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Spectrum Insights

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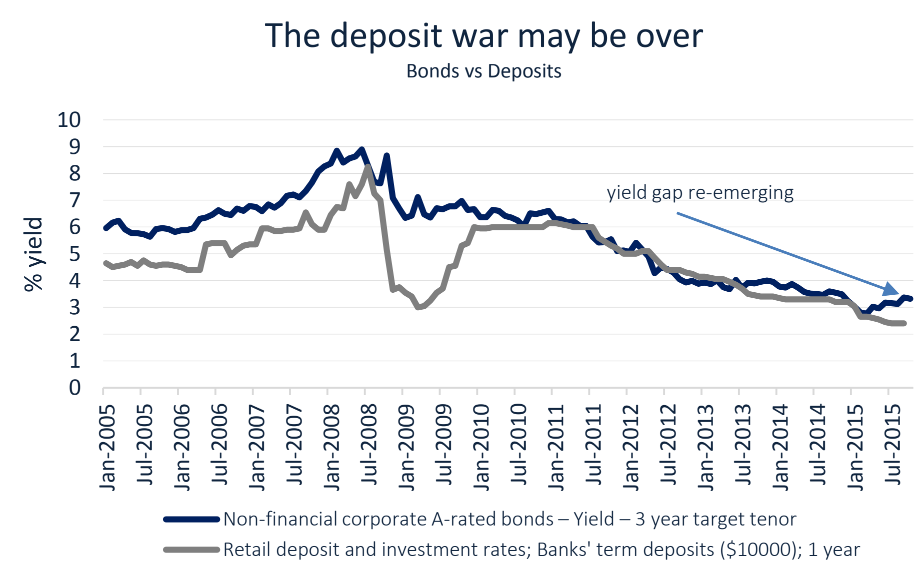
No corporate bonds? Time to reconsider

Australian superannuation investors have largely shunned corporate bonds. Post the GFC this was logical for many. Why invest in Australian corporate bonds when you could get the same yield for less risk and less hassle by sticking with Australian bank deposits? This rationale is changing, however. Low-risk short-dated corporate bond yields are now moving higher than those on deposits. Spectrum sees this as a return to "normal". If sustained, as we expect it will be, corporate bonds may be part of the solution for those frustrated with current deposit rates.

Why the deposit premium?

The so called "deposit war" between banks appears to be either over or in a state of cease fire. This battle began during the GFC. At that time there was heightened sensitivity to bank vulnerability across the globe. When looking at Australian banks the key weakness was deemed to be too much funding dependence on foreign bond investors and not enough local deposits. "Encouraged" by regulators and credit rating agencies, the banks took steps to address this. In doing so they raised the relative level of bank deposit rates and so began the deposit war.



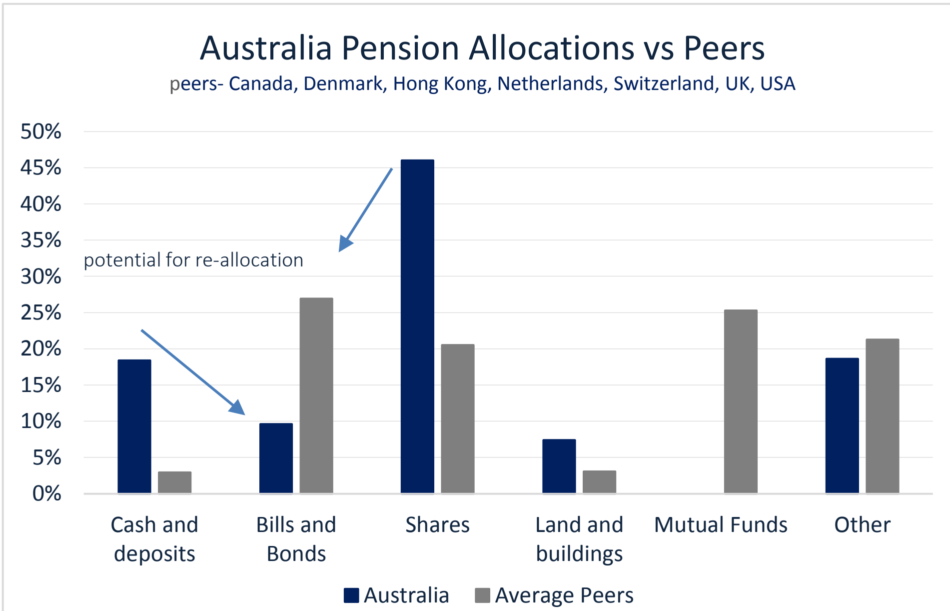
Sources: RBA, Reuters

The graph above shows that post the GFC, the yield on one year bank deposits was largely the same as one could get on a 3 year "A" rated corporate bond. Deposits, however, had some other appeal. These were and currently are as follows:-

- Deposits up to $250,000[1] carry a AAA-rated government guarantee,
- Deposits over $250,000 have higher Aa2 credit ratings for the big four banks,
- Deposits are shorter dated than the bonds being compared to, and
- Deposits are relatively simple to invest in.

