Where to go, now cash doesn't cut it

PORTFOLIO STRATEGY

ANDREW MAIN

THE widely publicised drop in official interest rates since late 2011 has been exacerbated for depositors by a reduction in the banks' needs to solicit retail deposits, according to fund manager Angus Bell of Goldman Sachs Asset Management.

Mr Bell makes it clear the picture is a bleak one for investors who are still sitting on big cash positions, many of them because they lost confidence in equities after the global financial crisis then baulked at the volatility that has ruled markets since.

There are two reasons why bank deposit rates have come down faster than official interest rates, he says, one being that the domestic banks have now built up a solid deposit buffer to satisfy the Basel III capital requirements.

"The other is that the credit premium that overseas bond investors were demanding for Australian bank paper has dropped away," he says. "Australian investors who are in retirement or close to retirement must be dismayed not only at the reduction in official interest rates but also by the normalisation of the premium that banks have been paying for retail deposits."

Given that they were getting almost 8 per cent on a three-month bank deposit during the GFC ructions of 2008 but are now lucky to get 4 per cent on the same deposit, you can see the problem.

Plus, as a recent Reserve Bank report shows, banks that were getting only 40 per cent of their funding from domestic deposits in 2009 are now getting about 55 per cent from that source.

What's remarkably hard to check is exactly how much cash is sitting on the sidelines, based on the common view that most Australian self-managed super fund investors have what's called a barbell approach to investing, with cash at the low end of the risk curve, equities at the other and not very much in between.

The big question is, how much cash is actually sitting idle, earning interest that, after tax where that applies, is not even keeping pace with inflation?

Steve Tucker, former chief executive at MLC and a panellist at last week's Funding Australia's Future discussion, pointed to a 2011 report by the Australian Centre for Financial Studies which noted that while retail and industry super funds had cash weightings of between 3 and 3.5 per cent, small funds (SMSFs) had cash holdings of just under 30 per cent while the fixed-interest investment position was the other way round, with the professionals holding between 25 and 30 per cent and the SMSFs holding a miserable 0.7 per cent.

"Logic says they can't both be right," says Mr Tucker, who has been tipped as a possible member of the Coalition's planned "Son of Wallis" inquiry into the financial system if it wins office.

He told the panel discussion that reforms should be undertaken to make it easier for retail investors to buy corporate debt securities directly.

Andrea Slattery, chief executive of the SMSF Professionals' Association of Australia, believes cash piles have come down since 2011. "The latest research by Vanguard shows that SMSFs' allocation to cash fell for the first time since 2010, with a flow into other investments as investor confidence has grown in 2013," she says. "So while trustees remain cautious about investment markets, and given the past five years who could blame them, they are looking to invest in growth assets."

Ms Slattery says a distortion arises because many reports base cash estimates on June 30 numbers and that date represents a spike (see graph) as superannuation find members make end-of-year concessional contributions.

But no one's doubting that retail investors who are close to retirement, or now in it, should mostly invest in something other than cash. In which case, what?

Mr Bell runs the Goldman Sachs Income Plus Wholesale Fund, which invests in a way that is not far from Mr Tucker's direct investment in corporate bonds. It is a steady compromise between fixed interest and equities. Its portfolio model allocates 40 per cent to cash, 20 per cent to mainly government bonds, 15 per cent to hybrid issues and floating rate notes, 10 per cent to global high-yielding bonds, 10 per cent to infrastructure and utilities, and 5 per cent to A-REITs.

"In other words, it's mainly fixed interest but has the potential for capital growth," he said, restating the often-forgotten point that retired people usually need capital growth as well as income.

His fund is actually only 32.5 per cent in cash and is well overweight in hybrids and floating rate notes at 21.3 per cent, but its one-year performance number is what catches the attention: 10.1 per cent for the year to May 31, of which 6.6 per cent was capital growth and 3.5 per cent was "distribution return" or dividends.

Banks have now built up a solid buffer

STUART McEVOY

Angus Bell says investors in retirement or close to retirement must be dismayed by the reduction in interest rates and the low premium banks have been paying for retail deposits

The rich know where to go – bet your assets on it

ANDREW MAIN

F. SCOTT Fitzgerald's comment that "the rich are different" might have been coined to describe proactive asset allocation.

