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Term Deposits –

Have they had their day?

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We also discuss some issues for investors to consider when looking at other alternatives.

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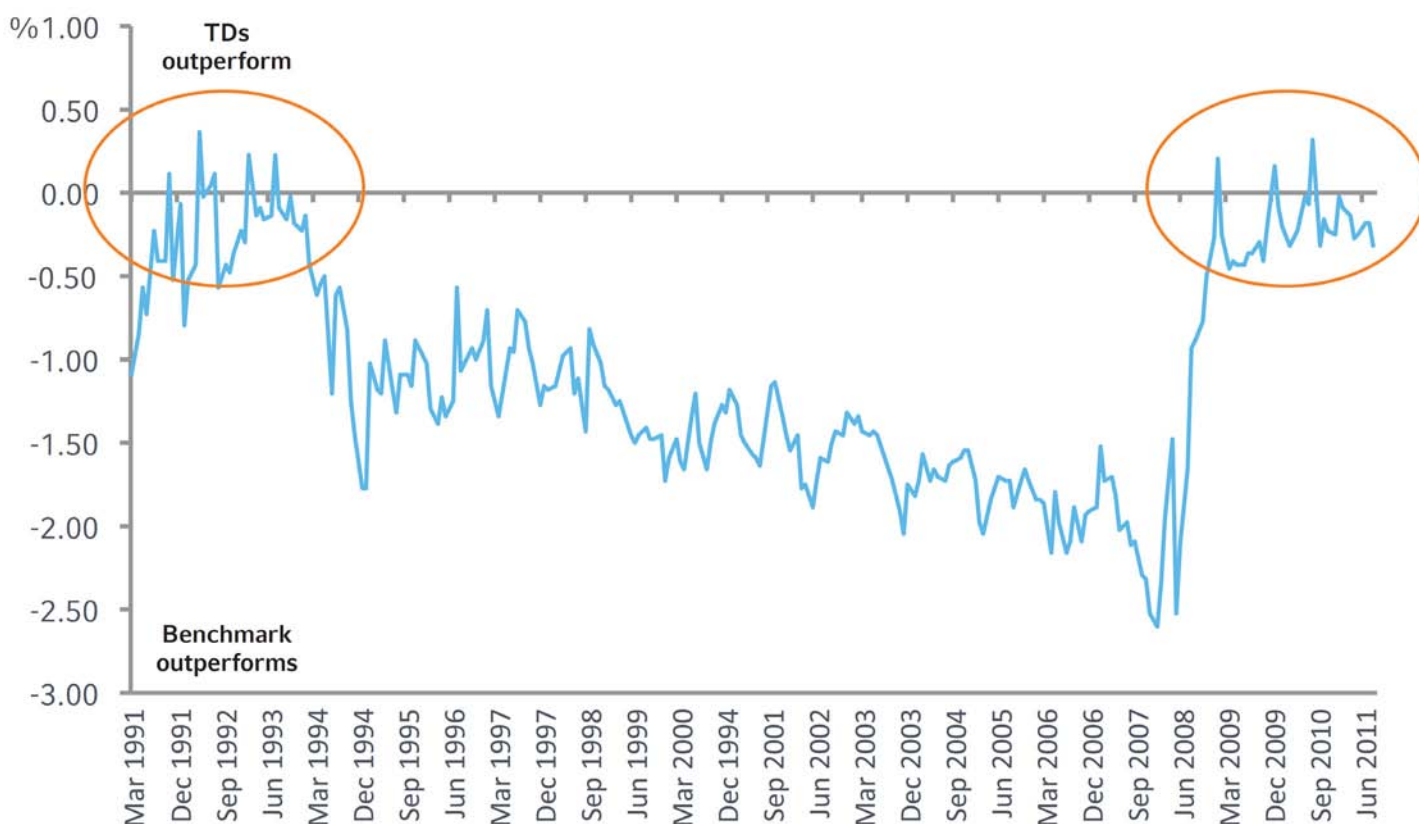
Term deposit rates are not what they seem

The period from 2009-2011 has seen banks offering historically attractive yields on term deposits ('TDs'). This has led many investors to view TDs as the cornerstone of their fixed income portfolios. While there is no doubt that recently TDs have proven to be very attractive investments, care must still be exercised by investors, especially for those with longer investment horizons.

