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IF CASH IS KING, WHO WILL SEE THE EMPEROR'S NEW CLOTHES?

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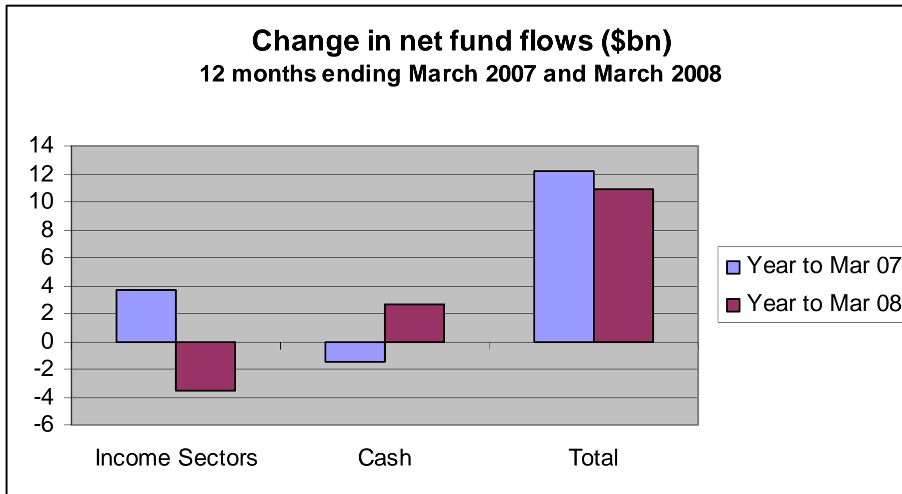
Cash is King! This is the cry often heard in financial markets at times of severe market stress or dislocation. Whilst there is some merit in this strategy, there are also some fundamental flaws, the most important of which is that cash (and its popular cousin the term deposit) has risks! These risks can be highlighted by considering Hans Christian Andersen's famous story from 1837 "The Emperor's New Clothes", the tale of a swindle whereby members of the emperors court knew that the emperor was exposed but were unwilling to point this out for fear of losing favour. With similar conditions influencing financial markets today, how do we tell clients that cash is not the best long term strategy?

This paper intends to highlight some of the risks associated with investing in cash and other income investments and how they can be managed. It will also look at the opportunities available within the new world of fixed income investing. Most importantly, it will demonstrate how we can all work with investors to educate them about the risks of investing in cash and term deposits.

The weight of money

The amount of investor's money flowing into cash is staggering. Although most investors have long-term horizons, many have nonetheless chosen to shun fixed income investments such as Fixed Income and Mortgage Funds in favour of Cash Funds.

As illustrated in Chart 1, below, in the 12 months ended March 2007 (prior to the Credit Crunch) $12.2bn of new money flowed into Australian-based wholesale managed funds. Of this, $3.6bn (or 30%) went into income funds such as Enhanced Cash, Australian and International Fixed Income and Mortgage Funds whilst $1.4bn flowed out of Cash Funds. In the subsequent 12 months, until March 2008, these flows reversed. Over $10.9bn of new money flowed into Australian-based wholesale managed funds but $3.5bn flowed OUT OF other income funds whilst $2.6bn flowed into Cash Funds. (Morningstar, March 2007 and March 2008).



Source: Morningstar

While these figures are resounding, they understate the true situation because they exclude the additional money flowing into the high interest cash accounts offered by the likes of Adelaide Bank, ING Direct and BankWest as well as the Term Deposits offered by the major banks. The flows into these sectors, while not directly reflected in Market Share Data can be observed in the fact that term deposits have now been added to the investment menus of some major platforms (including ASGARD, BT Wrap and ING One Answer) and are garnering a very large portion of new flows. The value of Term Deposits with Australian Banks increased by over $64 billion during the year to December 2007 (APRA, 2008).

It is easy to see the appeal of cash funds in an environment where the RBA Cash Rate has been at 7.25% since March 2008 but, as investors, we should examine the role of income assets and why fixed income as an asset class should be a core part of any strategic asset allocation.