Investors accordingly voted with their wallets and kept their superannuation out of fixed income and in equities and bank deposits.

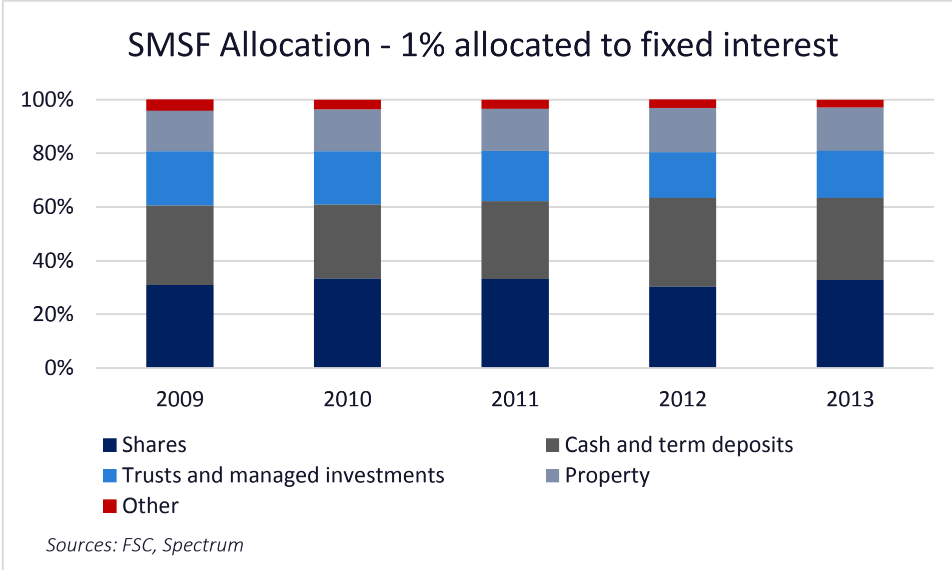
Spectrum believes the recent deposit war was a large reason why Australian pension or superannuation funds have far less exposure to fixed income than their peers around the world.



Sources: Financial Services Council, Spectrum

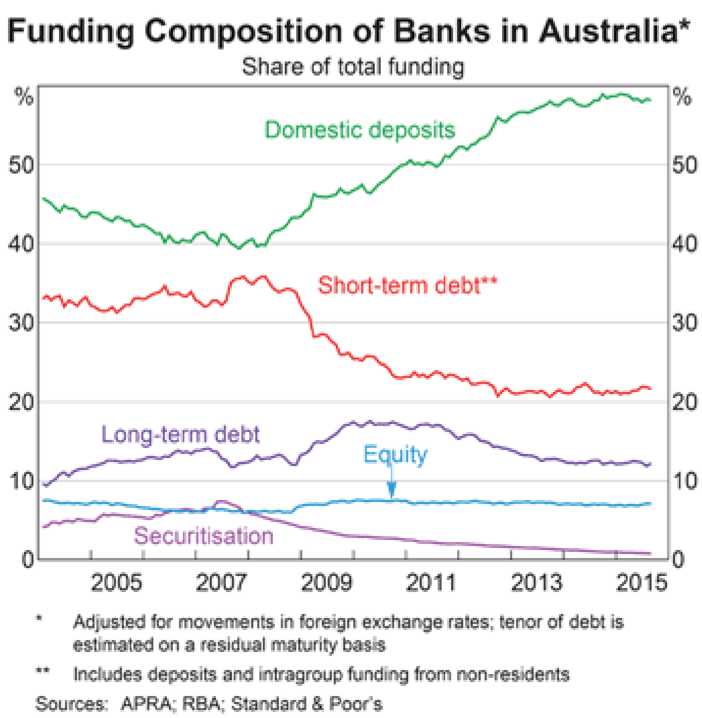
For Self-Managed Super Funds, fixed income accounts for less than 1% of investments. Spectrum believes Australian self-driven investors did not shun fixed income as an investment class. They rationally used deposits as a substitute for the reasons note above.