A first step in understanding the dynamics of the TD market is to look at historical returns. We have plotted the historical spread in Chart 1.

"However, it's important that investors understand the need to look outside these 'safety' assets to other investment opportunities as markets recover."

Chart 1: Equally weighted TD yield less equally weighted government bond benchmark



Source: RBA, UBS

¹ The calculation methodology used to plot the yield spread in Chart 1 involves establishing a TD yield and a benchmark yield. For the purposes of this paper, the TD yield is an equally weighted average of 1 month, 3 month, 6 month, 1 year and 3 year rates for TDs over AUD10,000, as published by the RBA. The calculation of the benchmark uses the average yield on 1 month, 3 month and 6 month banks bills and 1 and 3 year government bond rates. The resulting differential is the spread plotted in Chart 1. The spread calculation excludes so called "special" rates as the assessment of availability is problematic.



Key drivers of returns over the past year

Chart 1 shows that TD spreads are currently at the most attractive levels seen since the early 1990's. This period also corresponded with a time during which banks were anxious to attract domestic deposits as their balance sheets and sources of funding were under pressure.

However, it can be misleading to look at TD rates in this way, because the spread calculation combines short and long TD rates. We have disaggregated the TD yield according to different terms to maturity in Figure 1 to illustrate the spectrum of opportunities in the universe.

"...TDs are still unattractive on an absolute basis when compared to alternative options such as bank bills."

For the purposes of this discussion, we have classified TDs as short dated (1, 3 and 6 months) which are considered "cash equivalents", and long dated (1 and 3 year) which are considered "fixed income equivalents". Chart 2 compares the average for 1, 3 and 6 month TDs with the average yield on 1, 3 and 6 month bank bills.

Figure 1: Term Deposits by term to maturity

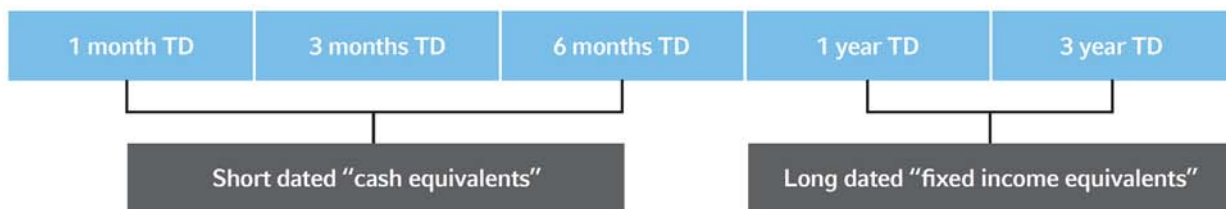
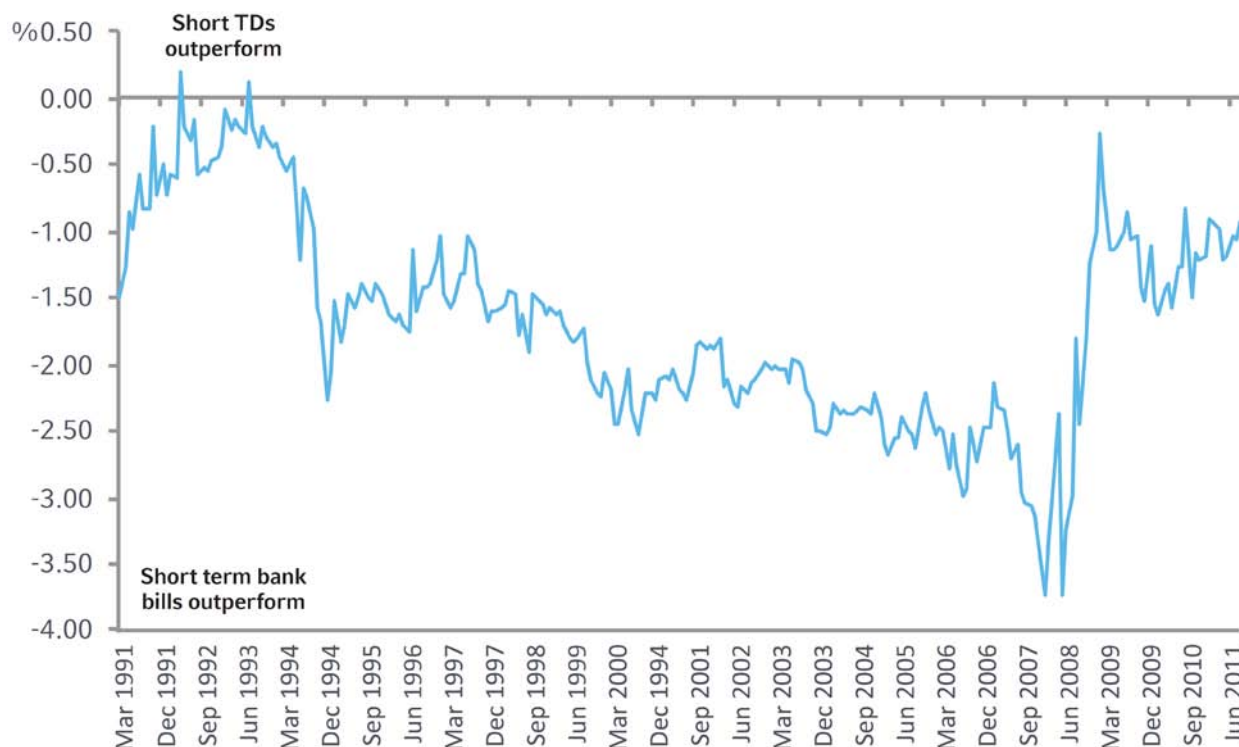