Why invest in fixed income?

Before we examine some of the opportunities, and risks, let's first remind ourselves of why we invest in fixed income as an asset class.

Fixed Income provides one overriding and essential characteristic that sees it at the core of most client asset allocations – it performs differently to equities. This low correlation allows fixed income to add attractive diversification benefits to an equity portfolio. Equities tend to follow the performance of the broader economy – that is, they generally perform well when the economy is growing and generally fall when the economy declines. Bond funds, on the other hand, often perform better when the economy is weak because decreasing inflationary pressures typically allow interest rates to fall and bond process to rise (Bodie, Kane and Marcus, 2001).

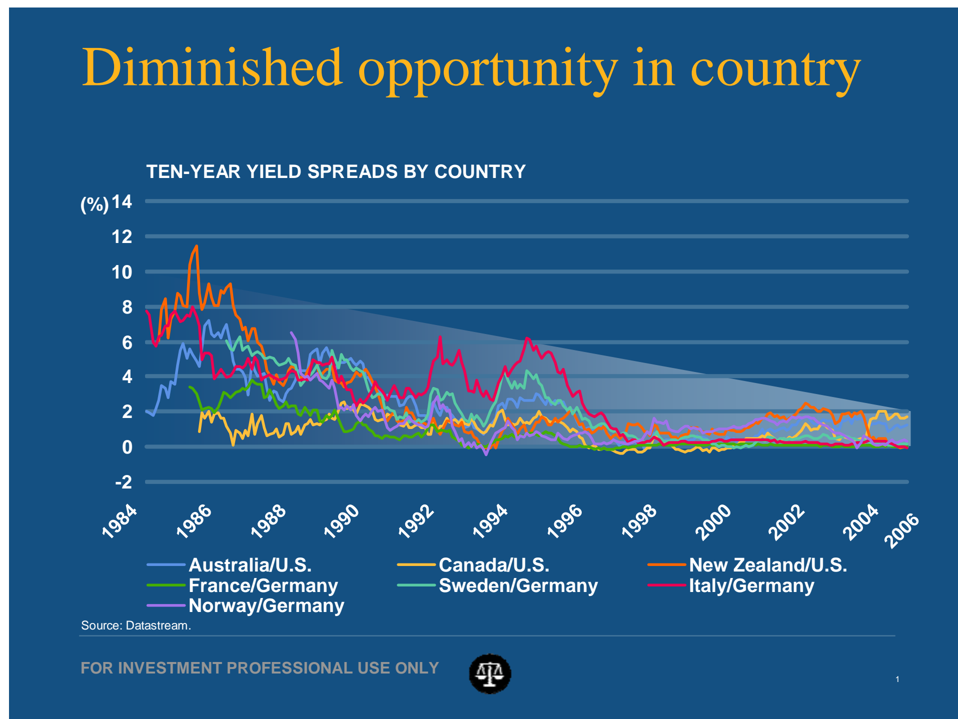
So if fixed income is a beneficial part of a strategic asset allocation, what are the appropriate ways to gain exposure to the sector?

The world of fixed income investing

Fixed income investing has changed significantly over the past 10 years.

From the mid-1980s to the mid-1990s, global fixed income markets experienced significant highs, which most active managers exceeded. In that period, yield spreads among countries were wide; countries with poor monetary policies had significantly higher yields than those with sounder policies. Illiquidity and bureaucracy plagued some markets, driving bond yields higher in those countries. Spotty, inconsistent, and often unavailable information led to market inefficiencies.

To capture the significant top-down opportunities created by yield and currency disparities (Chart 2, pre-1997) as well as general market inefficiency, fixed income managers were organised around macroeconomic (country) research and currency. There was an emphasis on frequent trading, trend following and capturing big ideas. Transaction costs, carry, or potential mistakes were less important. Many managers simply tried to get a few big decisions right without considering the shape of the yield curve, bond selection, or downside risk. For example, as late as 1995, the yield differential between Italy and Germany was a major contributor to active manager returns. It really didn't matter which bond you owned if you got the country/currency allocations right. Generally, they were rewarded, as big wins could offset losses.