Chris Selby, who is head of Deutsche Bank's wealth management practice and has many clients with $10 million or so to invest, has long noticed that where his clients go, others later follow.

"The higher you go, the more money has been taken off the table" in Australian equities, he says.

"They've taken money out because of the euphoria in this market and they've been moving funds across to the US and to alternatives such as private equity.

"They are taking a longer view because they know that in five to 10 years conventional markets will look OK, but near-term it's harder to predict," he says.

And they're not playing in straight fixed interest locally, he makes clear, due to low rates.

"Hybrids, domestic bonds and even residential mortgage backed securities are losing appeal for ultra-high-net-worth investors," he notes.

"Hybrids are OK for people who don't have a lot of opportunity to look elsewhere," he says, trying hard not to sound like a private banker.

"They are paying maybe 200, 300 basis points over the swap rate, but it's the 'over' that's the problem," he says, explaining their total yield now is not much more than 4.5 to 5 per cent.

He noted that 18 months ago there were products on offer paying as much as 800 basis points over swap "among unloved classes" such as mezzanine debt.

He says his clients had then been "looking for and getting 10 per cent yields but now we're at a new level, say 8 per cent maximum, and UHNWs are not satisfied with that sort of return. We were living in a Lewis Carroll world where traditional rules were tipped upside down and it stayed that way for a couple of years." Rather than Equities being the risk asset, as is normal, UHNWs took their risk in fixed interest and took minimal equity risk, especially small caps.

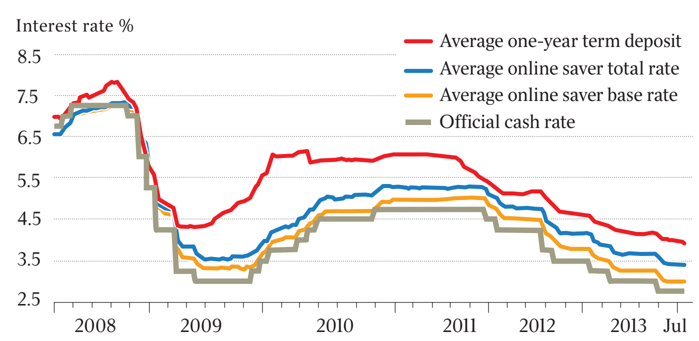
"People didn't buy government bonds but they bought widely discounted inflation-linked bonds, Australian bank paper issued in euros, and they bought the corporate risks that institutions were shying away from."

"They did very well in those areas and now we're back to a normal asset allocation style approach", he says.

So what are they looking for now?

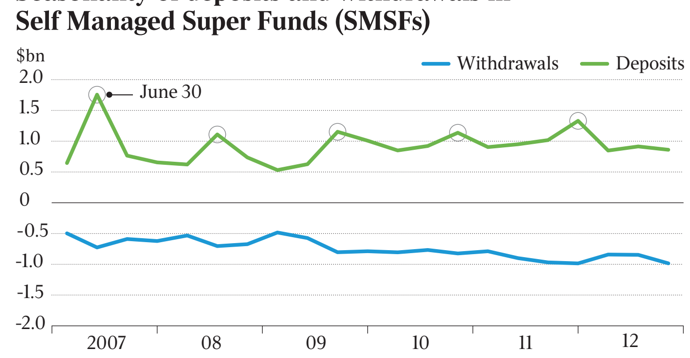
"Duration and currency diversity,whether in property, private equity , infrastructure or alternatives."

How cash deposit rates have been dropping



Source: Canstar

Seasonality of deposits and withdrawals in Self Managed Super Funds (SMSFs)



Source: Macquarie

Get ready to dive in before the market finds its feet and goes for growth

MICHAEL GABLE

A CHARTIST'S VIEW

IN an environment where currency and interest rates are dropping, the US economy is improving, and there is an easing of European debt concerns, we have the ingredients to see sharemarkets improve.

