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Spectrum Insights

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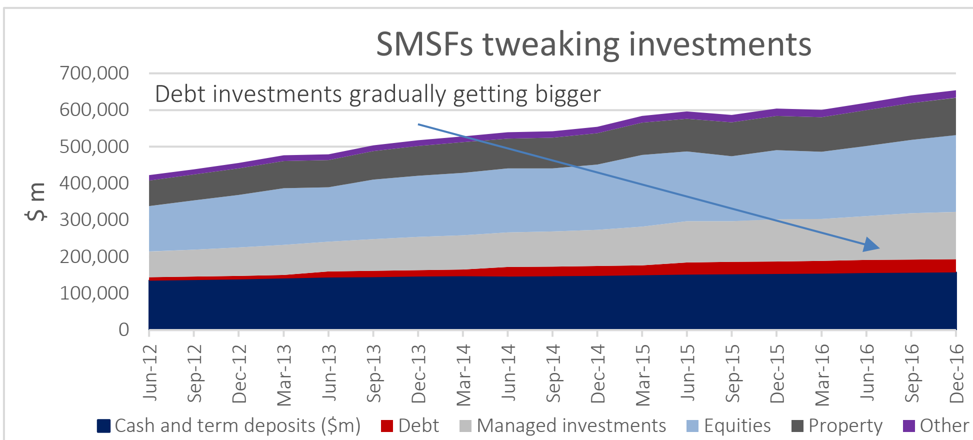
Why Australians are warming to corporate bonds

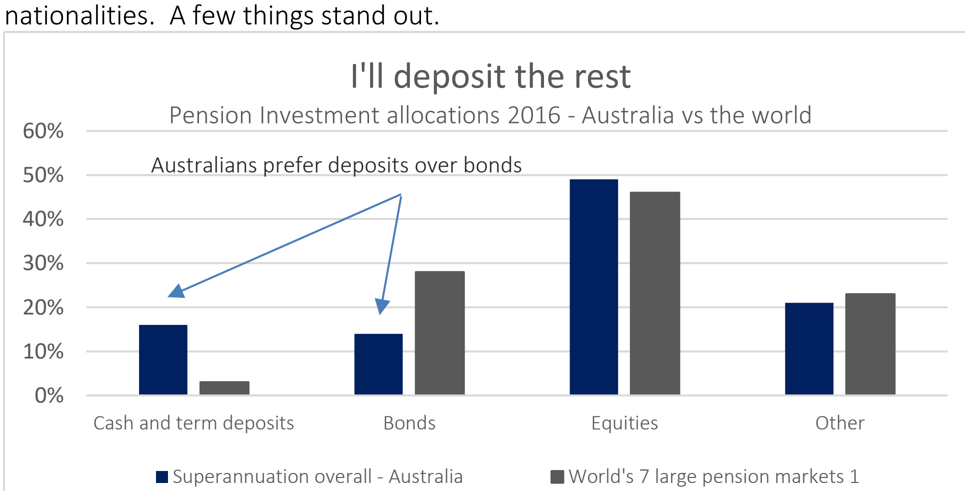
Australian super funds' "underinvestment" in bonds is declining. Despite this trend, Australian retirement funds continue to invest far more in deposits and less in bonds than their counterparts abroad. However, the reasons behind the Australian preference for deposits have evaporated. New regulations mean depositors give up ready access to funds if they want returns near the inflation rate. Even term deposit yields are now lower than a typical corporate bond or corporate bond fund. In the past, investors were rational in preferring deposits over corporate bonds. Now it makes sense for a more balanced allocation between the two types of investments.



Source: ATO, Spectrum N.B debt primarily debt securities i.e. bonds

The Australian way

The graph below shows how Australians invest for retirement when compared to other nationalities. A few things stand out.



