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The truth on three big indexing questions

Greg Davis

Indexing has become an undeniable force in the investment world. Consider that US$1.4 trillion in net new cash and reinvested dividends flowed into US equity index funds and ETFs in the decade through year-end 2016, which is astonishing compared with the US$1.1 trillion in net outflows from active funds in the same period.

Indexing's rise did not happen by accident. At Vanguard, the improvement in index fund management included refining index sampling techniques, better approximating the fundamental characteristics of benchmarks, working closely with benchmark providers and strengthening index methodologies.

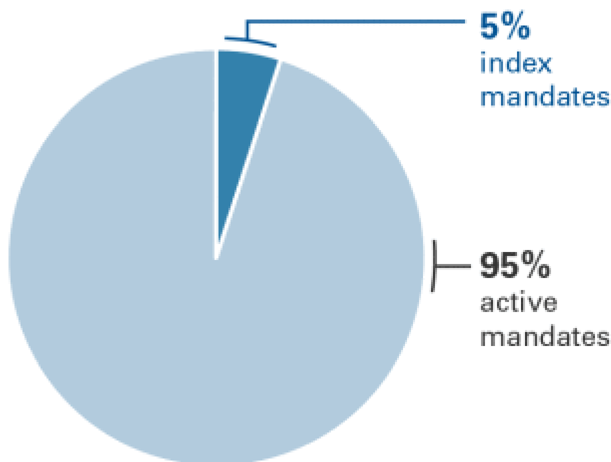
But the push to improve indexing does not stop there. In my new role as Vanguard's Chief Investment Officer, my global team and I are dedicated to staying abreast of new themes in the investment world, especially exploring the details of what makes indexing tick. Our mission is to optimise the investment outcomes for our clients and investors overall at a low cost.

I am a firm believer in the value indexing delivers to both the investor and the market as a whole. But over the last few months, indexing has received criticism from a few commentators alleging indexing hurts price discovery, stifles competition via common ownership, and leads to higher volatility. I believe those claims are inherently false, so let's walk through these arguments and set the record straight.

1. Does indexing hurt price discovery?

The concern about indexing hurting price discovery is naive. Price discovery is driven by active managers, Vanguard included. I know from my years as a bond guy the vital role that active managers play in keeping security prices aligned with their value. The thought that indexing could somehow get in the way of that is troubling for me. But the truth is that even though indexing has grown in popularity, it's still a small part of overall trading volumes (i.e. portfolio managers' trading of index funds' underlying securities). Since indexing represents about 5% or less of US equity daily volumes, as shown in the chart below, there is still considerable price discovery and liquidity provided by active managers.

Breakdown of overall individual stocks' trading volume



Sources: Vanguard and Bloomberg, 2017.

2. Does indexing cause a lack of competition?

Critics claim that managers of corporations whose stocks are in some of the leading indexes become complacent participants, rather than competitors, because stock prices are propped up by the steady drumbeat of index investments. There is no evidence to support these anticompetitive practices or that there is a cause-and-effect relationship between common ownership and product price competition. All the corporate executives that I know are diehard competitors and are doing everything in their power to expand market share, increase revenues, and boost profits.

In addition, as owners of just about every company in every industry, index funds have no incentive to favour one industry over another as higher product prices in any one industry would cut against fund investors' interests in other sectors.

We believe fierce industry competition produces greater shareholder return and a healthier industry as a whole, since competition forces companies to constantly innovate and find new ways to deliver value to both consumers and shareholders. We firmly believe the best performers should be rewarded, which is why we advocate for executive compensation plans to be tied to performance, not stock price, and have explicitly promoted competition among firms in their respective peer groups.

3. Does indexing drive volatility?

I do not see any substance to the concern that equity index funds contribute to market volatility. Regardless of size, indexing is not a monolithic investment strategy. Index investments are spread through many market caps and investment styles, and the majority of index assets are held by long-term investors in broad-based, market-cap-weighted funds. There is no convincing evidence that the growth of index funds has had an impact on market volatility or the dispersion of stock returns. Even as index funds' share of mutual fund assets has consistently grown, market standard deviation has risen and fallen in a seemingly random pattern. Dispersion among the stock market's securities has remained somewhat constant, except for the tech bubble and the global financial crisis.

The real truth: indexing has earned its accolades

Indexing has transformed the investment experience for millions of investors. We take pride in the fact that we have helped investors enjoy the many benefits of indexing, including:

- Low cost
- Broad diversification
- Relative predictability
- The potential for long-term outperformance compared with the performance of many high-cost active fund managers.

Indexing offers a firm foundation for investors seeking to achieve their investment goals, and as Vanguard's CIO, it's my job to make sure that indexing and active management continue their symbiotic relationship in the investment landscape.

Greg Davis is the Vanguard Group's global Chief Investment Officer.

