

understanding the difference between term deposits & fixed interest

The Global Financial Crisis has changed the way people think about the risks to their investments, especially those that are supposed to give them a steady flow of income.

When the GFC hit, many investments that were regarded as ‘low risk’ turned out to be either speculative or illiquid. In this environment, certainty of income and security of capital became paramount.

This has triggered a renewed interest in the characteristics

of traditional income investments like fixed interest and term deposits.

WHAT ARE THE DIFFERENCES BETWEEN BONDS AND TERM DEPOSITS?

Before making an investment decision, it pays to have a good understanding of the differences between an investment in a fixed interest fund and an investment in a term deposit.

This table summarises the key differences:

	Term Deposit	Fixed Interest Fund
What is it?	A term deposit is simply a deposit with a complying bank or financial institution for a fixed period (“term”) that pays a specified interest rate.	A fixed interest fund is a pooled vehicle that invests in a large number of bonds of varying quality from a number of issuers. The investor buys units in the fund at its net asset value and receives a variable income stream from the underlying bonds. The fund is usually actively traded, buying and selling bonds depending on their relative attractiveness.
Term	The term of the investment is fixed in advance usually for periods of 1 month, 2 months, 3 months, 6 months, 9 months, 1 year, 2 years, 3 years, or 5 years.	Although the underlying investments have a term, a fixed interest fund is usually open ended. An investor should be able to get their money out at any time. A fixed interest investment should be considered to be for a period of not less than three years.
Income	Term deposits pay a fixed rate of interest for the life of the term. The interest rate offered usually increases gradually the longer the term of the investment. This is to compensate the investor for the risk that interest rates may change in the future.	Income is generated from the interest payments from the bonds held in the fund. The interest payments on most bonds are usually fixed, so income should remain reasonably consistent. However, the income at the total fund level is not necessarily ‘fixed’. This due to a number of factors such as the pooling of fixed interest securities with different terms within a unit trust structure, currency hedging costs, and default and credit events which can reduce returns.
Capital growth	Term deposits do not generate capital growth. On maturity, the investor gets back only the original amount invested.	There is potential for capital growth through appreciation in the market value of the underlying bonds. This is because the fund actively trades the bonds it holds, buying and selling securities of different maturities. The value of a fixed interest fund can rise or fall with changes in interest rates. There is also the potential for value to fall if the bonds are down-rated or default.
Security of capital	Capital security is backed by the balance sheet of the issuing bank. It is therefore important to ensure the issuing bank is reputable and solvent.	Although fixed interest is a relatively low risk asset class, investors still can experience capital losses. Capital security depends on the credit worthiness of the underlying bonds, which is usually a mix of government, bank and corporate issuers. Low grade bonds carry significantly greater default risk and hence lower capital security.
Credit risk	Term deposits are liabilities of the issuing financial institution or bank, and therefore carry the same credit rating as that bank.	Bond fund portfolios are a mix of government and corporate bonds. The credit risk in a bond fund is the blend of credit risks of all the underlying bond issuers. Usually this is managed to a certain risk level, although ‘high yield’ fixed interest funds have higher credit risk.
Other risks	None.	These risks may include liquidity risk, equity risk, sovereign risk, currency risk and event risk.
Diversification	A term deposit is a deposit with a single issuer, the bank or financial institution, and is therefore not diversified.	A bond fund is a diversified portfolio of investments, so it effectively spreads the investment risk across many bonds with differing issuers, credit risks and different sensitivities to interest rate changes.

	Term Deposit	Fixed Interest Fund
Liquidity	Term deposits are not tradable. They must be held to maturity and should be considered to be illiquid. If you break a term deposit before maturity there are usually penalties in the form of a reduction in the interest rate received.	Most fixed interest funds are typically highly liquid as they predominately hold high grade securities. However, 'high yield' funds may become illiquid if they hold sub-investment grade securities, or securities that may be complex, difficult to price or which are infrequently traded.
Inflation protection	A shorter-term term deposit can provide reasonable inflation protection because it can be rolled over more frequently and thus the new interest rate will reflect new inflation expectations. A longer-term term deposit is more vulnerable to inflation; hence it usually demands a premium in the return offered.	Periods of strong economic growth can lead to rising inflation which erodes the value of the future interest payments on a bond. For this reason, long term bonds in particular tend to be sensitive to changing inflation expectations.

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WHY HOLD TERM DEPOSITS AND NOT FIXED INTEREST?

Term deposits should be used if the investor needs a reliable income stream to meet their cashflow needs, or the repayment of a known lump sum on maturity of the term deposit. As a trade-off for this security, a lower return is likely.

Investors can use fixed interest funds as a means of potentially earning more than a cash or term deposit alternative. However, while the income stream from a fixed interest fund is usually reasonably reliable, it is not guaranteed.

Similarly, while bonds can generate capital growth, repayment of the capital invested is not ensured.

For this reason, investors should regard a bond fund as a minimum three year investment that can be used as a secondary source of income.



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