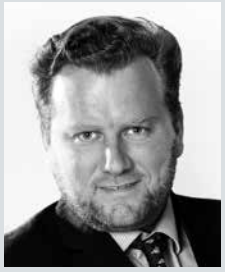

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Christopher Joye
portfolio manager,
YBR Funds
Management

Give cash a boost

With interest rates at record lows, many advisers are scratching their heads wondering how to get a better return on clients' cash, without materially increasing risk. More actively managed cash portfolios made up of term deposits and investment-grade floating rate notes could provide the answer.

With the Reserve Bank indicating its official cash rate could stay at a record low 2.5% well into 2015, investors are faced with two difficult choices. Either leave their cash wallowing in low paying term deposits, gaining little against the rate of inflation, or shift up the risk spectrum in search of more fruitful investments but at the cost of potential capital losses.

YBR Funds Management portfolio manager Christopher Joye says that for advisers and clients who are willing to educate themselves, it's possible to have the best of both worlds – additional returns on a portfolio of "active cash" investments without undue increases in risk.

Joye explains that investors can avoid the traditional capital risks associated with fixed-rate bonds by investing in floating-rate notes, which have interest rates that get reset every quarter off the bank bill rate that in turn tracks the cash rate.

A five year fixed-rate bond is like investing in a five year term deposit, he explains. In contrast, floating-rate notes are like 90 day term deposits and remove the big punt on interest rates that you get with long-dated fixed-rate bonds.

"With a floating-rate note you are not taking a long-term bet on interest rates. They therefore have much lower capital risk, which is highlighted by the fact that Australian floating-rate notes have historically displayed volatility of less than 1% per annum compared to closer to 5% per annum for fixed-rate bonds."

Senior-ranking floating-rate notes with less than 12 months to maturity issued by Australian banks are technically classified as "cash". And some can actually be safer than deposits for sophisticated and high net worth investors.

"Once you go beyond the government guarantee of $250,000 you are taking direct bank credit risk. A deposit is just an unsecured loan to the bank – investors sometimes forget that. There are, in fact, some floating-rate notes that are arguably safer than deposits."

One example Joye cites are the AAA rated, floating-rate covered bonds issued by the major banks. These have both higher credit ratings than the banks themselves (AAA versus AA) and are secured bonds – as opposed to unsecured deposits – insofar as the banks have to pledge a specific pool of assets to protect or "cover" the bonds. The problem, of course, is that these securities are only available in the wholesale bond market and not listed on the stock exchange. But in early 2012 they were paying interest rates equivalent to 3.75% today with daily liquidity (the market for these bonds is very active).

Low hanging fruit

Retail investor portfolios tend to be polarised between cash, equities and property because they are easy to understand and manage. Meanwhile, floating-rate notes and fixed-rate bonds have traditionally been the domain of wholesale investors with minimum investment sizes of $500,000.

But today, because of recent reforms, more and more rated bonds are being listed on the ASX.

"There is low hanging fruit for investors and advisers to get return outcomes that are significantly superior to traditional cash deposits with only a modest increase in risk," explains Joye.

He advocates creating a risk and return bridge between the "polarities of cash and equities" by allocating to a variety of fixed income investments, including traditional cash, floating-rate notes, AAA-rated asset backed securities and, with more caution, fixed-rate bonds that carry those implicit interest rate bets. Joye argues this affords investors exposure to a "more optimal continuum of risk and return outcomes compared to the traditional cash and equities book-ends".

Active cash

Naturally, understanding the relationships between all these investments and even which ones to invest in, takes a lot of knowledge and, perhaps more important for the busy adviser with lots of clients, a lot of time too. Constantly rolling over term deposits is a well-known bug-bear.

Fortunately, there are products, such as the YBR Smarter Money fund, which allow you to put the management responsibility for the portfolio in the hands of a professional.

Actively managed cash portfolios, or short-term fixed-interest funds, invest in scores of Australian deposits and investment-grade Australian floating-rate notes. These managed solutions dynamically switch between all the different types of cash and floating-rate note assets to squeeze a little extra juice from investors' cash while also diversifying you across over a dozen banks.

Managers can add value in this space through three key routes.

The first is through active deposit management. According to Joye, cash managers have historically been quite lazy and have just tried to track the bank bill index. But in fact, there are ways to add value through negotiating supernormal excess deposit rates and optimally timing duration exposure to future interest rate movements through a term deposit portfolio, which has no capital risk.

A second key method is to try and identify mispriced floating-rate notes.

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Joye explains how: "We think the Australian fixed income market is quite inefficient which opens up opportunities for active managers to exploit price discrepancies consistently over time. There are several reasons for this. One has been the proliferation of passive, index-orientated cash and fixed-income funds given the wafer thin fee structures – for many it is too expensive to be active. The absence of comparable representation of active managers relative to what you see in say equities has meant fixed-income prices can be less efficient."

"A second reason is the opaque market structure. When you buy and sell shares on the ASX, everyone in the market knows the prices at which you trade at almost immediately. In contrast, when you buy and sell corporate bonds in the wholesale market, there's no mandated public price disclosure and that can mean the market is quite closed. In turn the absence of that price discovery can present opportunities for active managers. Like active equities managers seeking out discounted shares, we are looking for mispriced bonds in an arguably much more inefficient market."

The third alpha opportunity available to managers is through active asset allocation between traditional cash and fixed income. For example, in its own Smarter Money portfolio, YBR Funds Management has held very low cash weights – circa 20% - when credit spreads have been very wide, and capitalised on opportunities to identify cheap fixed income assets. In contrast, as credit spreads have tightened considerably, it has significantly increased its exposure to term deposits – to around the 70%-80% mark – and correspondingly reduced portfolio weight to credit and short-term fixed income. This has been a successful contrarian strategy for them.

Getting the right blend

In the UBS Australian Composite Index, the benchmark index for the domestic market, the average interest rate duration across the bonds included in the index is around 4-5 years. This means managers are taking bets on where they believe interest rates will be four to five years from now. It is like investing in a four or five year term deposit.

However, even the RBA acknowledges that it extremely difficult to anticipate the inflation rate, the jobs rate and GDP growth over periods of more than 12 months. This means the RBA actually has little visibility on where interest rates will be beyond that horizon. RBA research has also shown that neither economists nor investors can consistently get interest rate movements right beyond a year.

Joye says he prefers not to bet on interest rates over the long-run: if his portfolio management team does take a view, they use term deposits of less than 12 months that do not expose the fund to capital risk.

The Smarter Money fund also has a very conservative investment mandate. It cannot leverage its portfolio and does not invest in fixed-rate bonds, foreign bonds, equities, convertible preference shares, unrated debt, sub-investment grade debt, YBR issued securities, or derivatives for speculative purposes.

"We've been able to generate 5.9% per annum after all fees since inception two and half years ago. Over the last 12 months we've returned 4.3% after fees, while the cash rate has declined to 2.5% from around 4.25% when we started. We target returns of 1%-2% above the RBA rate after fees and we've consistently delivered on that target with sustained top decile performance," finishes Joye. **FS**