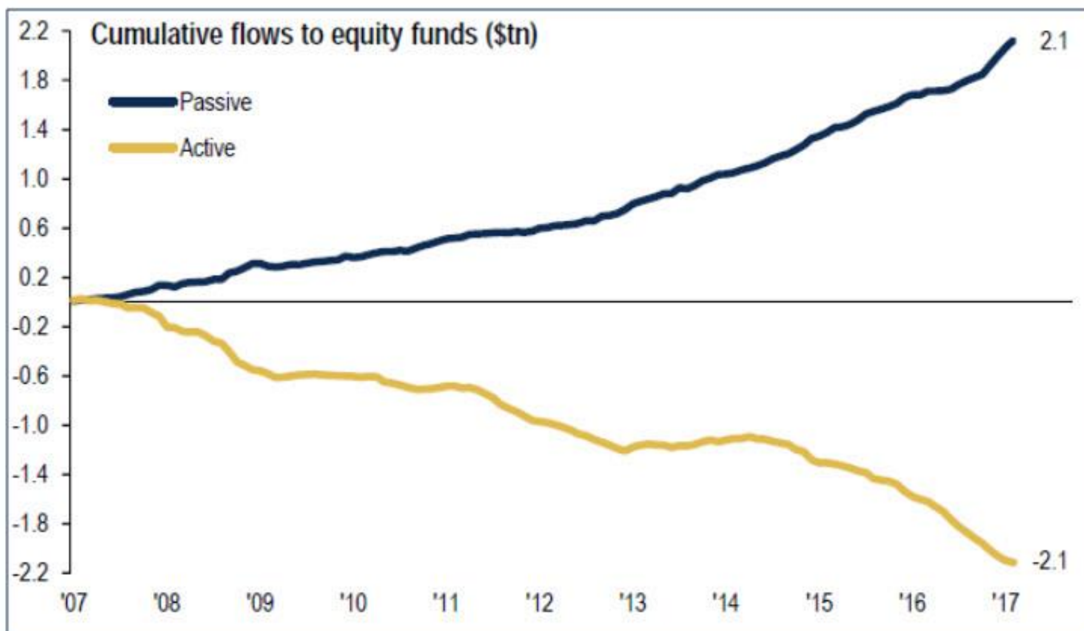
The paradox of passive investing

Greg Cooper

The rise of passive investing over the last decade has been remarkable, and the 'active versus passive' investing debate has intensified. The debate tends to focus on how much of the market is passively managed and less so on the capital flows i.e. who is buying the stock of companies and why? When stocks are being purchased without any thought to the underlying fundamentals of the company, this could create a risk to how markets operate.

Since 2007, cumulative flows into passive equity vehicles (which ignores segregated institutional accounts) have been US$2.1 trillion, offset by similar outflows from active vehicles. Passive exposure of the total market is estimated at circa 40% globally, and predicted to rise to as much as 60% over the next five years (*Deutsche Bank, 25 May 2017*). These numbers would be higher if we accounted for 'quasi' passive flows from non-market cap based index type strategies (including 'factor' portfolios).

Passive vs active equity flows since 2007



Source: Bank of America Merrill Lynch Global Investment Strategy, EPFR Global

There is clearly a benefit of low management costs that accrues to those using passive (or semi-passive) strategies. However, at what point are the benefits of low management costs outweighed by the causative effects of very large flows of capital being allocated with no reference to economic return. Is there a 'paradox of passive' so that investors have low management costs but in aggregate lower returns or higher risks? As more capital is invested with no thought behind what is being purchased, there has to be a tipping point where this irrational behaviour is no longer sustainable. When is that tipping point? We would suggest we are close to or even past the tipping point in some markets.

While the case for passive investing rests largely on the low cost (the SPDR S&P500 ETF, the largest in the world, has an expense ratio of just nine basis points, while the Vanguard total US market ETF is four basis points), investors in these strategies would do well to remember a number of points.

Value does not equal price

Passive (and semi-passive) approaches ignore value and price (and governance, capital management, etc.) as they invest on one criteria alone, which is the methodology for the construction of the index, often market capitalisation, or close to it. This creates a somewhat perverse outcome as the larger a company becomes, the greater the proportion of new money it receives. The indices on which passive investments are made, or indeed any rules-based approach, are prone to distortion.

Passive investing does not create the distortion in itself, if the index is an accurate reflection of market efficiency in capital allocation. However, if there is a distortion already or there are sufficient flows into a subsector of that index (e.g. a style or sector bias) then passive flows will amplify that distortion.

This process of correcting distortions is generally held in check by other non-passive (or active) investors, only to the extent those non-passive investors are influencing the price. That is not the case today with non-passive investors being large net sellers and passive investors being large net buyers. The distortions are complicated by non-market-cap based index investors biasing certain stocks.

Consider for example Amazon (AMZN), the market's consumer discretionary darling of the moment and the third largest stock in the S&P500 at 1.9%. The stock has risen 40% this year (versus S&P's 17.7%). It has a market cap of US$475 billion, up from US$114 billion at the end of 2012 despite poor fundamentals, a P/E ratio of over 200 times and never paying a dividend. However, it sits in at least 176 ETFs and is a top 15 holding in 117 of those.

The net result of this is that while the stock has a 1.9% market cap weight, the 'size based weight' of all the ETFs in which Amazon is listed is 2.7%. For every $1 of flow into these ETFs, Amazon receives 150% of its market cap based weight of flow. And based on filings in the US over the last 12 months, the top three passive managers have been buyers while the top five active managers have been sellers.

The risk is that if passive flows continue at their current rate, Amazon gets even more expensive, active managers underperform, passive flows get a further boost and we have a (not very) virtuous cycle.

