Adapt

The Low Rate GamePlan

How to Win At Investing In a Low % Environment

By Reuben Zelwer

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Thanks

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Winning the low rate game

With bank deposit rates at record lows, the challenge of generating sufficient income from investment portfolios to meet retirement needs has never been greater.

This booklet outlines the income characteristics of the major asset classes and can provide a starting point for investors considering their options for portfolio construction.

The **star system** is a quick and easy way to distinguish the benefits and risks of each asset class.

Income	Capital Risk	Income Risk	Complexity
★★★★★	★★★★★	★★★★★	★★★★★
More stars means more income	More stars means more capital risk	More stars means more income risk	More stars means more complex

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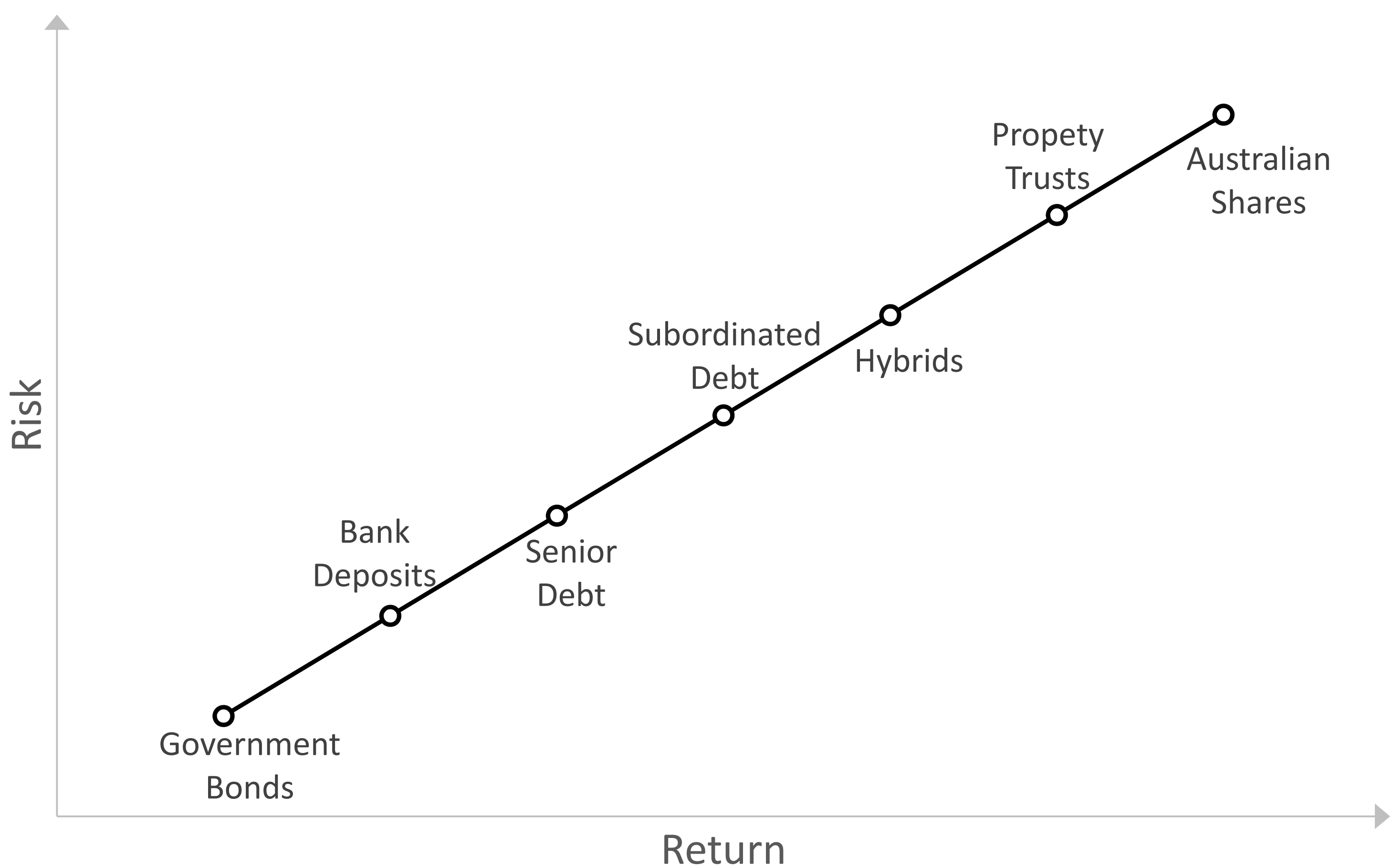
Risk and Return

In order to obtain a greater level of return, you often need to expose yourself to a greater level of risk. The following diagram illustrates in approximate terms the relationship between risk and return with respect to asset classes discussed in this paper.



