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MEDIA MONITORS

JUST RETURNED:

12%

What was this asset?

Shares Property

Cash Bonds



Time to rethink 'boring' bonds

In times of sharemarket volatility and interest-rate fluctuation, the best thing for your cash is to lend it to the government, writes **David Potts**.

It's the most unlikely of booms but it's producing double-digit returns, which is saying something.

Especially when the risk is as little as, and arguably even lower than, a term deposit.

There, that should give you a clue.

Give up? All right, the boom is in bonds and boring old government ones at that, not your fancy floating-rate hybrids that are all the rage.

Who'd have thought government debt might be good for something – but there you go.

Bonds are a sort of glorified term deposit; you're lending to the government for a guaranteed interest rate, called a coupon.

The difference is that a bond can also be cashed in whenever you like because it trades like a share, though not on the ASX.

What's more, if rates are lower than the coupon on your bond when you sell you'll even make a nice profit.

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If you own shares, blue-chip bonds are better protection than cash.

Aberdeen Asset Management's inflation-linked bond fund returned 12.2 per cent after fees in the year to September 30, according to Morningstar. At the same time, share prices slumped 9 per cent.

And that was with inflation easing slightly.

The reason it did so well was that indexed bonds go as far out as 2030 – and the longer the duration, as they say in the trade, the bigger the price rise when interest rates drop.

Just as the yield from the dividend on a share goes up when the price drops, the same goes for the interest coupon on bonds. And prices have rallied recently as the market has come to expect the Reserve Bank will cut the cash rate.

The rally has even surprised fund managers, which just goes to show bond markets can be as

crazy as the sharemarket.

“A 0.25 per cent rate cut has been factored in already,” the head of fixed income at Tyndall Investment Management, Roger Bridges, says. “Bonds have overreacted in the last three months.”

Foul-weather friends

You could almost say bonds thrive on adversity. Tough times usually result in lower interest rates, which are fodder for a bond boom.

“I see low growth in the world over the next few years, so sitting in cash or equities may not be the best idea,” Bridges says.

Remember, if you hang on to them until maturity, it's impossible to lose money on Australian government bonds, something that can't be said for shares.

But what was that about cash? Can't go wrong there, surely, especially when it's in an online account or a term deposit fetching a decent return. Yes, it's safer than anything else, including gold, which can always fall in value, as it has done for long stretches.

Yet if you own any shares at all, blue-chip bonds are better protection than cash. How so? Because in a sharemarket meltdown, bonds will go the other way. Cash, however, just sits there. Worse, the return from it will drop.

The only time bonds and shares tumbled together was in 1994. Even then, bonds did better than shares.

Cash's victory lasted less than a year.

Mind you, the head of fixed interest at Aberdeen Asset Management, Victor Rodriguez, doesn't expect this year's double-digit returns to continue. But, he says, bonds are the best insurance for a share portfolio, especially in a DIY super fund.

“As soon as you're in equities, you want insurance for it,” he says. “Term deposits won't rally when equities are falling 30 per cent. And if you move from bonds to cash, you've increased the overall risk of your portfolio.” Not that they'll make you rich. The capital gains from bonds are normally modest, though these days even that's something.



A 0.25 per cent drop in rates, for example, would only lift the price of a \$100 face-value one-year bond by about 25c and \$2.50 for 10 years. So you'll need a lot of them for the return to stack up, which isn't such a problem for the managers of bond funds.

The pity is, having turned their noses up at bonds for so long, investors shell-shocked by the sharemarket are going into the wrong ones.

They're heading for floating-rate bank and corporate hybrids, which, admittedly, come with franking credits, rather than the real thing, paying a guaranteed rate.

Hybrid prices bob about with sharemarket sentiment, the very thing you're trying to escape. And did you know none of the popular bank hybrids even promise to return your cash?

Instead you get shares at a discounted price down the track.

How to buy

It's not easy to get your hands on government bonds. Although they trade in the market like shares, you need a specialist broker such as FIGG Securities and will need to invest a minimum \$1000.

There's no brokerage because it gets the bonds for slightly less than it sells them to you. You can also buy bonds direct from the Reserve Bank if you're willing to go through the rigmarole, starting with what it's offering exactly each day.

Once you find that out, you have to fill in a purchase form and an identification reference form "together with certified copies of identity documents" and either take them to your nearest Reserve Bank branch (there are only two - in Sydney and Canberra) or post

them. There's also an "administrative charge" of \$2.50 per \$1000 face value of bonds you buy.

If you want higher-yielding semi-government issues, too bad.

You'll have to buy those through a specialised broker or turn to a bond fund that at least provides instant diversification through different issuers and maturities at wholesale prices.