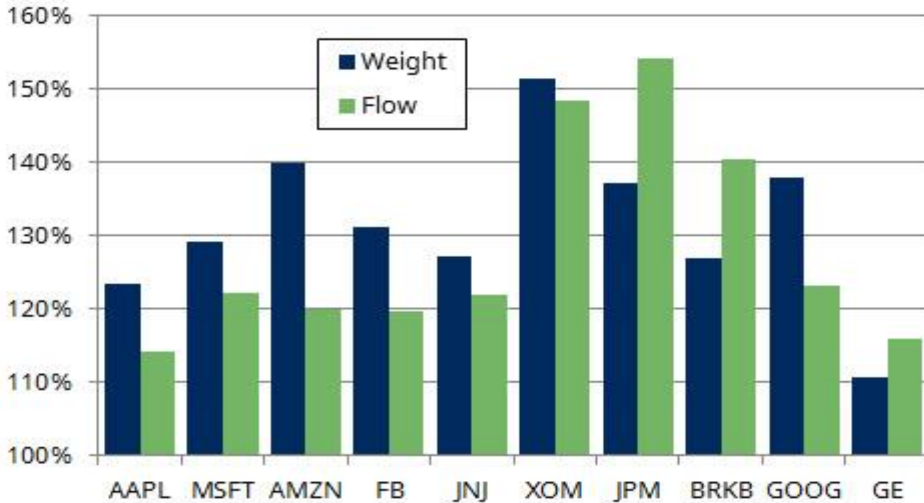
It is flow that counts

Passive exposures are still low, despite what is conceivable, but it is flows that cause prices to move, not 'stock', and these are massive. For the share registers of the top 15 stocks in the US, the dollar-weighted trading volume by grouping has been similar to the Amazon analysis with 'owners' and active managers net sellers, and passive managers, net buyers.

One method of analysing the distortions created by passive and other rules-based investment methods is to examine the weight of a stock in these indices and to compare it to its market cap weight.

To do this, we weight each component of the ETF by the aggregate dollar value in that ETF and compare the addition of these to the market cap weight. If the dollar-weighted value of the ETF holdings is greater than the market-cap weight then these passive strategies are collectively contributing to an overweighting in these stocks. We can examine this in terms of current invested dollars to gauge the impact of historical flows and in terms of recent flows. This is shown in the next chart.

Percentage of ETF weight/flow received relative to market cap weight/flow in 12 months to 6 June 2017



Source: Schroders, Bloomberg, ETF Database

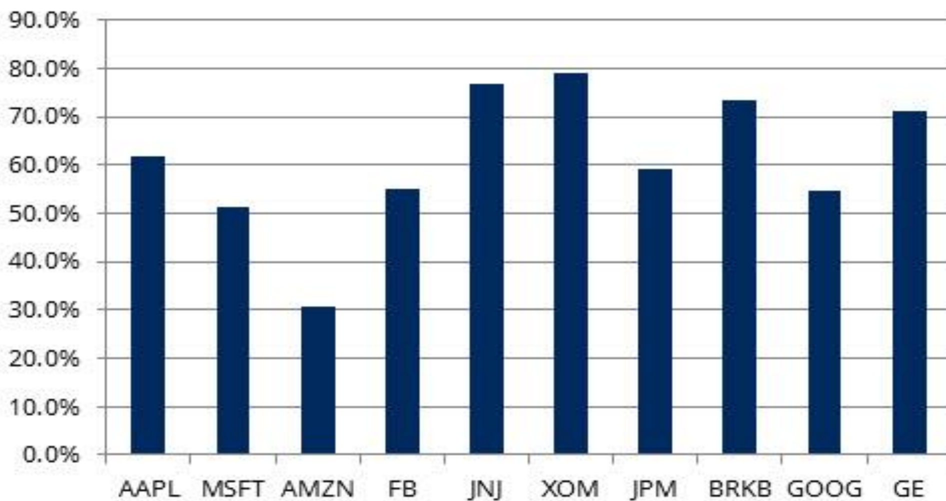
Every stock in the top 10 of the S&P 500 has received a significantly greater proportion of passive flow than its market share in the S&P500 would suggest. Their aggregate weights in all the ETFs far exceeds each stock's market-cap weight in the broad market index. For example, the average dollar-weighted value of Amazon in all ETFs adds up to 140% of its market-cap weight, implying that the historical flows into these ETFs has been at a rate 40% greater than its market cap would justify. Similarly, the dollar-weighted value of the flows into Amazon has been 20% greater than its market cap would justify.

Total portfolios can't be passive

Virtually no investors have a total portfolio that is truly passive. While Warren Buffet's estate might be largely passive in that inflows and outflows are dwarfed by the size of the corpus, the rest of us do not really have that luxury. Cash flows in and out mean that almost all investors have an active approach to their overall investment strategy. A low-cost strategy makes sense but investors should have regard to the way these pieces fit together, with some understanding and management of the components.

As the proportion of passive investment grows, the rigour applied in terms of governance and other issues is reduced. How often do passive, or other rules-based strategies, vote against management? It's an issue when passive investors are the largest holdings of these major companies.

Percentage of the top 10 shareholders that are passive (as at 31st March 2017)



Source: Schroders, Bloomberg

Conclusion

While we understand and generally concur with the desire to implement portfolios cheaply, investors should be cognisant of what they are buying. It is our view that the flows into passive and quasi-passive vehicles are having a distortive effect on markets at the moment and this is always prone to sudden reversals. Just as investors have jumped on the cheap bandwagon, the paradox of passive is that it could turn out to be an expensive mistake.

Greg Cooper is CEO of Schroders Australia and Global Head of Institutional. Opinions, estimates and projections in this article constitute the judgement of the author as of the date of writing. They do not necessarily reflect the opinions of Schroder Investment Management Australia Limited or any member of the Schroders Group and are subject to change without notice.

Investment innovation beyond the status quo

Raewyn Williams

Large super funds in Australia recently reported their eighth consecutive financial year of positive investment returns, with the median growth option delivering 10.7% over 2016-17 (source: Chant West). All investment options have met their long-term objectives since leaving behind the tough years of the GFC. While this is good news, our new research shows it is for investment success to breed complacency.

