

## The Wall of Money: term deposits and the BDM's lament

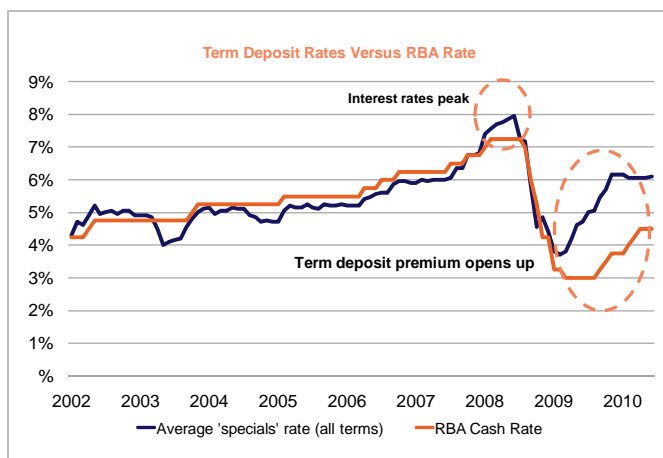
It's the bane of asset management CEOs in 2010. Retail BDM's (particularly fixed income BDM's) can't hit their sales targets, and outflows are elevated because, they say, all the money is going into term deposits.

So is the "Wall of Money" story actually true? And if it is true, is there light at the end of the tunnel?

### Yes Virginia there is a Wall of Money

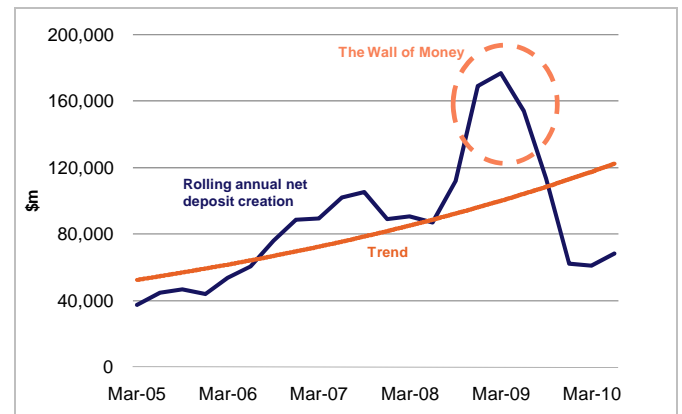
Even prior to the onset of the financial crisis, by early 2008 term deposits had become an attractive proposition for investors. As equity and fixed income markets collapsed in late 2008, term deposits became even more attractive as the Federal Government guaranteed deposits and banks were forced to pay increasing premiums over the RBA cash rate.

This sequence is highlighted in the chart below.



Source: RBA

As the next chart below illustrates, deposit creation in the Australian banking system has typically been fairly stable around a rising trend, but by March 2009 – the depth of the crisis – it had spiked to nearly twice this trend figure. Tria estimates that approximately \$70bn in additional new deposits was created during the crisis.



Source: APRA, Tria analysis

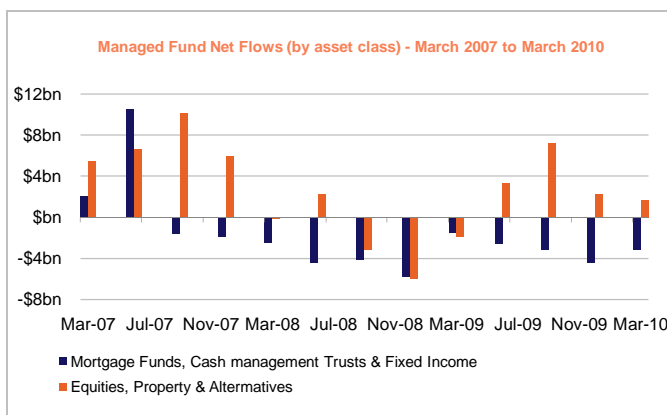
Facilitating the use of term deposits has been their inclusion on major retail wealth platforms, and the development of term deposit platforms such as 'termdeposit.com.au' and 'moneymarket.com.au'. These new means of accessing and managing term deposits have seen their use by financial planners increase significantly.