Since the 1990's, fixed income investing has changed significantly. Monetary policies are more consistent across the globe. Market information is readily available; yields, spreads, and volatility are lower (Chart 2, post-1997). At the same time, the market has become much broader in terms of investable, liquid sectors, and deeper in terms of sub-sectors and individual securities today ballooning from 1000 securities 10 years ago to many more than 14,000.

Issuance has migrated from government-backed securities to bonds issued by corporations or securitised by mortgage payments or other cash flows. Today, global fixed income is a sophisticated, complex asset class and global fixed income markets are deeper and more efficient, so it is harder

and less profitable to call top-down decisions. As a result, Beta opportunities in this asset class, meaning those that result from general market exposure, have been diminished, making alpha opportunities, those that result from market inefficiencies, much more important.

In this new world of fixed income investing, a manager with the right skills and tools can deliver alpha regardless of the direction of yields and regardless of the direction of spreads by using more sophisticated strategies like relative value trades that can work independently of market cycles.

Alternatives to fixed income

Whilst fixed income has a number of core characteristics, let's look at some of the alternatives, especially those where investor's are currently directing funds, and determine whether these exhibit the same characteristics.

Cash Funds or Cash Accounts

The attraction of these accounts is the perception that they are "risk free". This perception stems from the safety and security they exhibit in that their value cannot decline. Whilst this is true, they are not exactly risk free. As outlined below under "Risks of Income Investments", cash is affected by purchasing power or inflation risk. Also, the opportunity to generate alpha is limited.

Term Deposits

Although Term Deposits possess some of the core fixed income characteristics of income generation and diversification, they also possess risks. Like cash, Term Deposits are also seen as "risk free" but as with cash funds, this is not true. The main risks of these securities are term structure or re-investment risk and purchasing power risk, as outlined below.

The risks of income investments (and how to avoid them)

All income investments carry some form of risk – even cash funds and cash accounts! These risks are highlighted below. Importantly, most of these can be managed.The four key risks in income investing are term structure, volatility, credit and liquidity risks. These risks have different cycles and time frames and apply differently to each type of income investment. Liquidity risk is usually ignored because it is smaller and less cyclical than the other three risks. With Cash investments, the principal risk is purchasing power risk.

Term Structure Risk

This risk has a number of names including yield curve risk, re-investment risk or re-pricing risk.

It refers to a mismatch in the term structure of cash flow and liability. It arises if interest rates are fixed on liabilities for periods that differ from those of offsetting assets. One reason may be maturity mismatches. For example consider a scenario of a 65 year old retiree who invests in a term deposit (asset) at 8% pa for 2 years with a cash flow requirement (liability) of 6% pa. The asset matures in 2 years whilst the liability matures in 20 years (at age 85). If, in the meantime, interest rates fall to 5% pa, the retiree would be forced to reinvest at 5% and, for the remaining 18 years, would have a short fall on their cash flow requirements.

Whilst this risk applies to most fixed income investments, active strategies can minimise this risk by trading securities to ensure assets match liabilities. In the case of term deposits, this risk is unavoidable and is an important consideration that is often overlooked.

Volatility or Prepayment Risk

Prepayment risk relates to the impact on fixed income securities of changes in interest rates. Essentially, if interest rates decline, the borrower's preference would be to refinance his or her loan at a lower rate, and then repay the original loan. The original bond holder would potentially need to purchase new bonds at the lower rate. This is also referred to as volatility risk. In the new world of fixed income investing, active strategies can actually capitalize on this volatility and generate active returns. An example of the types of active strategies that could be used would be trading securities whose values relate to moves in interest rate volatility or trading securities that reflect either the interest only or principal only component of a mortgage.