Larger funds have a great store of resources and experience, so it seems they are well-placed to search for, test and embed new investment ideas. But the irony is that large funds face innate headwinds in thinking innovatively and may in fact be leaving it to their smaller counterparts to develop the investment ideas of the future.

Status quo traps

These headwinds to investment innovation are identified in our research on 'status quo thinking traps'. Larger funds have built knowledge and processes around the historical markets for their products. This includes investing a superannuation contribution stream on behalf of disengaged members to generate a lump sum payout to these members once they retire. Larger funds represent hold $1.3 trillion of superannuation capital which is no small investment pool!

So what's the status quo?

1. Same investment processes

Current investment thinking starts with a strategic asset allocation framework, adds active or passive philosophies across the asset classes and a currency hedging belief, then selects managers across the asset classes to run slices of the investment portfolio, often with the help of an asset consultant. Funds may cite their post-GFC investment success as the reason to continue investing this way. There is an organisational impetus to continue investing this way which can make it difficult to adopt new investment ideas and genuinely innovate.

2. Familiarity of current structures

The larger the fund's stake in the $1.3 trillion capital pool, the more its resources, processes, organisational structure and cultural values are built up around this existing way of investing. There is familiarity around these investment paradigms and it is easy to make decisions *inside* the paradigms that maintain the overall structure; for example, moving from active to passive, placing pressure on management fees, changing a manager or adjusting the fund's currency hedging ratio.

3. Incremental changes only

Changes like these are no doubt valuable and funds think intelligently and then manage their governance processes well to implement these investment changes. But in our experience, what a large fund might call a 'big' or 'innovative' change is,say, changing the asset allocation, moving from pooled funds to separately

managed accounts, or recognising a new asset class like private credit, US municipal bonds or emerging markets small caps. The problem is that these changes are fairly incremental, not *really* that big or innovative.

If the investable markets or investment problems of the future prove to be different from the past, these funds are only inching forward on the journey from 'here' to 'there'.

Changing investment horizon

Our concern is that the horizon for large fund investing does suggest significant differences from the past, including:

- Expected lower growth and yield in investment markets than historical averages
- Flows to factor-based investing and other 'smart beta' trends
- Ongoing nervousness about volatility, country shocks from political risk, climate change
- Investment objectives focused on yield (not growth or total return)
- Shift from mass accumulation to mass decumulation
- Fragmenting investment risk appetite and, indeed, definitions of risk
- New investment fees and costs transparency and accountability (RG 97)
- The rise of Responsible Investing (ESG, values-based) approaches
- The ageing population and governmental pressure to address longevity risk
- Capital flows generated by 'robo-advice' and DIY investors
- Insourcing of some investment management by funds
- Capacity constraints due to the amount of capital in Australia's superannuation system.

Innovations are needed to face these challenges

Meeting these (and other) investment challenges requires thinking not just within the existing paradigms, but beyond the paradigms themselves. Genuine innovation in investing could look at matters like:

- *Instead of an optimal investment risk/return blend,* introduce investment efficiency and portfolio transparency as third and fourth dimensions.

- *Instead of dividing managers into active or passive,* create a spectrum of manager strategies that span the continuum of possibilities between pure market-cap passive, enhanced passive, smart beta and 'systematic alpha' approaches, right through to active managers targeting pure 'idiosyncratic risk' from stock insights. There are additional levers to pull around active tax management (or not) within these possibilities.

- *Instead of choosing between investment outsourcing and insourcing,* break up and re-optimise all sourcing arrangements based on their components. This includes thinking about re-positioning a fund as the 'investment ideas generator' and working with a specialist implementation partner.

- *Instead of slotting investment opportunities into asset class buckets,* target common underlying risks or themes (for example, interest rates) that transcend asset classes.

- *Instead of investment trading done independently by each of the fund's managers (sometimes in opposition to each other),* centralise trading to eliminate redundant trading and create a whole-of-portfolio view for the fund rather than a collection of manager slices.

- *Instead of starting with a market-cap portfolio and introducing 'tracking error risk',* start with a reference portfolio that reflects the real, asymmetric risk preferences of superannuation members (limited volatility and downside risk, full upside risk).

The potential payoffs from genuinely innovative ideas are lucrative because they will deliver over and over again. The long-term investment horizon of super funds and many other investors would powerfully leverage the value of any such rewards. The investment success of large super funds to date could help them think boldly and confidently about what is needed for the future … or it could trap them in the investment paradigms of the status quo.

Raewyn Williams is Managing Director of Research at Parametric Australia, a US-based investment advisor. This information is intended for wholesale use only. Parametric is not a licensed tax agent or advisor in Australia and this does not represent tax advice. Additional information is available at www.parametricportfolio.com.au.

Bond demand is dumb, dumber and dumbest

Jonathan Rochford

One of the classic signs that the strong credit cycle is nearing its end is that borrowers that should not be getting financed are not only raising money, but doing so on terms that seem crazy. I have recently written about the silly things happening in global high yield debt, Chinese debt and the global attitude to sovereign debt. Continuing this theme are recent examples of emerging market sovereign debt in Greece, Argentina and Iraq. Each of these should not have been funded, but the desperation for yield saw all three achieve crazy funding levels. Here are the details to show how investors have gone mad.

Argentina

In June, Argentina sold $2.75 billion of US dollar denominated 100-year bonds at a yield of 7.92%. This was a mere 5.18% yield pick-up over 30-year US Treasuries. Argentina has a long history of defaulting on its government debt, including four defaults in the last 35 years. The 2001 default took 15 years of negotiation and litigation to resolve, with most bondholders losing their shirts and a few who bought late and fought hard achieving extraordinary returns.

