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CASH STRAPPED

Income Worried about diminishing cash returns? **Duncan Hughes** outlines four strategies to help you navigate lower interest rates.

ILLUSTRATION: SIMON LETCH

More than $300 billion could be in flux as millions of households consider what to do with their savings and investments as interest rates continue to fall.

That's the amount invested in discretionary savings and investments (not including super) that's likely to be moved around as households juggle how to generate income or spend their capital, says Martin North, principal of Digital Finance Analytics.

"This is creating an existential crisis," says North, as returns on more than 80 per cent of savings accounts and 44 per cent of term deposits slip below the headline rate of inflation, with more cuts on the way after the recent RBA reduction in official cash rates to 1.25 per cent.

Much of this money is likely to migrate to different banks, high-yielding property funds, real estate, infrastructure funds or global equities over coming months. "Households are questioning how and where to find a better return on their money and, if so, what risks they might face," North says.

Savers are also shopping around for best rates that barely top the headline rate of inflation, much less health, energy and food costs that continue to rise much faster. The following strategies offer some options to savers and investors.

WORK CASH ACCOUNTS

Top saver and term deposit accounts are paying just under 3 per cent, or more than twice the headline rate of inflation, for deposits of $50,000 and $200,000, according to analysis by Canstar, which monitors rates and fees.

"Savers will need to get their money working a lot harder and think beyond the bank branch on the next corner," says Steve Mickenbecker, a Canstar group executive.

For example, the top three- and five-year term deposits are paying 2.9 per cent on $50,000, meaning interest over the period of about $4000 and $6400 respectively.

For $200,000, the top rates over the same terms are also 2.9 per cent, equating to interest over the terms of about $16,000 and $25,600 respectively.

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Most banks, mutuals and building societies are cutting rates in response to the RBA's decision, with more cuts on the way. It's important to look beyond the big four banks as they're not offering top rates for term deposits or online bonus savings. NAB and CBA on Friday cut rates on a range of popular savings accounts by up to 25 basis points.

Bonus savings accounts, which provide a basic and bonus rate, come with conditions. For example, ING's Savings Maximiser, with a rate of 2.8 per cent for a $50,000 deposit, requires the customer to deposit at least $1000 a month into an ING Everyday account and make at least five settled card purchases each month. If these conditions are not met, the rate reverts to 1 per cent.

Low wholesale funding costs mean lenders are not as reliant on savers to boost their lending capacity, so it is unlikely there will be a savings rate war to attract new business.

DIVERSIFY

Richard Holden, professor of economics at the University of NSW Business school, expects to see a shift from cash into property and stocks. "Even though a relatively small change like 25 basis points – or even 50 basis points if the RBA cuts again in a month or two – shouldn't change behaviour a lot, negative real returns makes things salient," he says.

"This could easily lead to a discrete shift in behaviour of people currently investing in these cash products."

With APRA set to relax lending guidelines, mortgage rates coming down and house prices falling about 15 per cent from the peak in Sydney and Melbourne, one possibility is that those invested in cash will move to property in search of higher returns, he says.

"This could help to reignite the housing bubble, and would add to the already very high household debt levels, and thus create macroeconomic risks," he adds.

SQM Research covering the past 12 months shows Australian property rents vary widely between, and often within, cities. For example, rents for houses in Sydney are down about 4 per cent, compared to a 6 per cent rebound in Perth, where the overall property market is in recession.

Sydney house prices are down by more than 10 per cent but up about 7 per cent in Hobart.

Shane Oliver, chief economist for AMP Capital, which has $190 billion under management, believes the "chase for yield" will continue to support commercial property, infrastructure and shares offering sustainable high dividends.

Australian 10-year Treasury notes, a popular benchmark for measuring risk, are yielding 1.42 per cent, which is half what they delivered a year ago.

Billions of dollars have flooded into sectors that investors hope will provide additional growth and returns, pushing up prices and increasing the risk that latecomers will overpay.

During the past 12 months ASX-listed property stocks have returned about 22 per cent, while broader equities yielded about 14 per cent. The dividend yield across the top property stocks is about 5 per cent.

The top performer in terms of share price has been Charter Hall Group, up 80 per cent over the past year, followed by Goodman Group, up more than 55 per cent.

Financial advisers recommend that investors seeking exposure to an asset class or sector, such as property or infrastructure, consider a specialist managed fund providing diversification across a range of stocks.