Chapter

1

Cash & Fixed Interest

Commonly known as ‘safe’, this asset class is actually quite broad and risks can range from extremely low to very high.

Fixed Income

This broad asset class refers to a range of investments that relate to lending money to an organisation or Government. Because the terms of lending can vary substantially, investments within this class range from very safe to high risk, and potential payoffs correspond to the level of risk.

Government Bonds are considered the most secure option.

#1 Government Bonds

Federal and State Governments issue bonds as a way of raising money to fund capital projects or meet expenses. A bond is a promise for repayment after a defined period of time, and includes coupon (interest) payments which are generally fixed rate for the whole duration of the bond. Government bonds are issued for a minimum period of 2 years. They are considered the safest investment since governments very rarely default.

Bonds provide complete capital stability if held until maturity.

However, as there is no capital growth, when inflation is high the purchasing power of your investment can be eroded. As at August 2015, the current yield on Government bonds are 1.96% for 5 year bonds and 2.7% for 10 year bonds. As regular bank term deposits up to $250,000 are currently guaranteed by the Federal Government, many investors use term deposits (which generally provide a higher interest rate) as a proxy for Government bonds.

Income	Capital Risk	Income Risk	Complexity
★☆☆☆☆	☆☆☆☆☆	☆☆☆☆☆	★☆☆☆☆

#2 Cash

Cash is the asset class that most of us know and understand. It represents physical cash, bank deposits and short-term fixed deposits. Cash pay income in the form of interest.

The value of your cash and term deposits always remains constant, however when inflation is high, the purchasing power of these investment can be eroded. Interest rates on cash and term deposits can move substantially over time, so the income generated from cash investments can be volatile (even though capital is stable).

In recent history, cash rates have dropped from a high of 7.25% in August 2008 to 2% in August 2015.

The interest rate on term deposits as compared to cash rates reflects the bank's view on how cash interest rates will move over time. For example, at 28 August 2015, the average 5 year term deposit rate with a major banks is around 3% as compared to a cash rate of 2.25%. Investors are not receiving much pick up on interest for longer holding periods as the expectation is interest rates will stay low over the next 5 years.

Income	Capital Risk	Income Risk	Complexity
★☆☆☆☆	☆☆☆☆☆	★★☆☆☆	☆☆☆☆☆

#3 Senior Debt

Also known as senior loans, this asset class refers to debt that takes priority over other unsecured, more junior debt owed by the issuer. Senior debt is often secured by collateral, and that collateral can be sold to repay the senior debt holders. As such, senior debt is considered lower risk and carries a relatively low interest rate. Even though senior debtholders are the first in line to be repaid, they will not necessarily receive the full amount they are owed in a worst-case scenario.

Tip!

You've heard of diversification before when it comes to shares and property. The same theory applies to cash and fixed income. Each sub-class of investments carries different risk and return properties, so it's considered much safer spreading your investments amongst the various options.

This asset class refers to debt that takes priority over other unsecured, more junior debt owed by the issuer

#3 Senior Debt cont.

The value of your investment does not remains constant as it may fluctuate depending on the performance of the issuers and interest rate movements. Interest rates can move substantially over time, however the interest on senior debt normally won’t change.

Income	Capital Risk	Income Risk	Complexity
★★☆☆☆	★☆☆☆☆	★☆☆☆☆	★★☆☆☆

#4 Subordinated Debt

Subordinated debt holders are placed below senior debt holders in the repayment hierarchy, therefore these carry a higher level of capital risk. The debts may be secured or unsecured, however due to their position on the hierarchy they typically have lower credit ratings and a higher income payment.

