

TDs or not to be

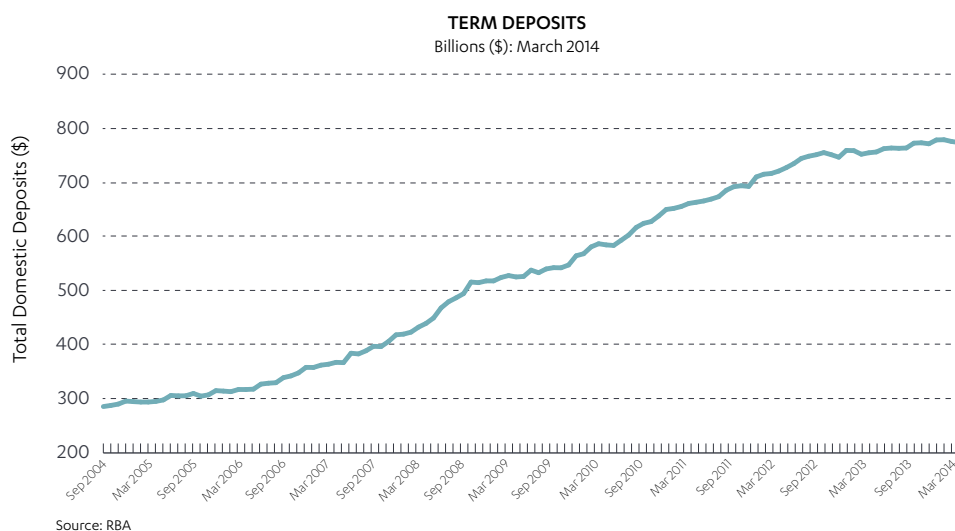
The ‘wall of cash’ remains strong

In the wake of a widespread loss of confidence after the Global Financial Crisis (GFC), Australian investors significantly increased their allocations towards cash-based investments such as term deposits (TDs) for their stability of capital and relative certainty of return.

In the years during and immediately after the GFC, the total amount invested in TDs increased significantly – over the five years to June 2012 the figure jumped from just under \$383 billion to \$744 billion. This phenomenon became referred to as a ‘wall of cash’ parked on the market’s sidelines.

Many would expect that with equity markets around the globe slowly but surely improving this ‘wall’ might begin to crumble. But while capital flowing into TDs is slowing, it appears a number of market ‘false starts’ have left both planners and their clients cautious. As Chart 1 below shows, money has continued to flow into TDs, peaking in March 2014 at \$773.62 billion.

Chart 1: Total Australian funds in TDs

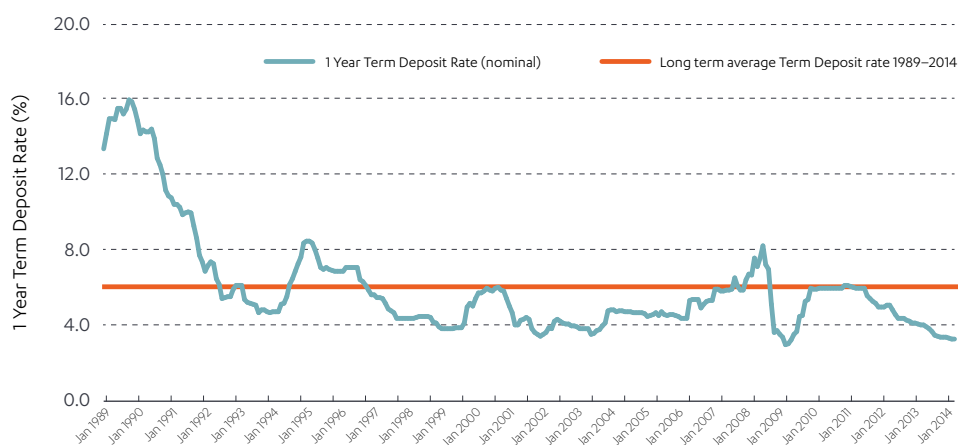


But if your clients continue to favour TDs for the certainty and security they offer, it’s important they understand the price they are potentially paying for that comfort. So let’s look a little more closely at how a TD stacks up as an investment option for your clients.