So the Wall of Money exists – it's not a BDM myth. However there is encouragement to be drawn from more recent data. Deposit creation has fallen below trend. This suggests that although much of these deposits are still rolling over, the problem is (a) at least not getting worse, and (b) may be starting to unwind.

## Who's suffering and why?

If term deposits have been big winners, mortgage funds, cash management funds and fixed income funds have been the big losers amongst competing yield solutions.

While advisers and investors have started returning to growth assets post the GFC, as indicated by the recovery in growth product net inflows below, they are still shying away from mortgage, cash and fixed income funds. These product categories remain in persistent net outflow..



Source: Morningstar

A decision to use a term deposit over an income fund is rational when you compare the return propositions. A typical income fund offers a likely income return no better than a 1 year term deposit - with considerably more risk around both the distribution and the total return.

## Typical income fund return proposition vs typical term deposit

Income Fund Return Objective	
UBSA Bank Bill rate (August 2010)	4.6%
Excess return target	2.0%
Management fee	(0.7%)
<b>Net return target</b>	<b>5.9%</b>
<b>Typical 1 year term deposit rate</b>	<b>6.0%</b>

Source: Rate City

While many income funds have recently been able to beat these objectives thanks to high credit spreads, the traditional customer for such products has not been able to tolerate the significant volatility of returns seen in the financial crisis.

Flawed product designs, redemption suspensions, and some instances of insufficient disclosure and mis-selling, have left a

sour taste in many planners' mouths. Some yield product categories may never recover.

## Why are term deposit rates so high?

Banks would love nothing more than to cut term deposit rates and reduce their funding costs. But they continue to maintain rates because other forms of funding are still expensive and / or unavailable.

Banks draw funding from a variety of sources. The tables below compare the funding of major and regional Australian banks in early 2010 to just before the onset of the GFC.

Major Banks	June 07	Jan 10
Domestic deposits	43%	48%
Wholesale short term funds	24%	18%
Wholesale long term funds	21%	25%
Equity	7%	8%
Securitisation	5%	1%

Regional Banks	June 07	Jan 10
Domestic deposits	39%	47%
Wholesale short term funds	23%	14%
Wholesale long term funds	10%	17%
Equity	11%	13%
Securitisation	17%	9%

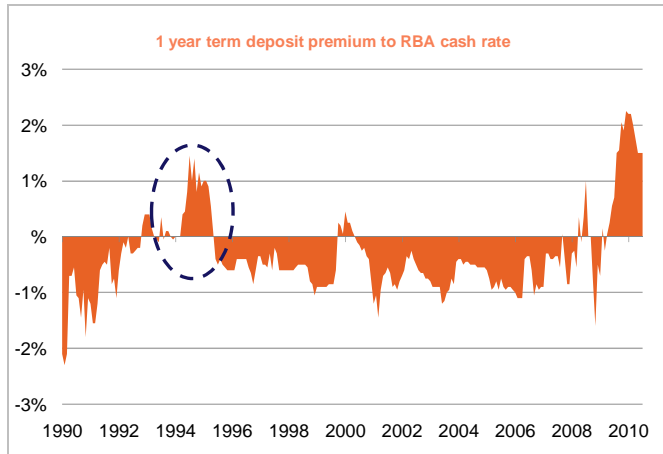
Source: RBA

Changes include:

- The freezing of credit markets in 2008-9 highlighted the risks of short-term funding and led Australian banks to shift funding in favour of longer term debt.
- There has been a substantial decline in securitisation, which is particularly important for smaller banks.
- It is the smaller regional banks with less ability to gain offshore funding which have had to scramble for increased term deposit funding – in turn driving up pricing for everyone.

For many in the asset management industry, dealing with unusually high term deposit rates has been a new and unwelcome experience. But while the *severity* of this event is

unprecedented in recent times, it has in fact happened before, as the chart below indicates.