The current outlook shows that not much has changed for Argentina. Inflation is running at over 20% and the government is aiming to cut the deficit this year to 4.2% of GDP, hoping to stimulate the economy out of recession. Investors are banking on the recent change in government to increase foreign investment and see sound economic management implemented. The need to reduce politically popular subsidies will be a major hurdle to that plan. S&P's rating of "B" and Moody's at "B3" reflect the country's weak credit profile. Taking all of this into account, Argentina is unlikely to get through a decade without defaulting, let alone 100 years.

Greece

In July, Greece sold €3 billion of five-year bonds at 4.63%, a 4.78% yield pick-up relative to five-year German government bonds. Investors have particularly short memories on Greece's debt, with the 2012 default seeing bondholders take losses of around 75%. The 2014 issue of five-year bonds traded as low as 56% of face value, a horrible ride for those who bought into it. The constant negotiations for further bailouts always come with the threat that Greece will not make further concessions and this time the Europeans and the IMF might have had enough.

Greece's position remains precarious as debt to GDP currently stands at 179%. The economy has been stagnant for years as its government continues to resist the structural reforms proposed by the IMF and Europeans. Some are optimistic as Greece recorded a primary surplus (before interest expenses) in 2016. Unlike the buyers of the recent bond issue, S&P (B-) and Moody's (Caa2), do not see a good prospect of Greece paying back its creditors.

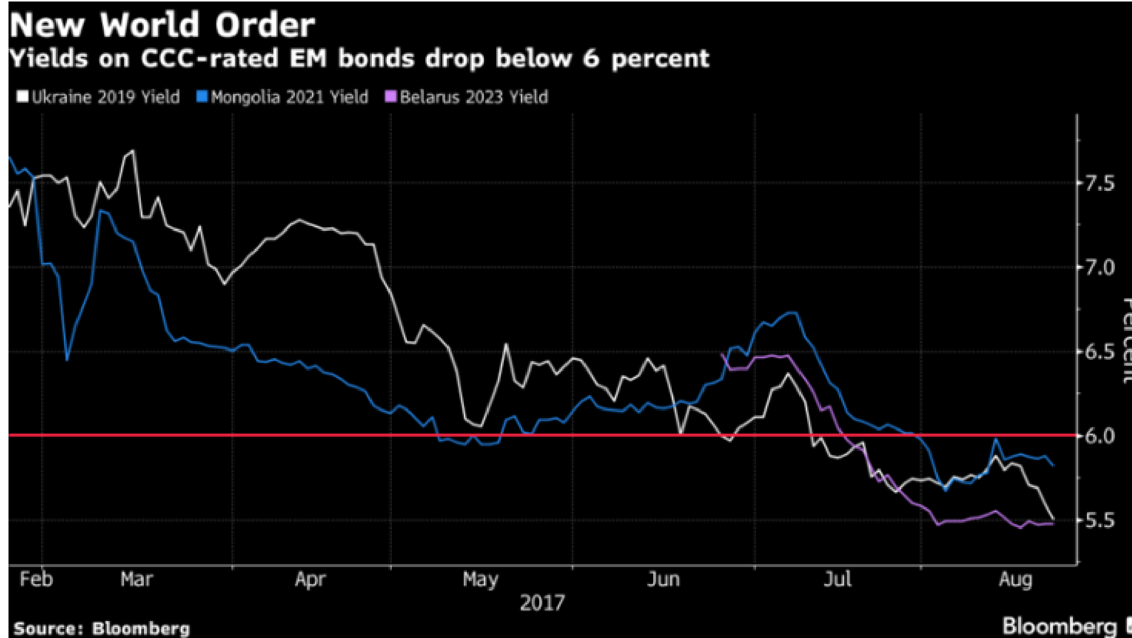
Iraq

In early August, Iraq sold $1 billion of five-year bonds at 6.75%, a 4.93% premium to US Treasuries. Iraq faces three major medium-term issues: the ongoing war, export revenues reliant on oil prices and dependence upon military and financial support from the US government. Each of these is out of its control. The 2016 deficit at 14% of GDP shows Iraq clearly cannot service its debts without a substantial financial turnaround. By buying the bonds, investors have effectively banked the equity case of the war ending and oil prices improving. The credit ratings from S&P (B-) and Moody's (Caa1) are a better reflection of Iraq's economic prospects.

Conclusion

In considering emerging market debt, investors must consider each country on its own merits. In the examples of Argentina, Greece and Iraq, bond buyers have suspended sceptical analysis. They have banked the equity case, hoping for a substantial change from historical precedents, even though they will not get a share of the upside if the rosy scenario occurs. The examples are not unusual, as shown in the graph below from Bloomberg. Belarus, Mongolia and Ukraine are all CCC-rated but have bonds yielding less than 6%.

Yields on CCC-rated emerging market bonds



These examples point to the greater fool theory playing out in many credit markets. We have now reached the point in the credit cycle where further gains seem dependent upon more dumb money arriving and pushing spreads even tighter. Calling the top of any cycle is nearly impossible, but calling out the current higher risk/lower return environment is simply common sense.

Jonathan Rochford is a Portfolio Manager at Narrow Road Capital. This article has been prepared for educational purposes and is not a substitute for tailored financial advice. Narrow Road Capital advises on and invests in a wide range of securities.

LIC reporting season wrap for 2017

Peter Rae

Our key measure for assessing listed investment company (LIC) performance is total portfolio return, being growth in pre-tax NTA plus dividends. However, we also look at reported earnings as they are a key driver of dividend payments.