Credit Risk

Credit risk refers to the inability for a counterparty to meet its repayment obligations, as when a bond issuer defaults on its repayments. High yield securities are a great example where credit risk is exploited and higher yields are offered to compensate for the higher risks. Today, whilst the headline yields of these securities appear attractive, when the range of potential losses is taken into consideration, these sectors are less attractive. Whilst much has been documented recently on credit risk, thorough research can help manage this risk.

Liquidity Risk

Liquidity risk involves the ease with which an issue can be sold at or near its true value (Fabozzi and Fabozzi, 4th ed, 1994). This risk occurs when there is no buyer for a security because of a lack of available liquidity in the market. The current fixed income environment is an excellent example of liquidity risk, since fundamentally sound securities are trading at prices well below their intrinsic value. Prices on some of these securities are trading well below historical averages, indicating the level of distressed selling by leveraged investors.

Purchasing Power Risk

Also called inflation risk, this refers to the risk that the value of your investment and the return on it will be eroded by inflation. Quite simply, if a cash or Term Deposit investment earns 8% pa and is taxed at the top marginal tax rate of 45%, this generates an after-tax return of 4.4% pa. The current rate of inflation in Australia is 4.5% pa (ABS, 2008) so the real (inflation-adjusted) after-tax return is actually negative (-0.1% pa). While this negative real return seems like a small amount, it represents the true risk of cash investments, and is far from a sound investment strategy. Generating high excess returns is required to avoid this risk.

How can you position these opportunities with clients?

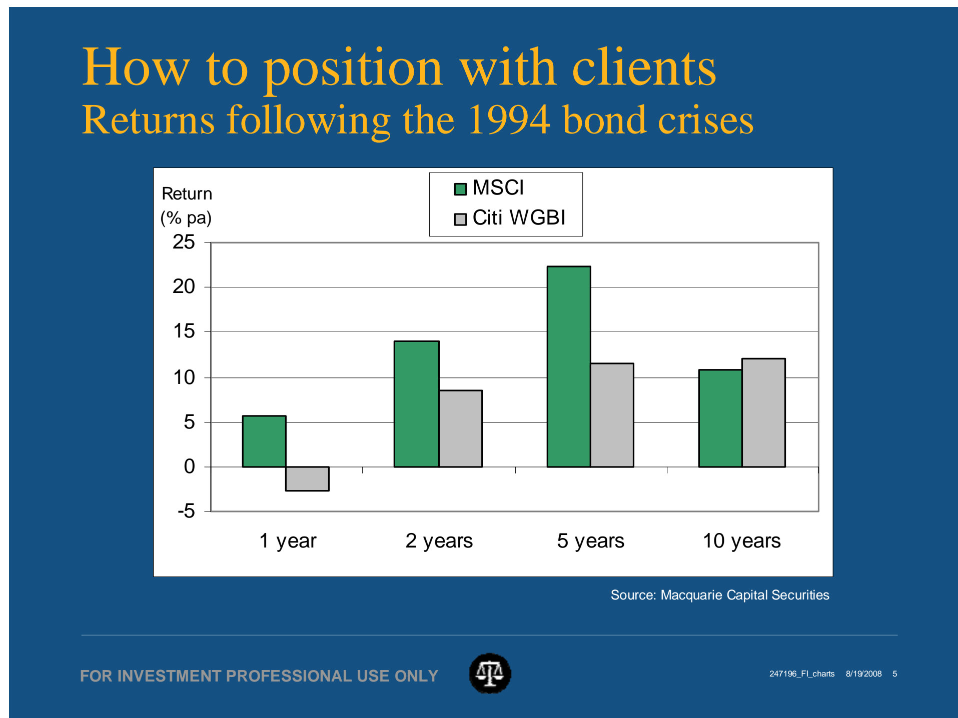
The most difficult barrier for advisers to overcome is the perception that risk should be avoided and that cash is safe. How then do we position the broader opportunities with clients? Below, are 3 general ways to do this.