You can buy units in a bond fund from the manager, a financial adviser or discount sites such as investsmart.com.au. The minimum investment is usually \$5000 and, these days, there are no entry or exit fees.

The management fee is usually 0.3 per cent or 0.4 per cent a year.

In the bond market it's not who you know but how much you have that counts, so fund managers also get first dibs at corporate issues that aren't available to mum-and-dad investors.

If you have a spare \$100,000, FIGG Securities has 2020 issues, such as Telstra with a yield of 6.7 per cent a year, Stockland at 6.9 per cent and Sydney Airports at almost 8 per cent, available. Shorter-dated bonds on offer include Leighton Holdings, yielding 7 per cent and maturing in 2014, and Mirvac at 7 per cent, maturing in 2016.

The pick of them, though, would have to be the 2014 bond from Rabobank, one of the few banks in the world that has a triple A rating. It's yielding almost 9 per cent a year.

The catch is you have to be a wholesale investor to get hold of one. And that's defined as someone who has at least \$2.5 million in assets and is earning \$250,000 a year.

See, money talking again.

Rates of return

FUND	1-year (%)	3-year (%)	5-year (%)	7-year (%)
Aberdeen Inflation Linked Bond Fund	12.15	6.69	6.38	6.89
UBS Inflation-Linked Bond Fund	11.58	4.95	5.20	5.91
Aberdeen Income Focused Bond	9.16	10.06	7.59	6.94
AMP Australian Bond	8.97	-	-	-
Aberdeen Australian Fixed Income Fund	8.76	9.95	7.43	6.88
ANZ Fixed Interest Trust	8.69	7.95	6.15	5.87
Tyndall Australian Bond Fund	8.65	7.85	7.03	6.54

SOURCE: MORNINGSTAR.COM.AU



Inflation-busting accounts key to future security

DESIGNER term deposits are the new black for pension-paying DIY super funds.

Some banks will let you set whatever term you want, link the return to inflation and mix and match between floating and fixed rates.

And how about having some of your capital returned with the interest rate?

The catch is you need to invest at least \$100,000, no big hurdle for DIY super funds frantically trying to preserve their capital and earn a decent return. Westpac is the most amenable, in effect turning a term deposit into a government-guaranteed annuity without the fees, commissions and rigidity.

NAB also lets big savers and super funds select their own term as well as fixed and floating rate periods.

But it's Westpac's inflation-fighting retirement deposits that are a godsend for DIY super funds.

One version, called CPI Plus, pays a fixed rate plus whatever the inflation rate is. Since many super funds already have a CPI-plus target, this does the work for them.

For example, recently Westpac's 10-year CPI Plus deposit was paying 6.26 per cent a year based on the fixed margin of 3.51 per cent and an inflation rate of 2.75 per cent.

If inflation were to climb to, say, 5 per cent one year, the return would be 8.51 per cent.

The margin changes frequently but, just like ordinary term deposits, once you sign up, it is fixed. In fact at one point it was 4.5 per cent and since the Future Fund has a CPI-plus 4.5 per cent target, it could have stocked up on Westpac deposits that day and shut up shop.

"The average self-managed super fund in the last 12 years returned 0.1 per cent over the CPI according to APRA," the executive director of global markets at Westpac, David van Ryn, says.

Because the deposits qualify for the government guarantee on the first \$250,000, they're as risk-free as a government bond.

The bank's alternative inflation-linked deposits have a base rate that increases by whatever the quarterly CPI is.

So for a 10-year deposit, based on a 2.75 per cent inflation rate, the annual return would be 7.34 per cent.

Not worried about inflation? Westpac has other designs that might appeal. The Coupon Select Deposit might interest sir or madam because you can fix, float or both. Last week a three-year with a two-year floating term was paying 6.84 per cent a year.

Or how about the Range Accrual where you can take a punt on interest rates by selecting a range and, if you hit the target, the bank pays a bonus? "You can do a portfolio of interest rates of short, medium and long terms, some fixed and some floating and inflation linked. They're all under a government guarantee," van Ryn says, adding the bank's longest-dated deposit so far is for 23 years.

The retirement deposits are ideal for tailoring cash flow in the draw-down stage of a DIY super fund, which doesn't pay tax, says Brisbane-based financial adviser Stephen Furness, head of investment of MGD Wealth.

"Retirees can't wait for the sharemarket to recover," he says. You don't want cash flow to be dependent on equities, which should be left as a long-term investment."

The retirement deposits can match liabilities with cash requirements. "Our clients don't care about the interest rate so long as it's guaranteed and outside the volatility of the sharemarket," he says. "This is a really good option as part of an investment strategy."