LIC dividends hold up despite earnings pressures

For the reporting season recently finished, 14 of the 24 LICs we cover that reported full year results saw earnings decline due to lower dividend income (in the first half of the financial year), particularly for those LICs that have capital account status. There was also lower portfolio capital appreciation for those LICs that report changes in portfolio value as part of their earnings. Dividend income rose in the second half of the financial year due to a recovery in dividends from the resources sector and dividend increases from many large industrial stocks, particularly in the Healthcare sector. The top two performing LICs from a portfolio returns perspective, Australian United Investment (ASX:AUI) and Diversified United Investment (ASX:DUI), both reported higher earnings.

Despite some earnings pressures, there were few reductions in dividends paid by LICs for the FY2017 period, as most LICs have a level of profit reserves that enables them to smooth dividends by holding back when profits are strong. There were four LICs that reduced dividends, seven held flat and 12 increased. Amongst the four largest LICs, Australian Foundation Investment Company (ASX:AFI) held its dividend flat, Argo Investments (ASX:ARG) and Milton Corporation (ASX:MLT) delivered modest increases, and Djerriwarrh Investments (ASX: DJW) reduced its dividend due to a decline in dividends received and lower options income.

Most of the dividend increases came from LICs that invest in the mid small and micro cap space. Standouts were Perpetual Investment Company (ASX:PIC) which increased its total FY2017 dividend from 2.8 to 4.7 cents per share, fully franked, and QVE Equities (ASX:QVE) which increased from 3.3 to 4.0 cents per share, fully franked. Both LICs reported higher earnings and good portfolio returns. There were increases from the Wilson Asset Management LICs, WAM Capital (ASX:WAM), WAM Research (ASX:WAX) and WAM Active (ASX:WAA). The Contango managed LICs, Contango MicroCap (ASX:CTN) and Contango Income Generator (ASX:CIE) also increased dividends but we have some concerns about the sustainability of the CTN dividend given poor portfolio performance.

Top performing LICs at a discount

Three Australian large cap focused LICs have delivered the best portfolio returns (pre-tax NTA plus dividends) in this sector over five years. At the end of July 2017, all were trading at discounts to pre-tax NTA. Whitefield (ASX:WHF), Diversified United Investment (ASX:DUI), and AMCIL (ASX:AMH) have delivered five-year returns in excess of the S&P/ASX 200 Accumulation Index five-year return of 10.7% p.a. and all have at least matched the 5.1% three-year return from this index.

Whilst these LICs are currently trading at discounts, they have all traded at discounts on average over the past three years, so there is no guarantee the discount will be eradicated. Catalysts for narrowing in the discount could include continued good portfolio performance or increased marketing and investor communication by the LICs. Here are further insights into these top performers:

Whitefield (ASX:WHF) - exposure to Australian Industrials

WHF is externally managed by the White Funds Management Group, but has the appearances of one of the older style LICs, having been founded in 1923. Its management expense ratio is relatively low at 0.37%. WHF uniquely only invests in Australian Industrial shares, resulting in lower relative volatility by excluding resources shares. WHF has a proprietary data base and structured quantitative analytics framework which provides a unique platform to assess stocks and implement its investment strategy. WHF has a diversified portfolio containing more than 160 stocks, although its top 10 stocks account for 46.6% of the portfolio, broadly in line with the benchmark index.

Performance tends to track the S&P ASX Industrials Accumulation index, with the portfolio having a low tracking error, although its beta is slightly above market. With no ETF that specifically provides Industrials exposure, WHF is a cost-effective option for investors looking for this type of exposure. The share price discount to pre-tax NTA of 6.8% at 31 July 2017 is broadly in line with the three-year average discount and represents a reasonable entry point for long-term investors. The company has paid a 17 cents per share p.a. dividend since FY2009. While dividends have been consistent, an incremental increase in dividends may assist with narrowing the share price discount to pre-tax NTA.

Diversified United Investment (ASX:DUI) - Australian large-caps with some international

DUI is an internally-managed LIC which listed on the ASX in 1991. It has a very low management expense ratio of 0.13% with the Board effectively acting as the portfolio manager. The portfolio is heavily weighted (over 70%) to Australian large cap shares. However, DUI also provides some exposure to offshore markets targeting 10-15% in international equities, gained through investment in international ETFs. There is also modest exposure to small caps at around 5% of the portfolio.

DUI is one of the best performing LICs over the 12 months to 31 July 2017 with the portfolio (pre-tax NTA plus dividends) generating a return of 10.5% versus the S&P/ASX 200 Accumulation Index return of 7.3%. The portfolio has also outperformed on a five-year basis and over the long-term, with the portfolio generating a return of 4.0% versus the benchmark index of 3.6% for the ten years to 30 June 2017. DUI was trading at a 4.5% discount to pre-tax NTA at 31 July 2017 compared to a three-year average of 6.1%. However, investors need to be aware that the Board makes changes to the asset allocation from time to time.

AMCIL (ASX:AMH) - a blend of large and small stocks

AMH is run by the same team that manages Australian Foundation Investment Company (ASX: AFI), but has less of a focus on large caps than AFI. AMH invests in companies of all sizes with around 45% of the portfolio invested in S&P/ASX50 stocks with the remainder in mid, small and micro cap stocks. Whilst the largest sector exposure is to financials, the portfolio is significantly underweight the major banks. AMH pays one dividend each year (3.5 cents per share fully franked in FY2017) so its shares are more suited to investors looking for long-term capital growth. The portfolio significantly underperformed over the 12 months to 31 July 2017 given

underweight positions in the strongly performing resources, energy and banking sectors. With AMH holding a weighting of 33% in small and micro cap stocks, performance was also impacted by the relative underperformance of these market sectors. Over the long term, the portfolio has significantly outperformed delivering a 10-year portfolio return of 7.6% versus the index return of 3.6%, although tracking error has been higher than some of its peers. At 31 July 2017, AMH was trading a slight discount to pre-tax NTA, consistent with its three-year average.