Chart 2: Equally weighted short TD rates less short term bank bills

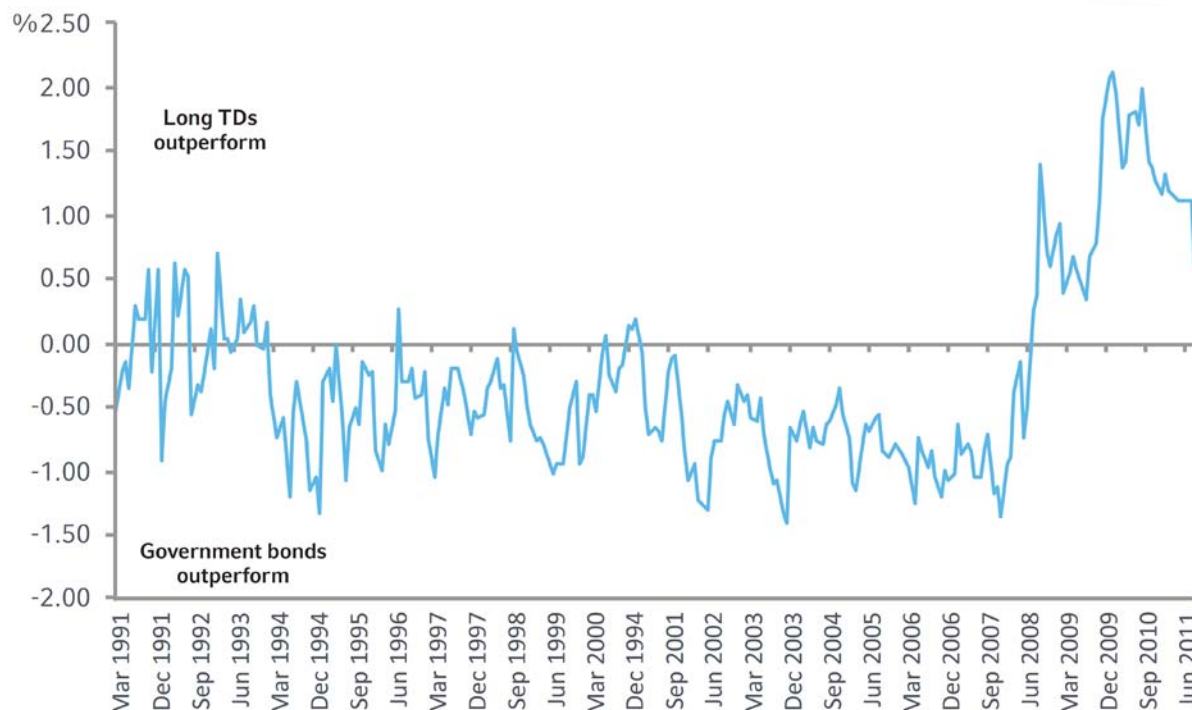


Source: RBA, UBS

Chart 2 demonstrates that while 'cash equivalent' TD rates are attractive from a historical perspective, the spread is still around 1% p.a. below the comparable bank bill rate. Effectively, for investors wanting liquid cash-like returns, TDs are still unattractive on an absolute basis when compared to alternative options such as bank bills.

