



Strategies for a period of rising rates

Diversifying will minimise risk as conditions change

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INTEREST rates are rising, which may be good news for many investors, but there's more to it than sticking your money in term deposits and leaving it at that.

Investors need to consider a range of investments to diversify portfolios and maximise opportunities as interest rates rise.

Online cash accounts and term deposits may be the first places you think of to park money, but there are many other assets that may deliver greater returns.

If you're invested in property, the news isn't so good, while equities may be immune to more interest rate rises, the experts say.

The Reserve Bank of Australia made it clear in its May board minutes released this week that a rate rise will come sooner rather than later. Economists are tipping a hike from 4.75 per cent to 5 per cent within three months, most likely in August, and possibly more rises after that.

"The outlook for interest rates is that they could be marginally higher. So where people are invested in fixed income, we like fund managers with a shorter duration target and we like floating rate notes and even some sort of hybrid that offers coupons to give exposure to higher interest rates," National Australia Bank private wealth chief investment officer Philip Kimball says.

"We continue to be in equities in defensive sectors such as consumer staples, which will do better than others as interest rates rise, while we're neutral on banks, as rates won't rise so much that it would hurt their businesses.

"They offer sizeable dividends which are above market, so that's attractive in a rising rate environment," Kimball says.

Rate rises aren't likely to dent investor interest in equities generally, which has been supported by decent valuations and favourable

liquidity conditions.

"Although we have long-term concerns around the sustainability of both global economic growth and earnings growth, and still expect the occasional correction, there isn't a strong case to have a very negative view on equities looking out six to 12 months."

Brad Newcombe, research director with fixed-income broking house FIIG, says a big advantage of fixed-income investments when rates are rising is that you get exposure to rising rates.

"Most fixed-income investments are floating rate bonds, so the coupon tends to rise with official interest rates," he says, pointing out that most Australian investors are overweight equity and property investments.

By comparison, fixed income offers investors a relatively safe capital investment, a reliable income stream and relatively good returns for low risk.

"Buying listed retail bonds or hybrid securities are two of the easiest ways of investing in fixed income. There is no minimum investment and there are a range of securities you can buy on the ASX," Newcombe says.

Returns from listed retail bonds or hybrids depend on the risk of the particular security and issuer, but hybrids issued by the big banks, for example, pay a coupon (interest rate) of 7-8 per cent a year, while hybrids issued by medium-sized banks pay 9-10 per cent a year.

Riskier securities pay up to 12 per cent, Newcombe says.

Returns for listed bonds tend to be slightly lower than for hybrids because they rank ahead in the capital structure of the company, so they will be repaid before other obligations, including subordinated debt and equities.

An example is the senior-ranking CommBank Retail Bonds issued by Commonwealth Bank,

with a face value of \$100. They are akin to senior-ranking bonds issued into wholesale markets and pay a margin of 1.05 per cent over the 90-day bank bill rate. So a bank bill rate of 5 per cent would give an annual yield of 6.05 per cent.

"The low margin range reflects the quality of the issuer and the CommBank bonds' ranking in the bank's capital structure, which is the key to their use — as high-quality bonds with high security of interest payments and capital repayment," Evans & Partners institutional broker and debt head Mike Saba says.

"These bonds will give excellent exposure to rising interest rates and are an alternative to cash trusts or term deposits, with ease of liquidation due to the outstanding credit quality of the issuer and the ability to trade corporate bonds just like shares," Saba says.

Another option for investors looking to benefit from rising interest rates is managed funds that focus on shorter dated or floating rate securities.

"What you want to look at is a product that has a shorter maturity, or floating-rate investments where investors will have protection from rising interest rates. You can hold cash as well, but return won't be quite as high," Principal Global Investors Asia-Pacific fixed income managing director Robert da Silva says.

"If you think rates are going to go up, then you want to hold shorter dated securities, where the price is less sensitive to a rise in interest rates than, say, a longer dated bond," says da Silva, who manages Principal's global strategic income fund.

Like any portfolio, investors in fixed-income assets need to diversify their investment across different bonds, issuers and maturities.

"Generally we recommend people have some amount of diver-



sification on their fixed-income investments and to buy a range of bonds in different sectors and from different issuers," FIIG's Newcombe says.

Maturities of fixed-income investments should also be diversified. HLB Mann Judd financial adviser Chris Hogan says a managed fund or direct investment in shorter dated bonds and hybrids is a good option for investors if interest rates rise, but there's also a role for longer dated bonds in case there's another financial crisis or sudden break in growth. "If you get the GFC mark II, then if you are in a longer dated portfolio, and the Reserve Bank slashes rates, those longer dated investments will rise in value and outperform shorter dated securities."

Hogan likes fund managers that actively seek out shorter duration bond investments and hybrids, but says index funds, which tend to have more longer dated bonds in their portfolio, also have a role to play in a diversified fixed-income portfolio.

Another obvious option for investors is term deposits. Rates on

shorter dated term deposits may rise with official interest rates, but probably not by as much.

"Term deposits are already pricing in at least two rate rises, so unless you expect more rate rises than that" they may not be of value, NAB's Kimball says. However, investors can keep their opportunities open with shorter dated term deposits and keep rolling them over.

Kimball also likes inflation-linked deposits, which protect against inflation.

At the other end, HLB Mann Judd's Hogan says five-year deposits are offering good returns, around 7 per cent a year. "Longer dated terms are still good value because you tend to do better in the first few years of a longer maturity deposit than if you stayed in shorter dated deposits."

But it's important to shop around between big and small banks to get the best returns, Hogan says.

Investors also need to take into account the lack of liquidity in term deposits. "If you need your money back, you'll need to pay a

break fee, so they may not suit those investors who need their money at call," Newcombe says.

If you're a borrower, higher rates are bad news and you'll need to minimise your interest costs. Fixing the interest rate on your mortgage is one option, but Newcombe says most people lock in at the wrong time, when rates are already high. A better approach might be to split a home loan between fixed and variable elements.

Splitting a loan "in two equal parts, no matter which way interest rates move the impact is halved because only half of your mortgage will be affected" RateCity chief executive Damian Smith says. There's still time to fix at three-year rates and save money, but this window of opportunity may close if interest rates rise next month.

If you hold property, the warnings have been delivered.

As higher interest rates bite, prices are falling, or are about to fall, according to data from the Bureau of Statistics and property forecasters.

RISING RATE EXPECTATIONS

Yield on 90-day bank bill futures (%)

Month	Yield (%)
MAR	4.85
APR	4.95
MAY	5.10

Source: Bloomberg

SMART YIELD IDEAS

These may benefit from rising interest rates

- TERM DEPOSITS
- CASH ACCOUNTS
- FLOATING-RATE RETAIL BONDS
- FLOATING-RATE HYBRID SECURITIES
- FIXED-INCOME MANAGED FUNDS WITH A SHORTER-DURATION TARGET