1. Explain the risks

Rather than avoid fixed income as an asset class, the real opportunity is to explain the risks to investors and ensure that they understand the opportunities that those risks present. As investors, short term volatility can be tolerated with a view to seeing better long term gains. More importantly, the risks that cash and Term Deposits possess are often overlooked and if these were explained to clients, it may reframe their perceptions.

2. Re-enforce the longer term time horizon for investors

The impact of a market dislocation is emotionally difficult but if viewed rationally, a discounted market presents opportunities. A good recent example of a market dislocation was the Bond Crisis of 1994. As illustrated in Chart 3, below, investors might have suffered from poor returns in 2004 as the crises hit but were rewarded for taking a longer term view as global fixed income outperformed global equities over the subsequent 10 years.



3. Outline the importance of diversification.

Diversification is important to any investment strategy but even within the income portion of a portfolio diversification is necessary. Chart 4, below, is a simple tool that demonstrates the

importance of diversification in income investing. It shows the performance of the major income sectors each year over the past 12 years with some very surprising results:

No single income sector has consistently outperformed and it is difficult for investors to 'pick a winner'.

Every sector finishes in the top two as well as the bottom three positions. This demonstrates the importance of diversification, because it is impossible to forecast changes in leadership.

Global Bonds (Hedged in A$) outperformed Australian Bonds in nine of the past ten years. Global bonds should not be ignored in a portfolio!

High Yield is as likely to finish at the top of the table as the bottom. Credit strategies should not be your only diversifying idea!

The average difference between best and worst sectors in any one year is over 24%!

The table also shows that cash, whilst being the best performer last year, typically languishes towards the bottom of the table. And more importantly, note that this table demonstrates index returns - for most income assets, additional alpha can be generated by a skilled manager.

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Alternating Bond Market Leadership

Annual returns for key indexes (1996–2007) ranked in order of performance (highest to lowest).

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
HIGHEST RETURN ↑	Emerging Market Bonds 20.19%	Emerging Market Bonds 37.98%	Global Bonds (unhedged) 20.25%	Emerging Market Bonds 15.36%	Emerging Market Bonds 33.93%	US Bonds 17.72%	Global Bonds (hedged in A$) 11.57%	Euro High Yield 13.71%	Euro High Yield 20.00%	Emerging Market Bonds 19.98%	Euro High Yield 13.69%	Australian Cash 6.77%
	Australian Bonds 11.87%	Global High Yield 37.56%	US Bonds 15.49%	Australian Cash 5.01%	US Bonds 31.45%	Global High Yield 11.00%	Australian Bonds 8.81%	Global Bonds (hedged in A$) 6.59%	Global Bonds (hedged in A$) 8.92%	Global High Yield 10.70%	Mortgage Funds 6.47%	Global Bonds (hedged in A$) 6.63%
	Global High Yield 10.37%	US Bonds 33.67%	Euro High Yield 14.33%	Global High Yield 3.51%	Global Bonds (unhedged) 21.50%	Global Bonds (unhedged) 10.26%	Global Bonds (unhedged) 5.93%	Mortgage Funds 5.61%	Global High Yield 8.78%	US Bonds 9.46%	Australian Cash 6.00%	Mortgage Funds 6.55%
	Global Bonds (hedged in A$) 9.48%	Global Bonds (unhedged) 25.83%	Global Bonds (hedged in A$) 10.08%	Global Bonds (hedged in A$) 0.28%	Global High Yield 18.99%	Emerging Market Bonds 10.09%	Mortgage Funds 5.54%	Australian Cash 4.90%	Emerging Market Bonds 7.55%	Global Bonds (hedged in A$) 6.62%	Global High Yield 5.81%	Australian Bonds 3.46%
	Australian Cash 7.57%	Australian Bonds 12.23%	Australian Bonds 9.54%	Australian Bonds -1.22%	Australian Bonds 12.08%	Global Bonds (hedged in A$) 8.29%	Australian Cash 4.77%	Australian Bonds 3.05%	Australian Bonds 6.96%	Mortgage Funds 6.22%	Global Bonds (hedged in A$) 4.41%	Global Bonds (unhedged) -1.71%
	Global Bonds (unhedged) -2.74%	Global Bonds (hedged in A$) 10.71%	Australian Cash 5.14%	US Bonds -5.04%	Global Bonds (hedged in A$) 9.74%	Mortgage Funds 5.87%	Emerging Market Bonds 2.05%	Global High Yield -1.04%	Mortgage Funds 6.07%	Australian Bonds 5.79%	Australian Bonds 3.16%	Euro High Yield -3.57%
	US Bonds -2.95%	Australian Cash 5.63%	Global High Yield 1.10%	Euro High Yield -5.74%	Mortgage Funds 6.54%	Australian Bonds 5.45%	US Bonds 0.23%	Emerging Market Bonds -5.14%	Australian Cash 5.62%	Australian Cash 5.73%	Emerging Market Bonds 2.33%	US Bonds -3.98%
			Emerging Market Bonds -6.09%	Global Bonds (unhedged) -9.81%	Australian Cash 6.27%	Australian Cash 5.24%	Euro High Yield -3.14%	Global Bonds (unhedged) -15.91%	Global Bonds (unhedged) 5.03%	Global Bonds (unhedged) 2.07%	Global Bonds (unhedged) -0.75%	Emerging Market Bonds -5.60%
LOWEST RETURN ↓					Euro High Yield -2.10%	Euro High Yield -5.30%	Global High Yield -5.33%	US Bonds -22.20%	US Bonds 0.29%	Euro High Yield -0.59%	US Bonds -2.90%	Global High Yield -7.39%

