Rethink your tactics with low rates in prospect

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Performance this year. *Source:* TheAustralian

WORLDWIDE, there's an excess of saving, monetary policy remains accommodating and inflation is negligible; in some countries, the dominant fear is of deflation. Meanwhile our economy is in a soft patch. It's no surprise that interest rates here and abroad are expected to stay low relative to their long-term average levels for some time yet.

As shown last week in this column, investors may also need to allow for changes in the term structure of Australian interest rates in 2015. Expectations are for our cash rate to be left unchanged next year but if there is a move it's more likely to be a cut than an increase, while yields on 10-year bonds could rise on the back of higher US rates.

How might Australian investors react? One obvious need is to get the best possible returns on cash and term deposits. Banks seeking to attract deposits generally offer more attractive rates on "honeymoon" deals, then later propose quite ordinary rates when funds are to be rolled over. Individual investors need to shop around, drawing on information from websites on interest rates available on bank deposits, and to negotiate directly with their bank or banks.

There’s been a shift of retail savings from bank deposits into “hybrid” securities issued by banks. Hybrids have features of both debt and equities. They currently offer income streams about double those available on bank deposits but they don’t carry the government guarantee that applies on bank deposits. And, in the event of a serious financial crisis, some hybrids could be reclassified as equities, perhaps with investors receiving shares worth less than the hybrid’s face value.

Investors have also been moving out of bank deposits to interest-bearing assets offering better returns but with higher risk, such as corporate bonds. Investors should be aware that “spreads” on bonds from different issuers have narrowed markedly recently and could quickly widen again, particularly disadvantaging holders of bonds considered lower quality or illiquid, when markets become stressed again.

The current structure of interest rates on long-dated bonds doesn’t mostly represent good value for investors, who need to allow for these bonds dropping in value as and when yields rise. Also, bond markets are likely to favour investors in bond funds that seek absolute returns relative to bond funds that measure their performance against that of the bond market.

The hunt for yield has also led investors to favour shares well-placed to pay good dividends. The need is for the investor to understand and accept the risks, and be selective in the shares they purchase.

Some investors are reacting to the outlook for interest rates by borrowing cheaply to finance additional investments. Again, the risks of this strategy need to be carefully thought through, particularly given the recent gains in shares and property.

So much depends on the individual investor’s needs and capacity to accept risk. Quite a few investors, including younger and middle-aged members of accumulation super funds, may be holding excessive amounts of cash and term deposits; in some cases, this is the result of neglect rather than intent. With SMSFs reporting $160 billion in cash and term deposits (30 per cent of total assets), there must be investors who could look at lifting their asset allocations to shares, property, higher-yielding bonds and infrastructure funds, and not just because interest rates are currently so very low.

But other older investors need to have enough safe assets to draw on; otherwise, they could be forced to sell good growth assets at lower prices.

For some, the scope to switch away from cash and term deposits is limited.

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