Sources: Willis Towers Watson 1. U.S, Japan, UK, Canada, Australia, Netherlands, Switzerland

First, Australians invest more in equities, in particular, local equities. This makes sense from a tax perspective. The dividend imputation system in Australia is rarely found abroad. This makes dividends more attractive to Australian tax residents when compared to most other countries.

Second, at face, Australians appear to have a strong preference for deposits over bonds. We have observed that they use deposits as part of their overall fixed income or bond allocation. Both are debt investments. When one adds deposits to bonds, the combined total allocation in Australia is around the same as other parts of the world.

From an historical perspective, this large allocation to deposits made sense. Post the 2008-9 Global Financial Crisis (GFC), term deposit interest rates were comparable to corporate bond yields. Add to this - the safety of a government guarantee for most deposits[1] plus ready access to funds - and the easy decision was to leave your money with your bank.

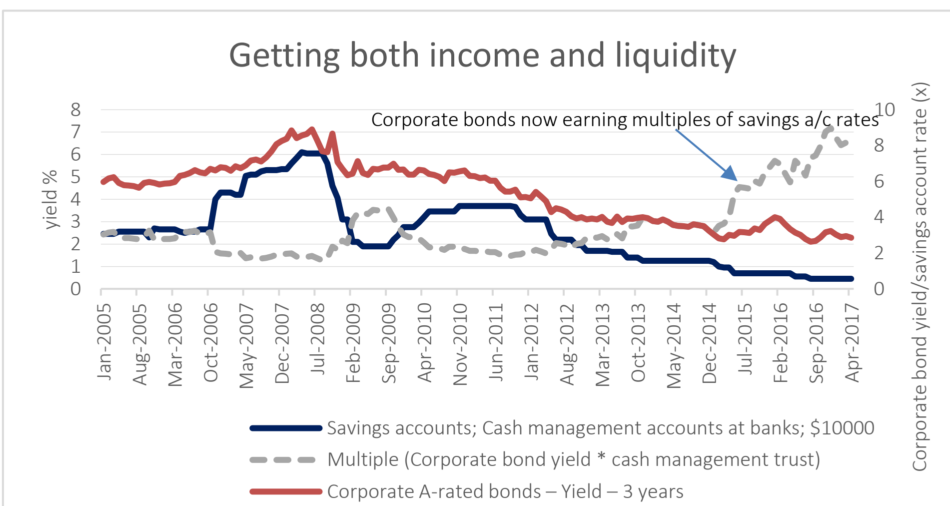
The changing landscape for deposits

The need for banks to pay up has fallen: Post GFC, the banks were willing to pay up for deposits to shore up the perceived stability of their funding bases. Regulator and rating agencies warned Australian banks that the high dependency on offshore bond investors made them vulnerable to shifting investor sentiment. Now that the banks have exceeded regulatory liquidity benchmarks, the pressure for them to raise more deposits has eased. Hence, the relative pricing of deposits has fallen.

New rules: The new regulations also tightened how banks treated term depositors. Previously, one could make a term deposit, enjoy the benefits of higher rates than savings deposits and break the deposit before maturity without penalty. Now, the depositor needs to give the bank 31 days' notice to break a deposit. And then the bank is discouraged from paying the interest earned until the break date. Nowadays, the premium for terming out a deposit comes with real risks.

Getting yield and not giving up liquidity

If an investor wants to be able to access funds at will and earn a reasonable return, a corporate bond fund or corporate bonds may be the answer.