Source: RBA

Term deposits usually track below the cash rate. However in 1994-5 there was also a significant spike following a period of distress in bond markets. It wasn't as extreme as we have seen since 2009, but it was just as long in duration.

However, we can take heart (particularly if you are a yield manager) from the fact that these periods do come to an end. And when the episode came to an end in 1994-5, it did so quickly.

### Will the Wall of Money return?

Clearly there are still funding issues out there. Credit markets remain difficult and concerns linger overseas of a possible bubble in Australian residential property, to which our banks are heavily exposed. These issues could continue to put a floor under term deposit rates.

We may be nearer the end of this term deposit premium period than we are to the beginning – but conditions remain uncertain. There are signs of reductions in rates - particularly for shorter term deposits. The \$70bn question for fund managers is whether the 'Wall of Money' will return to managed yield investments when rates reduce across the board.

The structural demand for yield has not gone away; indeed we expect it will continue to increase as the population ages. We still see a good market for high quality, liquid fixed income funds which diversify the limited direct lending opportunities in Australia. Their returns should offer enough of a premium to

make them compelling again when deposit rates drop. For managers with the right products, it is a waiting game.

Reduced deposit rates will also help AAAm rated cash management trusts, but pressure will mount for reductions in fees, which can be as high as 1.10% pa – too high for essentially a cash index product (notwithstanding the additional transactional services some products offer) .

On the other hand, the outlook for traditional mortgage funds looks bleak. Many investors have been burnt and the product category badly damaged – many funds will close in coming years.

It may be the case that a new generation of term based mortgage funds emerges, with withdrawal features that better match the underlying assets. However even if this occurs, the retail opportunity will be smaller than in the past. This asset class's future may be better aligned with institutional investors which can better judge the benefits and risks, and have less need for liquidity.

While we expect some fund categories to recover, there will be financial planners and investors who stick with term deposits. The shift towards direct investments is well understood in the context of equities, but term deposits are also just another type of direct investment - a loan to a single financial institution.

Their inclusion on platforms has helped carve out a space with financial planners which will not be quickly replaced.

This formative experience may prove a spur to the evolution of a retail bond market. As term deposit rates fall but upwards pressure remains on lending rates, companies will find it attractive to borrow directly in the rate gap which is created. Further, the AOFM is looking at how government bonds could be traded on the ASX in retail parcels.

There are a range of issues to overcome for this form of debt raising and trading to become economic. But we are optimistic and clearly there is an audience of retail investors interested in lending to well known corporate and government borrowers. This will create new competition for managed yield investments, but equally new opportunities for managed solutions.

### Smart business choices for yield managers

While the Wall of Money is real, this does not mean that asset management executives are powerless. Far from it.

We may be seeing the early signs of improvement, and with them the imperative to prepare for improved business conditions. Different types of fixed income products are already winning flows; existing products may need to be modified or closed.

This suggests it's also a good time to take stock of how your product suite is positioned going forward. Even as their dominance fades, deposits will have an elevated role as part of the drift towards direct investment. This is a changed landscape. When the Wall of Money returns, it will not be business as usual.



### For more information please contact Tria Investment Partners

**Andrew Baker**

Managing Partner

[abaker@triapartners.com](mailto:abaker@triapartners.com)

**Mark Watmore**

Partner

[mwatmore@triapartners.com](mailto:mwatmore@triapartners.com)

This email has been produced by Tria Investment Partners Pty Ltd (ABN 14 108 209 721). We are located at Level 3, 275 George Street, Sydney, NSW, 2000. We believe the information contained in this email is accurate, but disclaim responsibility for errors and omissions. This email is general in nature and for the information of industry professionals. Your and / or your firm's specific circumstances need to be taken into account. We do not provide securities advice, financial product advice, or investment recommendations. Where we comment on certain aspects of investments or investment products, this is for the purpose of general discussion and information. Copyright - This email is copyright. If you would like to reproduce elements of it, please get in touch with us.