Busting some common TD myths

Investors commonly believe that TDs offer a high nominal rate of return. However, a look at historical rates suggests that even factoring in the very high TD rates at the beginning of the 1990s, nominal one-year TD rates have averaged around 6.06% pa.

Chart 2: One-year nominal TD rates



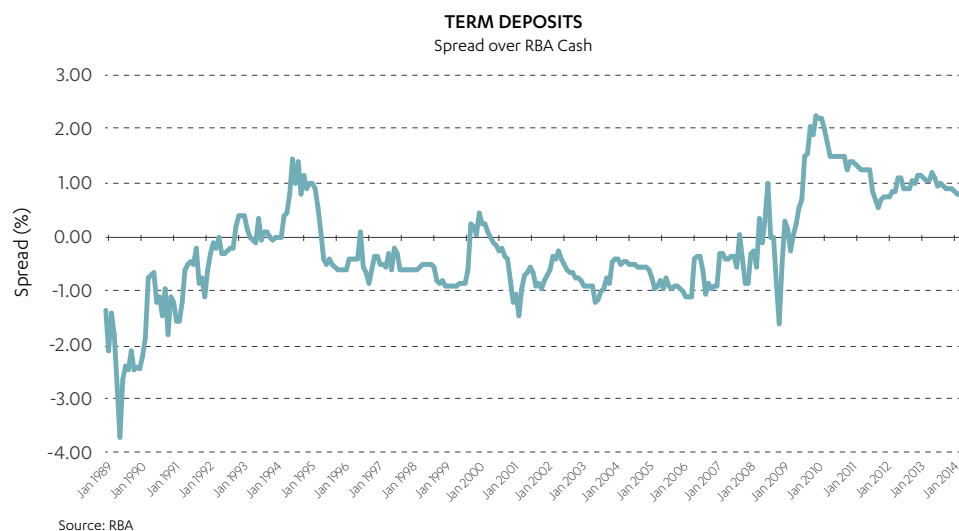
Source: RBA

Another misconception is that TDs offer a significant margin over a typical cash or savings account, which generally closely track the RBA cash rate.

Again looking back at the last 20 years, the difference between nominal TD rates and the RBA cash rate was most attractive in 2009 when banks, faced with an extraordinarily tight wholesale funding market after the GFC, increasingly turned to consumer deposits as a cheaper and more reliable source of funding. This factor caused increased competition among the banks, drawing average one-year TD premiums to 2.25% over cash.

Since then, however, not only has the cash rate fallen to its current historical low of 2.5%, nominal TD rates across the board have fallen well below their long-term averages. With banks much less concerned about funding, the margin offered to TD investors above the cash rate has also narrowed further. As you can see in Chart 3, the recent margin above the RBA cash rate being paid to one-year TD investors is only 0.80%.

Chart 3: Historical spread between average one-year TD and cash rate



... But the real truth is even more confronting

When assessing whether an allocation to TDs is performing the desired role in a client's portfolio, it is even more important to look at the **real** rate of return. The real rate of return is the return achieved after subtracting inflation from the nominal rate and, put simply, represents the purchasing power of TD returns.

Chart 4 shows us that one-year TDs are currently yielding less than 2% in real terms¹, below the long-term average of 3.23%².

¹ As at 31 March 2014.

² Source: Factset. Average taken from January 1990 to March 2014.

Chart 4: Real one-year TD rates



Source: RBA

Once tax is taken into consideration, the picture becomes even more bleak. If we assume a personal tax rate of 30%, the real return on a one-year TD drops even further to approximately 1%.

Based on the downward trend in both nominal and real rates, it's clear anyone investing in TDs purely for the returns would do well to re-visit their strategy.

But to the risk-averse investor, the relative safety of TDs when compared to other asset classes can be just as important a consideration as the rate of return. So let's now look at how an investment in TDs compares with an investment in equities³.