Peter Rae is Supervisory Analyst at [Independent Investment Research](). This article is general information and does not consider the circumstances of any individual.

Why the times suit active fixed interest

Jay Sivapalan

It is hard to believe, but back in August 1982, the Australian cash rate averaged 16.95% (the unofficial rate as high as 19%) and the yield on a 10-year Australian government bond was 16.5%. 35 years later, the cash rate is 1.5% and the yield on a 10-year government bond is around 2.6%.

Over this period, the Australian fixed interest sector has been in a structural bull market, propelled by the shift from a high to low inflation environment and demographic factors which lowered real rates. More recently, conventional and unconventional monetary easing has driven yields even lower.

For investors in the sector, the last 35 years have generated handsome returns, even allowing for the 1994 bond bear market. Returns of 9.5% p.a. compare favourably to 12% p.a. from the Australian share market and 7.6% p.a. from cash over this period.

Chart 1: 10 year Australian government bond yield and Australian cash rate

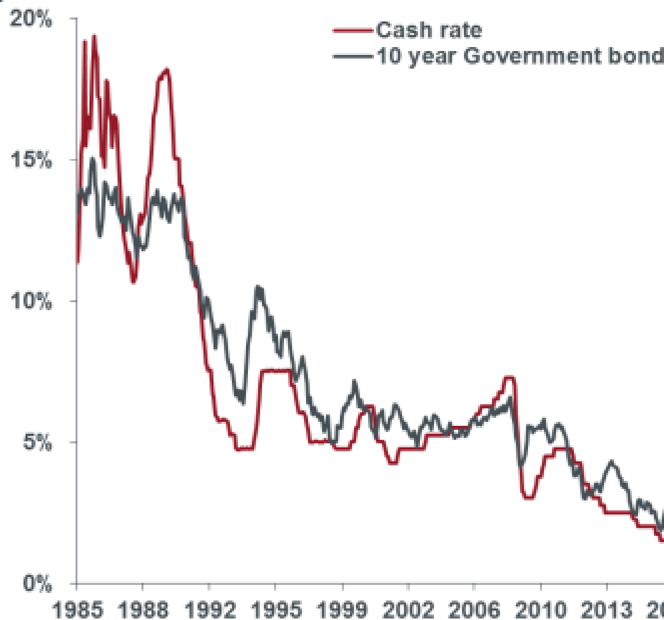
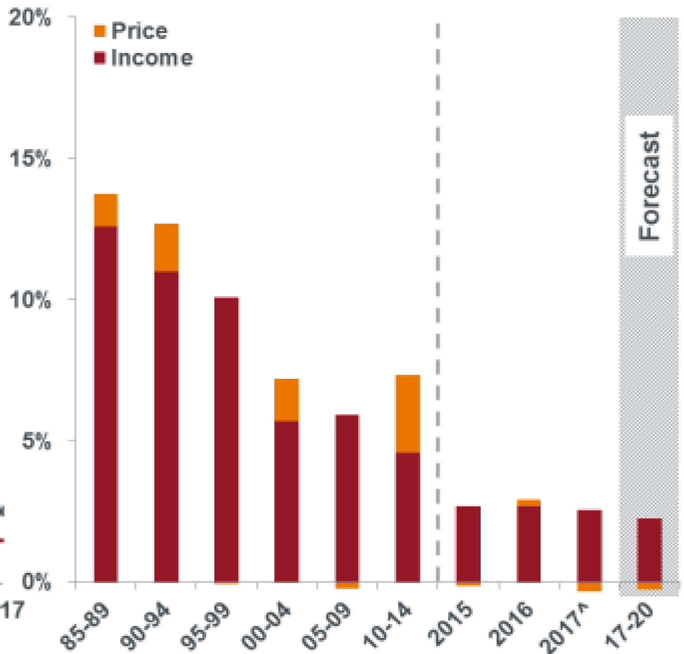


Chart 2: Bond total returns



Source: Chart 1: Bloomberg, as at 30 July 2017. Chart 2: Source: Janus Henderson Investors, Bloomberg, Ausbond Indices, UBS, SBC Brinson. Spliced history of Australian Bond market returns. As at 30 June 2017. Forecast numbers are estimated projections only. ^CYTD 2017.

Beware the bull complacency trap

A common trap that investors can fall into is becoming complacent about the risks that may be building up in their sector exposures after a prolonged period of structural change and good returns.

With the global economy enjoying a cyclical recovery and central banks signalling a desire to begin withdrawing high levels of policy accommodation, investors' attention should focus on two sources of risk embedded in the sector benchmark, the Bloomberg AusBond Composite 0+ Yr Index (benchmark) that have built up progressively since the GFC.

Lengthening benchmark duration = more interest rate risk

Just because the level of interest rates is low by historical standards does not mean that a small rise in rates will have a limited impact on sector returns. Investors need to be aware that since 2009, the duration (a measure of maturity term) of the Australian fixed interest sector has risen from around three years in mid-2009 to around five years currently.

In 2009 when bond market yields averaged around 5.5% and duration was three years, investors' exposure to interest rate risk was such that a 1% rise in bond yields would have resulted in capital loss of 3%, delivering a total return of around 2.5% (i.e. the income of 5.5% minus the capital loss of 3% from rising bond yields).