The top-performing property fund over the past 12 months has been AMP Capital Property Securities, with a return of about 22 per cent, according to analysis by Morn-

Diversification and calm approach key to coping with low rates

Comment

John Wasiliev

With the interest rate reality that investors face in the foreseeable future – one of continuing low rates – the key question you need to ask is how much capital security you want from your investments.

Do you want a decent income flow where you are not worried about changes in the capital value of your investments, or is absolute capital security your most important consideration?

If the latter is your priority, then unfortunately with the latest reduction in the official cash rate to 1.25 per cent, bank deposits paying less than 1 per cent and term deposits paying below 2 per cent will increasingly be the best you can get. For many this will be a dismal prospect.

But if you can tolerate fluctuations in the capital value of your assets, identifying investments that offer income such as share dividends that can pay income of 4 to 5 per cent and distributions from managed funds, including exchange traded funds (ETFs), are available alternatives.

Further, many of these investments since the federal election continue to be enhanced with dividend imputation franking credits that pay cash refunds to investors on marginal tax rates below 30 per cent. Investors most relieved by this are self-managed superannuation funds that pay investment-tax-exempt pensions.

As AMP Capital's head of strategy Shane Oliver, a veteran financial markets follower, shared with me: "History tells us that in Australia if you have a portfolio of diversified companies that pay reasonable dividends, that income flow should be relatively stable."

The challenge is to identify such a portfolio and the only way to do so is to become a more active investor.

That said, any strategic move should be approached in a calm and disciplined way.

After all, deciding to allocate a majority proportion of your funds – as high as 70 to 80 per cent – to shares and income-paying managed funds, with the balance in cash and term deposits, might come across as a radical idea.

One suggestion for retirees that has been around for quite a while is having a no-risk cash and term deposit pool equal to three or four years of income needs. This is supported by a second pool of medium-risk assets to cover your life expectancy and replace your income investments as they are spent.

Falling interest rates can be good and bad news for investors and this will depend on where you are invested. While it is bad news for those in bank deposits, lower interest rates can make assets like shares and property look cheaper.

It is one of the realities of investing that anyone who is more active and has a diversified approach to investing can always cope much better in difficult times than those who rely on a single-strategy approach like being overly reliant on term deposits.

As far as opportunities to become a more active investor are concerned, a focused investor can expand his or her horizons by adding ETFs to the portfolio. If there is one a category of investments that offers instant diversification, it is ETFs. It is also a category with a strong emphasis on explaining what they offer, as any visitor to the websites of prominent ETF promoters Vanguard, State Street, Blackrock, BetaShares, ETF Securities and VanEck will find.

Included among these offerings are funds with portfolios that have been deliberately designed for their diversified income potential. An example is the Vanguard Australian Shares High Yield ETF. This fund invests in 56 shares with higher forecast dividends relative to other Australian companies. Over the last three years to the end of May, its average annual performance has been 9 per cent. SI

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ingstar, which monitors fund performance.

ANZ Property Securities was the worst performer, says Morningstar, returning just over a 2 per cent return for the same period.

Income funds, which last year benefited from a bonanza of high dividends, have been posting double-digit returns. Plato Investment Management is the top performer over three years with a return of 13.6 per cent, according to Mercer. Plato has $5 billion under management.

But yields are also expected to fall this year as prices rise and dividend streams slow.

Infrastructure funds are benefiting from investors attempting to diversify from low-yielding, fixed-income products.

Top-performing Vanguard Global Infrastructure Fund is up nearly 25 per cent for the year while the worst-performing CFML RARE Emerging Markets fund has returned about 9 per cent, according to Morningstar.

Investors considering an investment fund, particularly in property and infrastructure, need to research the fund manager, investment strategy and performance. Complicated financial structures should be avoided as they increase risk and expense. Make sure the underlying assets are high quality – for example, do property assets have strong tenant agreements and long-term leases?

Also check the level of gearing, or borrowing. Experts generally advise against borrowing of more than 50 per cent in unlisted funds and 30-40 per cent in Australian real estate investment trusts (A-REITS). High gearing increases risks in a market downturn.

Make sure any performance fees are based on a reasonable hurdle and check whether there are additional fees for raising debt.

With infrastructure projects, are they fully funded, is gearing disclosed and how regularly are the assets valued? Finally, ensure regular updates on fund performance, assets and strategy to enable critical assessment of management.