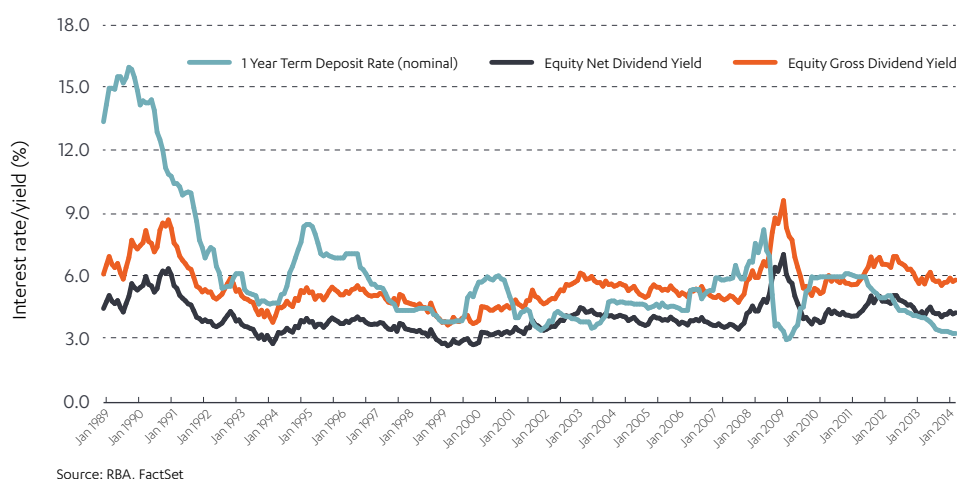
³ Index used: ASX All Ordinaries up to 1992 and S&P ASX 300 thereafter.

TDs vs shares – how do they stack up?

Lured by the relative certainty of returns, TDs are an attractive option for many; – yet some common misconceptions sway investors from investment options that could better meet their objectives. Even when taking the increased risk of equities investments into account, a comparative investment in TDs will often fall short against shares. Based on average capital growth alone, equities offer higher returns with the added benefit of a regular income from dividends.

Chart 5 below shows a comparison of one-year TD and equity returns. With net equity dividend yields currently around 4.2% pa they are considerably higher than the prevailing nominal one-year TD rates, which have fallen to 3.3%⁴.

Chart 5: One-year real TD rates versus equity dividend yields



Assumptions:

- > Dividend yield is based on the ASX200 12-month consensus forecast.
- > ASX200 franking levels are estimated at 79.4%.

The margin grows even further when you take the gross dividend yield (the orange line in Chart 5), which includes the effect of franking credit, into account.

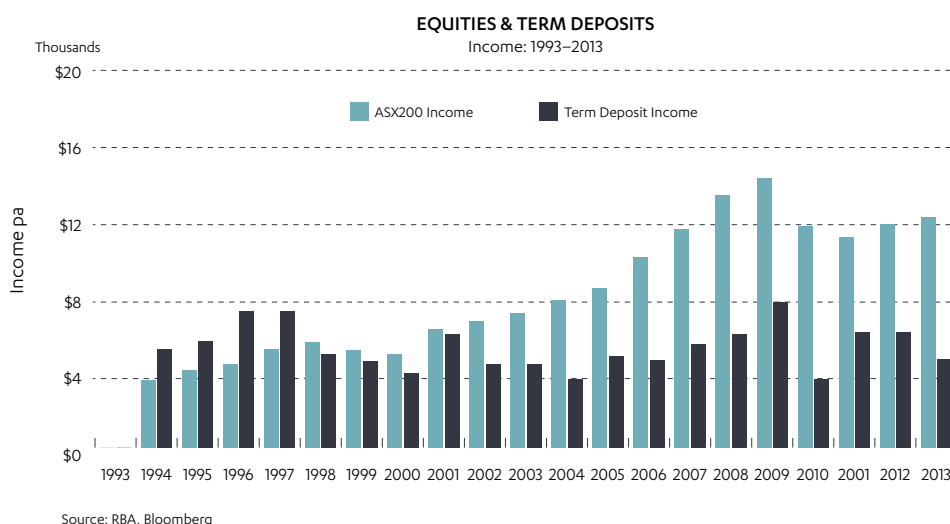
These shorter-term comparisons serve to illustrate a key point, but for your investors the long-term view is often more important. So in the next section we explore how the total return profile of TDs compares with an equity investment over 20 years.

⁴ Source: Factset. Average of ANZ, NAB, CBA and WBC one-year TD rates as at 20 May 2014.

How do longer-term TD investors fare against equities?

Chart 6 tracks an investment of \$100,000 in June 1993 in a one-year TD – then at 13.4% pa – with the capital rolled over each year at the prevailing average TD rate until June 2013. This would have earned the investor \$104,700 in interest over the period.