This brings us to 'fixed income equivalent' TD yields, where the spread is calculated versus equivalent government bonds. Chart 3 shows that the spread between long TD rates and Government Bonds widened most significantly in the last 2 years with the GFC and ongoing market turmoil.

Chart 3: Equally weighted long TD rates vs government bonds



Source: RBA, UBS

By separating out the long and short term components of the TD spreads in this way, we have demonstrated that the relative attraction of TDs is being driven by the 'fixed income equivalent' TD yields. These longer dated TDs incorporate material levels of interest rate and credit spread risk and so, in our opinion, are not really cash equivalent investments.

In order to make a fair comparison with cash alternatives, potential costs associated with redeeming the TD before its official maturity date should be considered. These potential costs may include penalty fees, administrative fees and/or interest adjustments incurred in the event of early redemption, which may have a material impact on the returns.

Credit risk associated with Term Deposits

It's important to keep in mind that longer dated TDs also involve credit risk being assumed on the part of the lender.

It is therefore useful to compare the movement in TD spreads versus the spread on credit in general, proxied here by the Australian 5 year iTraxx contracts in Chart 4.

There are several points to note from Chart 4:

» Long dated TD rates have declined materially from the highs seen in early 2010. Will TD spreads continue to decline back to the levels seen pre GFC? This depends on the bank demand for TDs, which itself is driven by the range of funding alternatives open to the banks. In Russell's view, it is unlikely that TD spreads will decline to the levels seen pre GFC due to two reasons. Firstly, Basle III makes longer dated deposits more attractive as a source of funding and secondly, global availability of funds, and associated costs, are unlikely to return to pre GFC levels.

» TD rates are currently below corporate spreads, with the return on TDs lagging overall credit risk premiums. Further, this comparison is only valid if the TD is held to maturity; i.e. penalty changes for early redemption have not been taken into account.

» TD spreads are not following the credit spreads as set in the secondary market. This is due to the difference in pricing dynamics between traded fixed income securities. For regular fixed income markets, the existing supply is effectively fixed, with changes in lender demand driving movements in yields. With TDs, the dynamic is effectively reversed. Banks, or the borrowers, determine their demand for TDs and set a rate sufficiently high enough to attract the relevant funds; i.e. lenders are not price setters but rather price takers. This means that the TD yield is less sensitive to changes in the pricing of risk in the secondary market and more sensitive to the balance sheet requirements of the borrowing banks.

Alternative investment options for conservative investors

For conservative clients, there are other investments that provide competitive returns and income to term deposits. Any discussion regarding potential alternatives to TDs is complicated by the fact that the objectives of investors will not only vary at a point in time, but indeed will vary over time. Accordingly, investors must keep in mind that fixed income markets comprise a diverse range of investment opportunities each with varying risk/reward characteristics. As highlighted by Figure 2, TDs are just one aspect in the larger opportunity set.

Key drivers of returns over the past year

Chart 4: “Fixed income equivalent” TD spread versus Australian 5 year iTraxx spread