Once again, the value of the investment is fixed if held until maturity, but may fluctuate on the secondary market depending on the performance of the issuers and interest rate movements. Some debt can be issued as 'floating rate', meaning interest payments will move in line with changes to interest rates.

Income	Capital Risk	Income Risk	Complexity
★★★☆☆	★★☆☆☆	★☆☆☆☆	★★☆☆☆

#5 Hybrid Securities

Hybrid security is a generic term used to describe a security that combines elements of debt securities (described above) and equity securities. They typically offer fixed or floating interest rates that are greater than debt securities, but this comes at a price. After the agreed period, hybrid securities are either repaid or converted into equity. Generally, these securities are ranked behind all other debt securities and only ahead of ordinary equity (that is, you become a shareholder). As such, these securities tend to offer investors higher yields to compensate for the additional risks associated with the investment.

The value of your investment on the secondary market does not remains constant as it may fluctuate depending on the performance of the issuers and interest rate movements.

Income	Capital Risk	Income Risk	Complexity
★★★★★	★★★☆☆	★★☆☆☆	★★★☆☆

Warning!

Whilst hybrid’s might seem like a safe option, in market downturns they can be converted to equity at the discretion of the company. This results in greater level of capital risk.

Chapter

2

Equities (Shares)

Equities are simply ownership interests in companies listed on a stock exchange, such as the Australian Stock Exchange (ASX).

Equities (Shares)

Shares provide investors the opportunity to purchase an ownership interest in companies listed on the ASX. Shareholders are entitled to dividends (profit distributions) which historically make up about half of the total long term returns (the other half being capital growth in share prices).

Australian Shares can be volatile, but provide excellent income and growth opportunities

#1 Australian Shares

As at August 2017, the average dividend yield for the Australian share market is 4.4%. The level of dividends which a shareholder receives is dependent on two factors:

1. The profitability of the company. Companies with strong market share and growing profits are in the best position to pay increasing dividends over time.
2. The dividend payout ratio i.e. portion of profits which the company returns to shareholders as dividends versus retaining to reinvest in growth, pay off debt or add to cash reserves.

Dividends often carry tax (franking) credits which compensate investors for the tax which the company has paid before distributing profits. The quoted “grossed up” dividend yield takes these franking credits into account which has the effect of increasing the quoted yield on Australian shares when compared on a like for like basis to other investments which do not have franking credits. As at August 2015, the grossed up dividend yield for the overall Australian share market is 5.9%.

Because dividends are so important to investors, companies are often reluctant to reduce their dividends even when their profits fall sharply. This can lead to the perverse outcome of companies borrowing money to pay out dividends. Over time, their shares will usually drop and the dividends as a percentage of their share price (dividend yield) may become very high. This is known as a ‘dividend trap’ because a high dividend yield may mask the underlying financial problems of the company in question. Inevitably, the subsequent share price fall more than erases the benefit of the temporary high dividend yield.

Income	Capital Risk	Income Risk	Complexity
★★★★☆	★★★☆☆	☆☆☆☆☆	★★☆☆☆

Specialist Share Strategies

There are specialist investment strategies which can be used to generate a higher income return from a share portfolio than can be achieved by dividends alone.

#2 Buy-Write Using Options Strategy

This strategy involves selling call options over an existing share portfolio.

A call options gives the holder the right to buy a share at an agreed price (strike price) on or before a particular date. As the seller of a call option, you earn additional income (premium) for granting this right to another investor. However, you may forego part of the capital appreciation in the share price if the market value of the share rises above the strike price.

In a nutshell, the buy-write strategy gives away some upside in the share market in exchange for higher income. This may suit investors who seek a high level of income and are less concerned about capital growth. There are specialist fund managers which implement these strategies. It is also possible to Do It Yourself (DIY) with a stockbroker who is accredited to advise on Exchange Traded Options.

Income	Capital Risk	Income Risk	Complexity
★★★★★	★★★☆☆	☆☆☆☆☆	★★★★☆

Warning!

Trading options can be a high risk strategy when executed by non-professional or inexperienced traders. Proceed with caution.

#3 Dividend Targeting

In order to increase the level of income, some investors use the strategy of buying shares in companies about to pay a dividend. This strategy can be useful in targeting franking credits which are particularly valuable for investors on a low tax rate (e.g. superannuation funds) as the value of these credits may be refunded by the ATO. There are a number of traps to be aware of as share prices will normally fall after a dividend has been declared which may erode at least part of the benefit of the strategy.

