SPECIAL TOPIC – Managing Income in a low interest rate environment

Contributed by Suzanne McCarthy, Financial Planning Client Services Manager

Managing Income volatility

The announcement of the RBA on Tuesday 6 August 2013 to cut cash rates to 2.50% was the 8th cut since November 2010. The consequence for investors is that as Term Deposits mature they are likely to see available rates cut by 50% compared to those available in 2010. According to an ASIC study released in 2010, 45% of all Term Deposits belong to investors aged 65 or older so rate cuts impact greatly those of retirement age.

In the aftermath of the GFC the focus has been on the preservation of capital. Investors have been happy to ride out the storm in the relative safe haven of cash and fixed interest. That has come at a cost as in a lower interest rate environment Capital risk has been replaced by income risk (the lack of return) as a key consideration for retirees.

Equity and Fixed Interest Investments

A mix of Australian Equities, International Equities, Fixed Interest managed funds as well as Term Deposits are required to address income risk. During periods of financial market turmoil such as we have been experiencing since 2008, fixed income securities (such as bonds) should outperform term deposits. This is because term deposits don't "mark to market", i.e. they aren't continually re-priced, whereas bonds are. This means that an investor in a term deposit won't benefit from the capital appreciation that a bond investor will gain in markets where fixed income investments are performing strongly. Bonds also tend to pay higher returns than term deposits, particularly when interest rates are falling. On the negative side, Bonds also lose value

A common misconception about term deposits is that they are similar to fixed income in providing good diversification to equities in a portfolio. However, term deposits have been positively correlated with equities during four periods over the past 10 years. Even when they are negatively correlated with equities, it tends not to be as strongly as bonds. Despite a brief period from 2004- 2005 where bonds were positively correlated with equities, they have been negatively and mainly strongly negatively correlated. As such, Term Deposits provide better diversification to equities in an investor's portfolio.

In the current strengthening economical low interest rate environment, Term Deposits will not provide sufficient income and therefore a well diversified portfolio can provide the least income risk to retirees.

Planning points:

- Review investment strategy
- Review asset allocations
- Reduce / limit exposure to growth assets

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