EAT CAPITAL OR CUT SPENDING

Martin Loughran, 67, father of two adult children, is worried falling interest rates will force him to cut down on luxuries, such as going to the theatre and other entertainments.

Loughran, who as a child was the youngest of a family of 18, says he expects falling rates will affect him over the next decade, as rising costs and falling income force him to eat into capital.

"I may not be able to go into the city to see shows and my mates," says the retiree who lives in Belmont, about 70 kilometres southwest of Melbourne. "But I'm not going to go without fresh food and vegetables."

He's also avoiding any new credit card debt – and paying existing debt off as quickly as possible.

The highest cash rate advance fees on credit cards is nearly 30 per cent while the purchase interest rate is about 25 per cent.

The average savings account balance for a couple aged 65 is about $90,000, according to the Association of Super Funds of Australia. This excludes superannuation.

Interest returns on this amount have fallen from $5400 10 years ago to just over $1700 now, as interest rates tumbled from 6 per cent to about 1.9 per cent. That's a reduction in monthly income from $103 to about $32.

According to ASFA, weekly outgoings for a modest lifestyle for a retired home-owning couple are $763 and about $530 for a single retiree. Lower cash returns make retirees increasingly dependent on additional income from super or any other investments.

Credit experts advise those coming up to retirement with housing loans, which average $14,000, to make the most of low mortgage rates to pay them off.

The outlook is particularly tough for 3 million households that rely on interest rates to make ends meet, such as retirees and other pensioners, according to analysis by Digital Finance Analytics. It will force more than 1 million households to dip into their capital, it finds.

While the overall inflation rate is low, some costs are rapidly increasing, according to ASFA.

For example, medical costs are up more than 4 per cent over the past year, compared to an inflation rate of 1.3 per cent. Vegetables increased by about 8 per cent and food and non-alcoholic drinks by more than 2 per cent.

Pam Brown, 79, and her husband, Pat, 80, who have three children and six grandchildren, are also concerned about rising costs and falling income from their savings.

The couple, who live in Freshwater on Sydney's Northern Beaches, receive a regular income from a defined benefit pension scheme, a specified payment based on Pat's employment as a teacher. He continues to earn "pocket money" playing organ at religious services.

But they want to use any income from their savings to spend on their grandchildren. "We've always watched every penny we spend," Pam says about how they manage their family accounts.

ACCESS HOME EQUITY

From July 1, cash-poor property owners will be able to apply for the federal government's expanded Pension Loans Scheme, which is a "reverse mortgage" that enables borrowed cash to be repaid out of the proceeds of an eventual sale.

About one million people are expected to be eligible for the scheme, which is open to those who own a house (including investment property) outright and either are of pension age or have a partner of pension age.

Those who meet the criteria can apply to receive an income stream of 1.5 times the maximum rate of pension each fortnight (singles $926 and couples $1396).

Brendan Ryan, founder of Later Life Advice, which advises people on living off their retirement savings, says: "Reverse mortgages can strike fear into the hearts of people because a loan with compounding interest can have a dramatic effect on people's wealth."

Ryan, a former Macquarie Bank analyst, says the new government pension loan offers a facility to draw down income.

"It creates a cash flow to help retirees' standard of living, rather than a lump sum." He wants to see more detail before making a final judgment, but is encouraged by what he has seen so far.

Reverse mortgages fell out of favour with banks and borrowers over the past decade because of their complexity and expense.

But with about four million Baby Boomers currently aged over 65, and 8.8 million by 2057, there is increasing demand for a credit, or equity, product enabling property owners to tap into their equity.

New providers, such as ME Bank, are moving into the market with different types of products, such as "reversion schemes" that provide a lump sum repaid upon death as a percentage of property sale proceeds.

Other new schemes include "fractional release", which allows a property owner to sell equity in their property.

Investors in a senior equity release receive monthly rental income of 3 per cent (net of all fees) and "own" a share of the capital value through units in a segregated sub-fund, according to DomaCom, an investment company.

When the property is sold, the vendor and investors receive their share of the sale price. This can happen when the vendor dies, or if they decide to move.

Another way to unlock capital is to downsize, which involves costly and time-consuming property transactions. Increasingly volatile property markets mean it might be hard to predict the outcome. **SI**

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President Trump and the Fed are best of 'frenemies'

The cut-through

Patrick Commins

"Dow Jones has best week of the year!" crowed the US President on Twitter recently.