Dividend targeting can dramatically increase your income, but is not without risks...

#3 Dividend Targeting cont..

It is important to be aware of the impact of the '45 day holding rule', which requires investors to hold their shares for a minimum of 45 days to receive the benefit of the franking credits.

Once again, these strategies can be executed on a DIY basis in conjunction with a stockbroker. There are also specialist managed funds which execute these strategies using a more rigorous approach on behalf of investors.

Income	Capital Risk	Income Risk	Complexity
★★★★★	★★★☆☆	☆☆☆☆☆	★★★☆☆

Chapter

3

Property

Property investments include residential and commercial properties, which can be accessed directly or via Real Estate Investment Trusts.

Residential Property

Buying residential property has long been a popular strategy. Relative to the rest of the world, home ownership rates are high in Australia (around 70%) and bank finance for residential investment property has generally been easy to obtain.

Units have a higher rental yield, but houses provider greater long term growth

#1 Residential Property

The availability of capital gains and negative gearing tax concessions (which incidentally apply equally to shares) have been a significant factor in both the growth in number of property investors, and the average number of properties owned per investor.

Rental yields on property vary by state and property type e.g. house or unit. In general, yields on units tend to be higher, but houses win out in terms of capital growth. Just as with individual shares on the ASX, each property will have its own unique income characteristics.

The table below shows the overall average gross rental yields (i.e. before costs) for properties in the four major cities

	Houses	Units
Melbourne	3%	4.1%
Sydney	3.2%	4.2%
Brisbane	4.4%	5.5%
Perth	3.9%	4.5%
Combined Capitals	**3.4%**	**4.3%**

Source: Corelogic RP Data, July 2015

The above numbers do not take into account ongoing expenses, which can be quite high depending on the age of the property, outgoings (e.g. rates and body corporate fees) and repairs and maintenance. According to a Reserve Bank of Australia Research Paper 'Is Housing Overvalued' (June 2014) the running costs of a long term rental property are 1.5% per annum. This reduces the take home rent substantially and means that buying property in the current market is unlikely to provide a reasonable income yield as compared to other options.

Having said that, many people will have purchased investment properties at much lower prices than today and their rental yield based on their original purchase price may be quite good. In this case, holding paid off investment property in retirement is a sound strategy as part of a diversified portfolio.

Income	Capital Risk	Income Risk	Complexity
★★☆☆☆	★★★☆☆	★☆☆☆☆	★☆☆☆☆

#2 Australian Real Estate Investment Trusts (A-Reits)

A-REITs give investors access to property assets by purchasing securities on the Australian Stock Exchange (in the same manner as buying shares).The major benefit of A-REITs is that they can provide access to assets that may be otherwise out of reach for individual investors, such as large-scale commercial properties. A-REITs are designed to generate wealth in two ways: they provide exposure to the value of the real estate assets that the trust owns and the accompanying capital growth, as well as rental income.

The fund manager selects the investment properties and is responsible for all administration, improvements, maintenance and rental.

Real Estate Investment Trusts can give investors exposure to assets such as large shopping centers.

#2 A-REITs cont.

While each A-REIT will have its own set of characteristics, the properties selected are usually diversified across regions, lease lengths and tenant types. Some A-REITs specialise in particular sectors, and usually fall into one of the following categories:

