credit Union NSW ACT Term Deposit (above \$10000)	8.0	6.30%	monthly, half- yearly, annually, maturity	reduced interest

Source: Mozo

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