[1] On 12 October 2008 the government introduced guarantees on deposits of up to $1million. This cap fell to $250,000 on 1 February 2012.



Why there is a cease fire in the deposit war?

Australian banks have succeeded in building deposits in recent years. As seen in the graph below deposits have grown from around 40% of banks' balance sheets during the GFC to nearly 60% now.



The near 50% increase in deposits, in particular those with maturities in excess of 30 days, helped the banks to meet new liquidity regulations. Specifically they were required to have over 100% for their Liquidity Coverage Ratio (LCR) due by January 1 2015.

Banks meet new liquidity regulation

	LCR	Date
ANZ	119%	31-Mar-15
CBA	120%	30-Jun-15
NAB	118%	31-Mar-15
WBC	114%	31-Mar-15

Sources: NZ, CBA, NAB, WBC

Return to normality

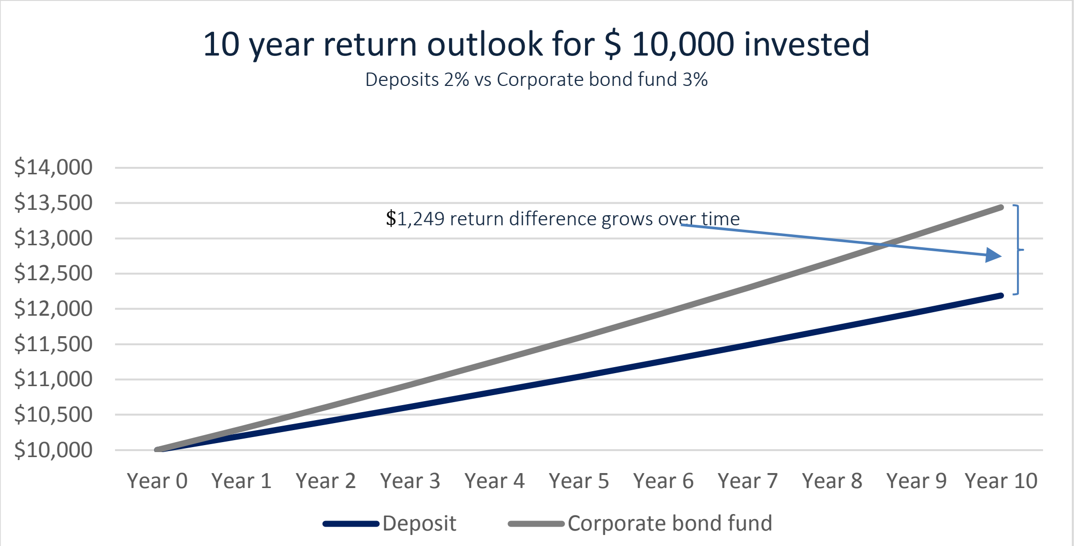
In Spectrum's view bank lending markets are not sustainable when deposits give the same yield as highly rated short dated corporate bonds. The reason is simple. The most basic business of a commercial bank is lending to borrowers at greater yields than the bank borrows. And if highly rated companies borrow at the same rate as bank depositors the core bank business model does not work.

Pre GFC the yield difference between 3 year A rated corporate bonds and bank deposits was around 1.3%. This is not only typical of what happens in Australia but in most developed banking markets around the world. As the graph on page 1 shows, the yield gap is beginning to emerge again towards this level. More importantly, Spectrum believes the positive spread that short dated corporate bonds have over deposits is likely to be the norm for at least the medium term.

Is 1% extra a big deal?

It can be. The reason is yields on most investments have collapsed in recent years. An additional 1% per annum compounding over several years can make a large difference.

For example consider a bond fund that delivers a modest 3% per annum and compare this to a deposit that gives 2% per annum. The income difference over 10 years for $10,000 invested would be around $1,250. Or, put another way, the bond fund would deliver an additional 57% in income.



Source: Spectrum Asset Management

Outlook

Corporate bonds usually yield more than banks deposits. Some key drivers which stopped this happening post the GFC have eased. This improved relative yield outlook for corporate bonds may soon get the attention of superannuants. For a modest increase in credit risk investors can improve their returns notably for what may be only modest increase in risk. In the current era of low deposit yields this could just be what some investors are seeking.

Spectrum Asset Management manages the Spectrum Strategic Income Fund. This fund invests in AUD 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