Not all is rosy, however, with a slowing of growth in China causing headaches for the Australian resources sector. These competing forces make it difficult to gauge what the overall market might do here. So by which means will we uncover the clues to its future direction? Looking at a daily chart of the market, recent price action has started to provide me with some signals. While I believe our market will be trading higher at the end of the year, for the next few weeks at least I am expecting the risk to be to the downside. This is particularly useful for investors looking to cash in some holdings and reposition into better opportunities. After finding a low in June, the S&P/ASX 200 managed to rally nearly 10 per cent. After nearly a month of edging higher, it dropped by nearly 2 per cent in a day. Usually a big move down at the end of an uptrend is a sign the market is getting nervous. The market may not drop like a stone straight away, but any upside will be limited. And if that is the case, expect a lot of volatility, as volatility generally increases at the top of the trend as the bulls and bears fight it out. If this is the case, then we should expect some short-term weakness in the overall market. As a result, I would be looking for it to ease back to strong levels of support.

My analysis shows strong levels of support down near 4850, and a breach of that could see levels as low as 4700. So while the market has the potential to be trading higher over the next few months, the next few weeks could potentially provide investors with an opportunity to reposition back in the market at lower levels.

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S&P/ASX 200 index

Source: Novus Capital

Virtuous circles create wealth

ROGER MONTGOMERY

THE expression "success breeds success" is often used to explain how leaders emerge in their respective fields. Winners can experience an exponential rise because of their ability to build on past achievements: with each win comes new knowledge, which in turn can spur further success in a positive feedback loop.

The same phenomenon is observed in economics, but it is referred to as a "virtuous circle". Companies that focus on continually improving their product or service are likely to see an increase in earnings, which in turn can be reinvested in further innovation. Virtuous circles can endow companies with sustainable advantages that not only make it difficult for competitors to win market share, but can also protect earnings during turbulence. Over time, this feedback loop can have a considerable impact on earnings, in much the same way compounding interest ultimately produces exponential returns. Resmed is a good example of a company that is generating a positive feedback loop. The company has become a global leader in the production of flow generators and masks for sleep-disordered breathing by focusing solely on building a culture of innovation.

Resmed has historically dedicated 8 per cent of sales to research and development. This drives the creation of more valuable products, which in turn further increases sales. This positive loop has contributed to the company growing revenues by more than 18 per cent each year for the past decade.

The dollar-spend on research and development does not in itself guarantee technological breakthroughs — the depth of knowledge is just as important to drive innovation.

Resmed has been producing sleep devices for more than 20 years, and during this time it has developed a considerable knowledge.

Research and development drives the creation of more valuable products

One advantage of this knowledge base is Resmed's ability to tailor algorithms in its machines to collect higher quality data from users — at any time the company knows if a device is turned on, how the patient is breathing and the efficacy of the air pressure. This data not only aids in furthering the comfort for patients, it is also highly valuable for distributors and insurers who wish to track user compliance. This increases the reliance of these parties on Resmed devices, which in turn deepens the knowledge base and raises switching costs.

Virtuous circles can drive cost reductions as well, and Resmed is seeking further efficiencies by putting its data online. Historically, the company had to send CDs to each of its customers in order to upgrade software. Today, the machines update automatically online. This migration also requires fewer representatives to visit distributors. Once again, the virtuous circle is reinforced as cost reductions are reinvested into the business to drive further efficiencies. This virtuous circle of innovation has endowed Resmed with considerable pricing power. Not only is Resmed able to charge premium prices, this circle has also provided it with a stronger bargaining position over distributors during industry turbulence. Medicare in the US recently cut reimbursements to distributors by 40 per cent. While this has caused consolidation among distributors, Resmed's market position has remained strong. Virtuous circles can only endow companies with sustainable advantages if the feedback is reinforced. A company that rests on its successes, rather than leveraging them, can provide gaps for competitors. Management at Resmed is aware of this and, while the company has a running start over its competitors, directors are careful to note "it's only the first mile of a marathon".

As value investors, it is important to search for companies that are generating strong virtuous circles, and this is one of the reasons why Resmed holds a position in our funds here at Montgomery Investment Management. Resmed is leading at the first corner and, even though it is early in the race, we are expecting this lead to be sustained.

Roger Montgomery is the founder of Montgomery Investment Management and the author of Value.able: How to Value the Best Stocks and Buy Them for Less Than They're Worth, available at www.rogermontgomery.com