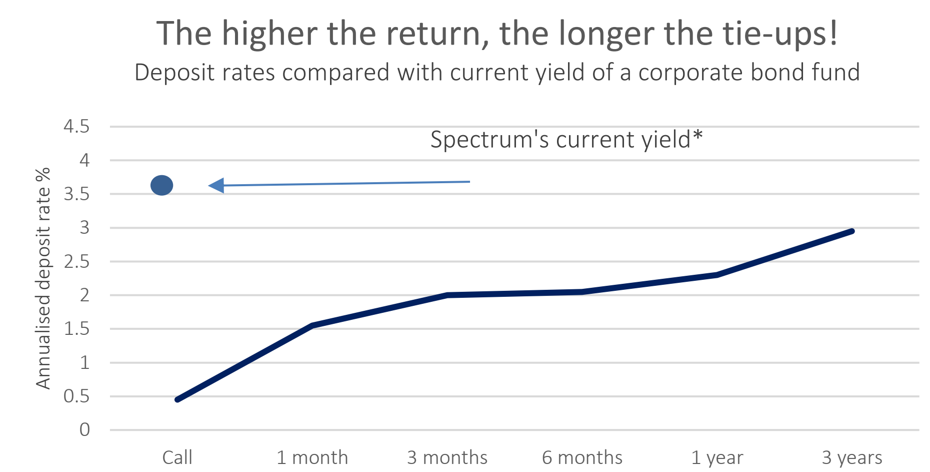


Sources: RBA, Spectrum

Savings accounts give you access to money at call. But now the interest rates offered on them are nearing zero percent. Corporate bonds can earn multiples of this. Sure, they are typically riskier than deposits, but the relative compensation may be sufficient for many investors.

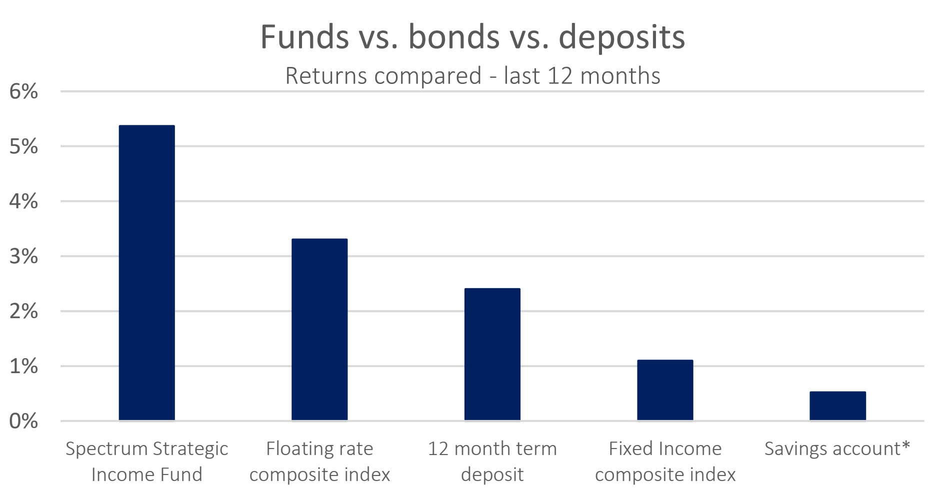
Like savings accounts or cash management trusts, corporate bond funds can provide readily available access to funds[2]. To get deposit returns near typical corporate bond yields, an investor needs to give up liquidity and tie up the funds for a longer period.

Given this changing landscape, it is little wonder why Australian pension investors are gradually allocating less to deposits and more into debt investments such as corporate bond funds.



* yield to call/maturity of the Spectrum Strategic Income fund which invests in corporate debt and income securities. This yield is likely to change and the total annual returns of the fund will likely to be different. For example the Spectrum Strategic Income Fund has returned 5.37% over the past 12 months and started a yield to maturity of 4.48% a year ago. This figure is before management fees.

Sources: RBA, Spectrum



Sources: Reuters, RBA, Spectrum

* savings account calculation presumes it is rolled over on a monthly basis

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1. The Australian government guarantees deposits up to $250,000. This effectively equates the risk to that of the Australian government. Currently, the government enjoys AAA ratings from the 3 major credit rating agencies.
2. Many but not all bond funds provide daily liquidity. For the funds that provide daily liquidity, once a redemption noticed is received it typically takes two to three days from the funds to be received by the investor. There is also usually a small fee called a "spread" applied to the redeemed proceeds.

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.auor contact your mFund brokerhttp://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