■ **Lehman Global High Yield Index A$** provides a broad-based measure of the global high-yield fixed income markets in Australian dollar terms.

■ **Lehman Global Aggregate Hedged A$** is an unmanaged index of global investment-grade fixed-income securities hedged in Australian dollars.

■ **Lehman Global Aggregate Index A$** is an unmanaged index of global investment-grade fixed-income securities expressed in Australian dollar terms.

■ **Lehman Aggregate Bond Index A$** is an unmanaged index of US investment-grade fixed income securities expressed in Australian dollar terms.

■ **Lehman Emerging Markets Index A$** is an unmanaged index of the fixed and floating-rate USD-denominated US Emerging Markets Index and the primarily EUR and GBP-denominated fixed-rate Pan-European Emerging Markets Index expressed in Australian dollar terms.

■ **Merrill Lynch Euro High Yield Index 3% Constrained A$** is an unmanaged index of investments in high-yielding, non-investment-grade debt obligations issued by Europe-domiciled corporations or those whose revenues stem largely from Europe expressed in Australian dollar terms.

■ **Morningstar PG W ITr Mortgages Index A$** is an unmanaged index of investments in the mortgage bond markets expressed in Australian dollar terms.

■ **UBS Australian Composite Bond Index** is an unmanaged index tracking the performance of the Australian fixed income asset class. The UBS Australian Composite Bond Index covers 297 securities with a market value of A$175 billion.

■ **UBS Australian Bank Bill Index** is an unmanaged index tracking the Australian cash and fixed interest markets.

Data is historical. Past performance is not a guarantee of future results. It is not possible to invest directly in an index.

Summary

The key messages of this paper are especially relevant in the current market. Investors have been scared away as a result of the sub-prime mortgage collapse and the credit crunch. Many have therefore avoided some income sectors altogether, to the detriment of the overall diversification of their portfolios. And whilst cash and Term Deposits may be seen as kings, for the astute investor, fixed income possesses many more riches, without many of the same risks. Now is exactly the time that a diversified income portfolio is important and the risks of cash and Term Deposits should be highlighted to investors. Otherwise, investors might not recognize that the emperor has no clothes! As Warren Buffet famously wrote "when the tied goes out, we can all see who has been swimming naked". The difficult thing for investors is to call this when the tide is still high!

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