Chart 6: Comparison of income generated from one-year TDs vs dividends



An equivalent investment in the equity market⁴ would have earned the investor an income from dividends (not taking capital growth into account) of \$165,685 over the same period.

This doesn't take into account the added potential benefit of franking credits which would have resulted in even higher effective returns for Australian investors – \$226,041 in total income.

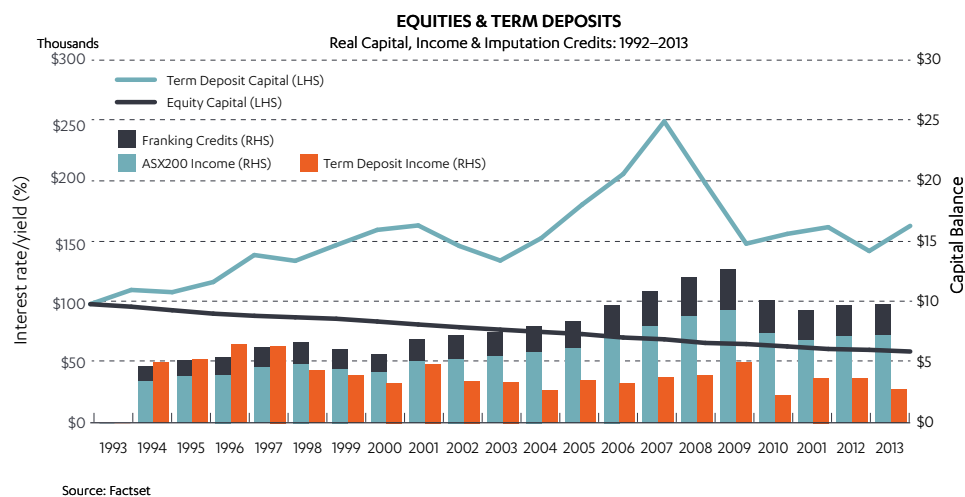
⁴ Source: Factset, average of ANZ, NAB, CBA and WBC as at 20 May 2014.

Long-term comparison adding in the effects of inflation

Another important long-term consideration for investors is the corrosive effect of inflation. Chart 7 below shows the final yearly TD income payment in real dollar terms on a 20-year TD beginning in 2013 is \$2,763 compared with \$5,038 in the first year (orange bars, right axis).

When you consider that the original \$100,000 TD in today's dollars is worth \$60,062 (dark line, left axis), it compares poorly with the real capital value of \$165,959 from an investment in the equity market (light line, right axis) over the same period.

Chart 7: Capital performance and income – real returns



Even when factoring in the higher 1993 TD rates of around 13.5% pa, an investment in the equity market overall is the bigger yielder by a substantial margin.

If we add each of the yearly income amounts in Chart 7 we find that an investment in a rolling one-year TD would have provided a cash flow of \$81,485 to the investor in real (ie inflation-adjusted) terms. By comparison, the same investment in the equity market would have provided the investor with an inflation-adjusted total income of \$121,391.

It's clear from this that TDs, when compared with equities, have historically been a less effective long-term investment for the purposes of income generation.

Where is the shares versus TDs tipping point?

How much do equity markets need to grow each year to provide a better return than TDs over five years? Assuming a 5-year TD rate of 4.46%⁴ pa and a constant equity dividend yield of 4.2% pa, then the answer is around 0.26% pa. Of course investors will need to consider the trade-off between the lack of liquidity but stable capital from a TD investment, as opposed to a highly liquid but more volatile equity investment.

The outlook for TDs

While it's easy to understand the attractiveness of TDs for investors made risk-averse by their experience through the GFC, with the cash rate now at record lows and the majority of commentators predicting continued monetary policy easing for at least the remainder of 2014, the argument for TDs as an income generating asset class is significantly weakened.

Investors need to keep their long-term strategy in mind and the benefits – from both an income generation and capital growth perspective – of investing in growth assets such as equities are clear.

**Equities need only grow by
0.26% pa over 5 years to beat
a 5-year 4.46% pa TD.**

⁴ Source: Factset, average of ANZ, NAB, CBA and WBC as at 20 May 2014.

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