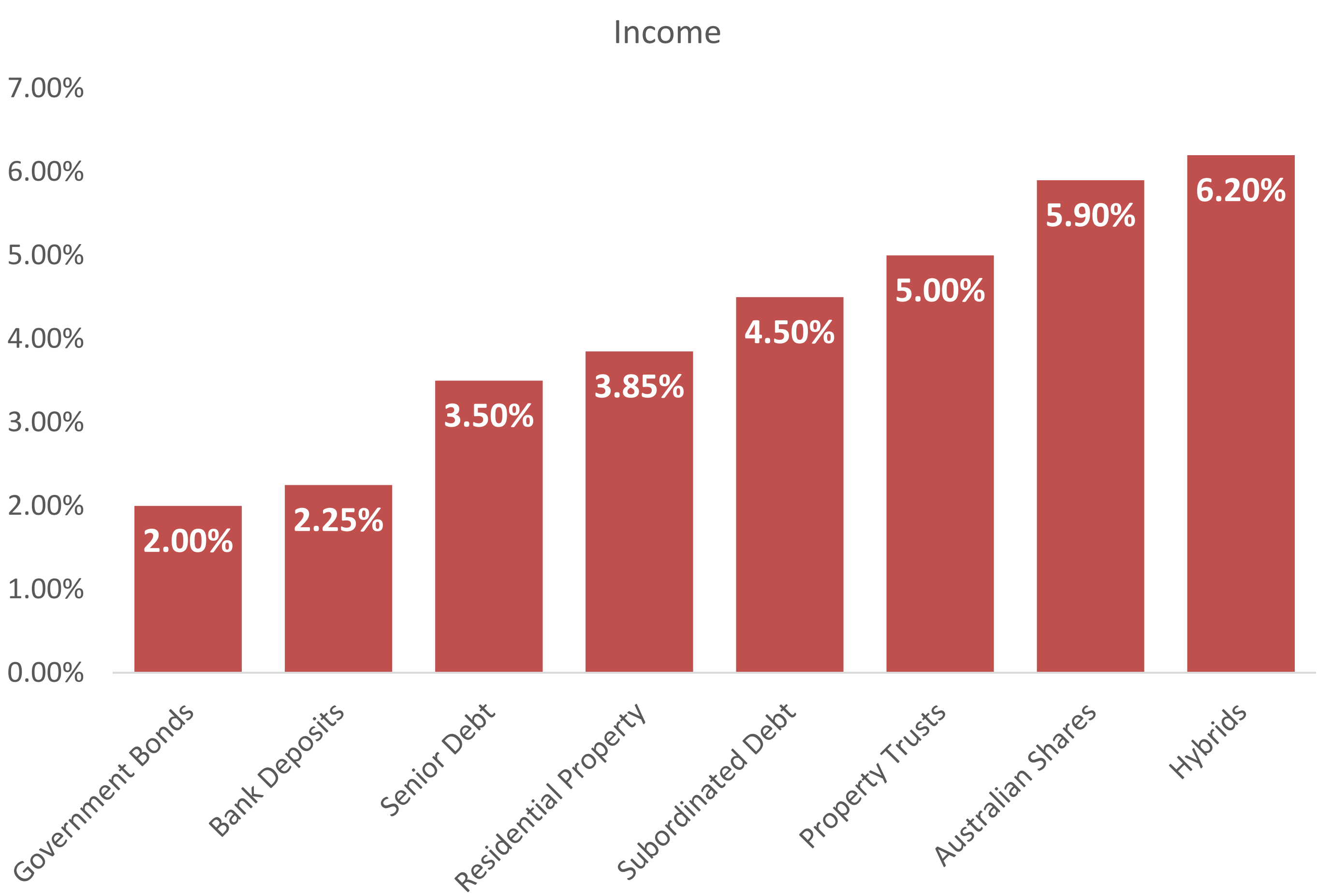
- Industrial trusts invest in warehouses, factories, and industrial parks
- Office trusts include medium- to large- scale office buildings in and around major cities
- Hotel and leisure trusts invest in hotels, cinemas and theme parks
- Retail trusts invest in shopping centres and similar assets
- Diversified trusts invest in a mixture of industrial, offices, hotels and retail property.

As at August 2015, the current average yield for A-REITS listed on the ASX is around 5%. Holding some exposure to A-REITS provide retirees with an cost-effective and convenient access to both Australian and international property markets. However because A-REITS are listed on the ASX, they can (particularly in the short term) be highly correlated to regular shares. This reduces the diversification benefits of the asset class relative to holding direct property.

Income	Capital Risk	Income Risk	Complexity
★★★★☆	★★☆☆☆	★☆☆☆☆	★★☆☆☆

Income Summary

Each asset class offers a unique income profile and corresponding growth potential and associated risk. The following chart compares estimated income yields for various assets classes listed in this paper.



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Losing Interest?

If you want to know more, or to speak to a Financial Adviser, feel free to contact us via the details below.

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