Donald Trump's conflation of Wall Street gains and the success of his economic and trade policies is another curious feature of a most curious presidency.

The fact that his policies drive share prices is incontrovertible. Trump's massive tax cuts turbocharged earnings and growth through 2017. His trade war with China has had the opposite effect.

But analysts this year have been toying with another idea: that the relationship between his policies and Wall Street also runs the other way.

So it is that major trade pronouncements have come at times when the US sharemarket is towards the top of its trading range, research by Deutsche Bank shows, suggesting he feels emboldened when Wall Street is doing well.

More precisely, the analysis shows that Trump makes his big moves when the S&P 500 is near or past 2900 points.

The benchmark measure was around this level when he first announced tariffs in February 2018, and then again when he put a 10 per cent tax on Chinese imports around September.

His decision to lift those taxes to 25 per cent happened in early May, after a spectacular rally had once again left the US sharemarket gauge above 2900 points.

And where's the S&P 500 today? As I write it's at 2890 points.

Conversely, Trump has shown a tendency to moderate his trade war talk after his protectionist threats sink the sharemarket.

The 20 per cent sell-off on Wall Street in the final quarter of 2018 was followed by "an extended period of de-escalation" of trade rhetoric from Trump, the Deutsche analysts note. Moreover, "there were no escalations below 2650 and this naturally looks to be the Trump put level, if there is one", they reckon.

All good then: just wait for his damaging protectionist policies to push stock prices lower and perhaps Trump will rethink this whole trade war thing.

But there's a problem: the Federal Reserve is similarly sensitive to asset prices. It showed this at the beginning of this year when it signalled it would stop raising rates following that rout on Wall Street in the final months of 2018.

The sharemarket might be able to exert some discipline over the unruly leader, but the Fed will always step in to support financial markets when they wobble. In this way, the Fed's defence of the status quo extends, via the sharemarket, to enabling Trump's trade wars.

The US President seems well aware of the role the Fed can play in bailing him out of trouble. He has been quick to pile pressure on the central bank when things begin to look dicey. This week he tweeted that the "Fed interest rate is way to high" and that Fed officials "don't have a clue".

So what could be the circuit breaker? The obvious one that jumps to mind is the one thing that has been missing for over a decade: that former scourge of the business cycle and investors alike – inflation.

A sustained pick-up in consumer prices would allow central bankers to begin tightening monetary conditions once more.

> *In this way, the Fed's defence of the status quo extends to enabling Trump's trade wars.*

Presumably, any inflation would come hand-in-hand with desired developments: stronger wages growth and a lift in demand. This is essentially a growth-led escape from the low-growth post-GFC world.

Unfortunately there is little sign of this. The US Fed's "core" measure of inflation continues to soften in 2019. American 10-year yields remain below the short-term rate, suggesting investors see even weaker growth and inflationary outcomes ahead – perhaps even recession.

There is, however, another way we get inflation – and that's through Trump's tariffs pushing up prices for American consumers. This is bad inflation – it comes with a weaker economy and reduced household purchasing power.

Analysis by Goldman Sachs shows a stark divergence between tariff- and non-tariff-affected consumer prices, with the former moving higher after tariffs on Chinese imports were first implemented in early 2018, even as the second continued to fall.

The Goldies analysts estimate that the tariffs will lift core consumer price inflation by about 0.1 percentage points, but this could lift to 0.5 percentage points were Trump to impose 25 per cent tariffs on the roughly $US300 billion of remaining Chinese imports.

All in all, maybe not enough to move the dial as far as the Fed is concerned.

That said, modelling the impact of Trump's trade war has proved incredibly difficult, as businesses reassess their global supply chains and change investment plans to accommodate the higher taxes.

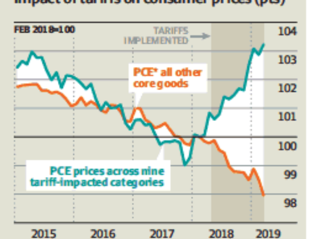
These knock-on effects are still working their way through the global economy, and this uncertainty is why investors remain so sensitive to every Trump tweet on the subject.

People have made much of the US President casting the Federal Reserve as yet another enemy. But this analysis suggests that the term "frenemy" might be a better fit.

Unhealthy relationship

S&P 500 Index (pts)

Impact of tariffs on consumer prices (pts)



*Personal consumption expenditure

SOURCE: DEUTSCHE BANK, GOLDMAN SACHS

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