Today, with average bond market yields of around 2.5% and the duration of the benchmark around five years, a 1% rise in bond yields would result in capital loss of 5% delivering a total return of -2.5% (i.e. 2.5% income less 5% capital loss). A 0.5% lift in yields would result in flat returns (i.e. 2.5% income less 2.5% capital loss).

Chart 3: Australian average bond market yield and modified duration

Source: Bloomberg, as at 11 August 2017. Date is monthly to December 2016, daily from January 2017. Australian bond market based on the Bloomberg AusBond Composite 0+ Yr Index.

With the RBA Governor indicating that the next move in rates is likely to be up, investors need to be mindful of the interest rate risk in the sector benchmark. Over the last few years, investors in passive fixed interest products have enjoyed a good run as interest rates fell and the duration of the benchmark lengthened.

Looking ahead, investors in such strategies need to be aware of their exposure to capital loss from even modest rises in rates. By way of example, the yield to maturity on the benchmark lifted from 1.98% at the end of July 2016 to 2.43% at the end of July 2017. With the duration of the benchmark at historically high levels, resultant capital loss more than offset any income, with returns down 0.24% over the period.

We believe active fixed interest strategies or absolute return strategies, where managers are not bound to hold duration at benchmark levels, are better positioned to preserve investors' capital in a rising rate environment.

Benchmark compositional risk: lower-returning government debt, less diversification

Since the GFC, there has been significant change to the composition of the Australian fixed interest benchmark. The heavy issuance of increasingly longer-dated government debt (federal, state, supra national) combined with corporate deleveraging has hastened the 'crowding out' effect in the benchmark. As a result, the market weight of the higher-yielding credit sector in the benchmark has fallen from 36% in 2008 to around 8% in 2017 currently.

Investors in passive index strategies have progressively lost access to both the higher yields available in the credit sector and diversification benefits of broader holdings in the benchmark. Longer-dated government debt has increased the interest rate risk. The past year highlights the importance of interest rate management in navigating the gradual reversal of the bond bull market.

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Six ways to improve your term deposit outcome

Graham Hand

Investors who want a secure place to keep their money without any market risks are faced with meagre choices. The cash rate is only 1.5%, and term deposit rates are around 2.5% for most terms, which is barely higher than inflation.

Yet term deposits and cash accounts are the mainstay of most personal investment portfolios, including about 30% of the assets of self managed super funds. With such low rates, investors need to rethink their term deposit rollover strategies and not simply accept the poor rates offered by their bank at maturity time.

The power of 'retail inertia'

Back in the good old days, before political correctness, banks used to describe the willingness of customers to accept poor term deposit rollover rates as 'retail inertia'. This means that banks might have a term deposit special at 3% and rollover similar deposits at 2%. The vast majority of existing customers accepted the lower rate.

Check what it says on a typical term deposit rollover letter: "If you have a special rate, that rate will generally apply for a single term. Standard term deposit rates may apply for subsequent terms."

Which is bankspeak for: "You'll receive a lower standard rate on rollover unless you ask for a special one."

Banks also offer special bonus rates for the first four months on some at-call deposits. At the end of the four months, customers fall to the 'standard' rate, and most don't leave.

A 0.3% bonus for four months is equal to only 0.1% per annum, an immaterial cost to the bank for gathering genuine retail deposits. It's the same with credit cards and the 'six months interest free' for switching banks. They hope customers can't be bothered changing again.

Don't ignore the bank rollover letter

The term deposit rollover letter is not like the gas or electricity bill where the customer must accept the cost. There are many ways an investor can improve the outcome:

1. Critically review the rollover rate. Most depositors tick 'rollover for the same term on maturity' when they open a term deposit, and if no action is taken, the rate offered by the bank will be locked in. Most banks give a one-week grace period if the rollover date is missed.

2. Phone your bank and ask for a higher rate. First, go to a comparison website such as ratecity.com.au or mozo.com.au, and arm yourself with the highest rate. Deposits of less than $250,000 with any 'Authorised Deposit-taking Institution' (ADI) are guaranteed by the Government.

Even if the bank is not prepared to match the offer from a small credit union, the bank will probably offer more than in the rollover letter.

3. Watch changes in terms and conditions. In the past, banks allowed early access to term deposits but they have become much stricter and usually impose penalties for early withdrawal. In some cases, banks have written to customers saying funds cannot be accessed (even with a penalty) inside a 31-day notice period.

4. Consider another term, although accepting higher rates for longer terms carries risks of being locked in for longer. A five-year rate at only 3% might be too much exposure to rising rates.

5. Don't leave the paperwork until the last minute. Although banks usually nominate a grace period to negotiate a rollover, some require attendance at a branch to verify a variation.

In today's online and mobile world of banking, it can be frustrating finding a branch just to sign a form. Also, the interest rate paid during the grace period is nominal, 0.5% to 1%, so act early.

6. Review the range of alternatives. Where term deposits once offered decent rates, now they give little more than capital security with the protection of the Government Guarantee for ADIs.

It's worth checking alternatives such as bonds, bond funds, Exchange Traded Funds or listed securities, but they come with more risk and professional advice may be useful. All investment platforms have a range of bond funds and income-based options.

Whenever you see the words 'Automatic Renewal' on a term deposit rollover, there's a strong chance you can do better.

Have you taken steps to improve the return on your term deposits?

Graham Hand is Managing Editor of Cuffelinks. This article is general information and does not address the circumstances of any individual.

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