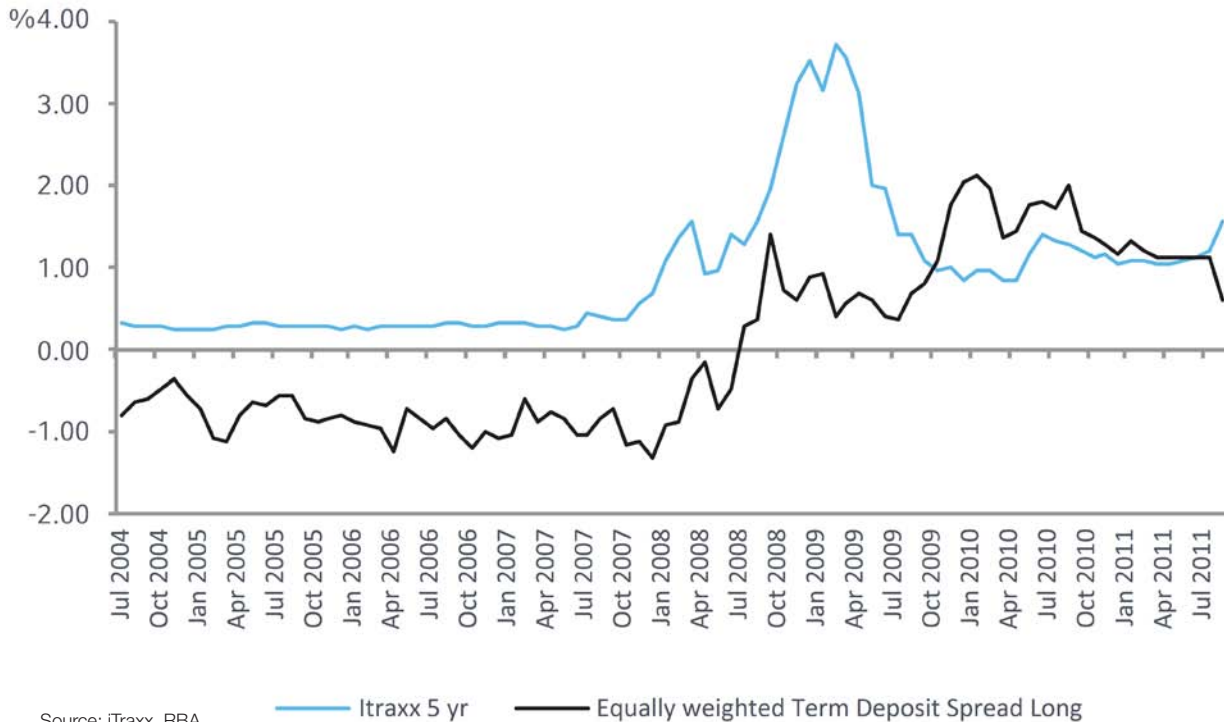
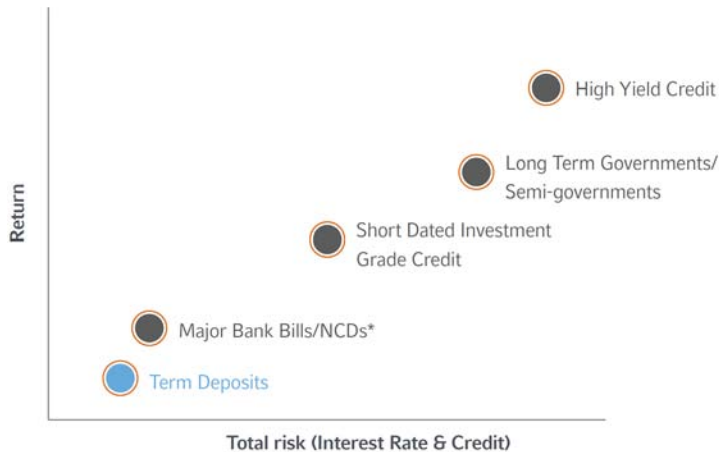


Figure 2: Stylised Fixed Income Opportunity Set: Risk & Return Spectrum



Given the diversity in opportunities, the important issue for investors is ensuring that the mix of fixed income investments chosen is consistent with their investment objectives. In achieving this objective some of the key points for investors to keep in mind are:

- » Clearly understand the investor's objectives, desired returns and acceptable risks;
- » Understand the risks and returns associated with the different opportunities in the fixed income universe;

- » Structure fixed income investments so that they are compatible with the desired risk/reward outcomes; and
- » Ensure that there is sufficient flexibility/liquidity so as to be able to take advantage of opportunities as they arise.

Viewing TDs in the context of a structured approach to fixed income investing highlights that they are not necessarily the “silver bullet” they may often be portrayed as. Rather they are simply another part of the fixed income universe whose relative attraction and compatibility with investor objectives will be subject to change over time.

Conclusion

While investors have embraced TDs as a safe haven during the Global Financial Crisis and the ongoing market volatility, most of the opportunity to enhance returns comes from longer dated TDs which have similar characteristics to fixed income. Accordingly, investors need to be aware of the relatively limited liquidity in such securities and the level of returns available on other income generating alternatives when deciding how much to invest in TDs.

“Term Deposits are not necessarily the “silver bullet” they may often be portrayed as.”