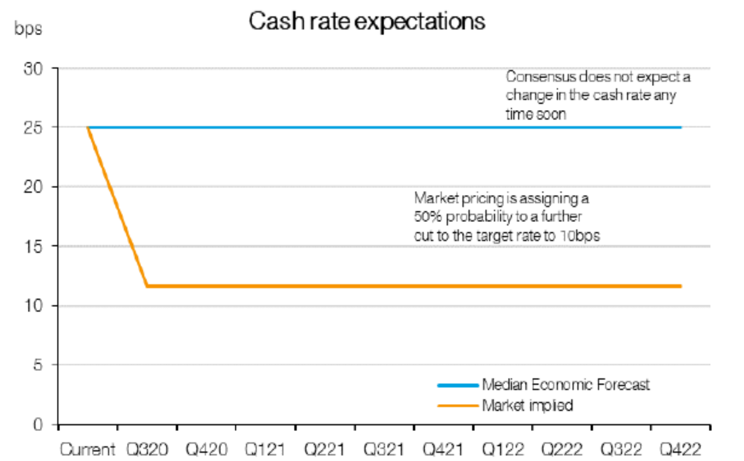
Focusing on returns from cash

Cash rates are already at historic lows and are forecasted to remain at these levels for years to come. This is problematic for investors because in real terms (adjusted for the rate of inflation), the return on cash held in traditional short-term deposit/transactional accounts is already negative.

Never before have Australian investors had to consider “actively” managing their cash balances like is required at present.

This is made even more pertinent given: 1) expectations that the current low rate/negative return environment could last for many years to come (i.e. low rates are a secular phenomenon); 2) the RBA’s yield curve control (YCC) - a bond buying program designed to keep bond yields (up to 3 years) in line with the cash rate; and 3) elevated cash levels (in part precautionary) due to the COVID-19 scare.

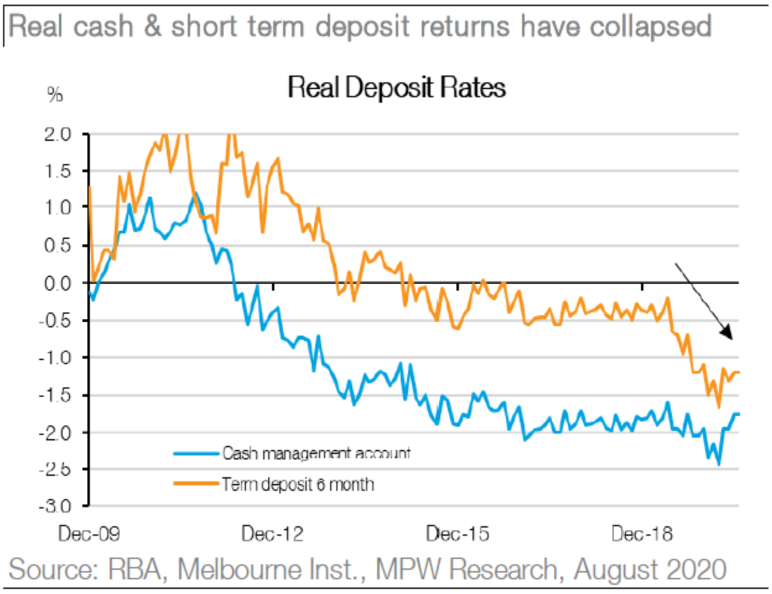
Cash rates are not set to rise for years to come



Source: Bloomberg, MPW Research August 2020

Real returns on cash / equivalents are negative

As cash rates have fallen, so too has the ability to generate income returns from cash. The cash rate is now lower than the inflation rate with the implication that the purchasing power of cash balances is being eroded making the opportunity cost of holding cash relative to other assets far greater than in the past (or put another way, the cost of your safe haven cash is now a drain on both returns and your purchasing power.)



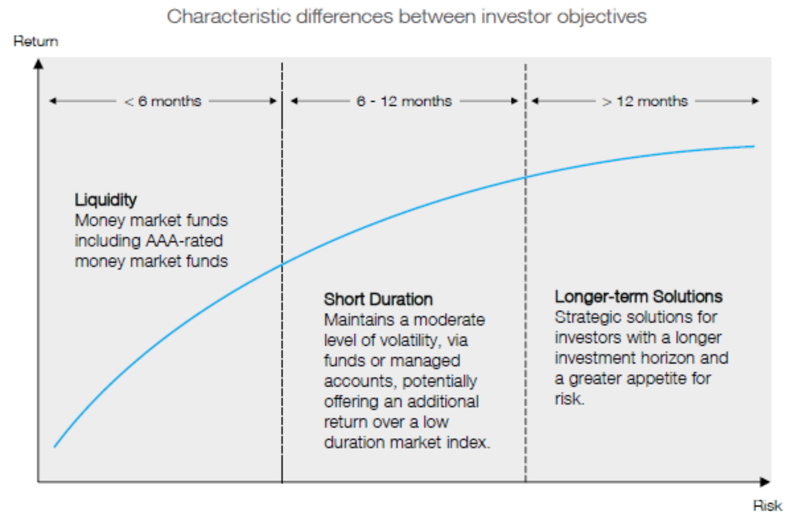
Managing "cash" objectives

We think the objectives of someone who chooses to hold cash can generally be classified as either for, **capital preservation, liquidity and/or return generation**.

Importantly, for investors who are not familiar with actively managing their cash positions, options should always be high quality and have a degree of flexibility.

To maximize the return and minimise risk for holders of cash, we recommend investors approach this task by creating "cash sleeves". **A short-term sleeve of less than 6 months for liquidity purposes** and **a medium to long term sleeve of more than 6 months (available for cash conversion but with slightly enhanced returns.)**

Cash satisfies different investor objectives



Source: JP Morgan Asset Management, June 2020

Sleeve 1: Short-term (less than 6 months)

This bucket should consist of “at call” bank deposits, cash management accounts and term deposits that match the investors term preferences.

The investment objective of this sleeve is simply **immediate access to liquidity.**

Unfortunately, the cost of having immediate access to this cash in the current economic climate is material given interest rates are where they are.

However, there are alternate ways to boost income levels on short-term required cash.

A Macquarie Cash Management Accelerator Account is a high interest savings account linked to the Macquarie Cash Management Account (CMA.)

The Accelerator account sits alongside the CMA, the hub of your investment portfolio and allows for real-time transfers to and from your linked CMA during business hours with no fees and no minimum or maximum limitations.

The benefit of the Accelerator is entirely in the interest accrued on cash within the account which is currently 0.90% p.a compared to the CMA at 0.05%.

Sleeve 2: “Rainy-day” liquidity (6+ months)

The focus on medium term liquidity should be viewed as necessary cash to meet unexpected obligations or cash shortfalls.

A “emergency” fund where **same day liquidity is not required, however capital preservation is key**.

Here we recommend that investors use a cash enhanced fund which seeks to generate enhanced returns compared to traditional cash products.

Whilst enhanced cash funds are exposed to credit risk (risk of the borrower defaulting), term risk (interest rate movements) and liquidity risk (inability to convert the securities into cash) they are not all created equally.

We believe those without structured credit and those with limited exposure to changes in credit and interest rates are best suited for portfolios.

Ardea Real Outcome Fund (HOW0098AU & XARO)

Our preferred defensive income security currently is the **Ardea Real Outcome Fund (HOW0098AU & XARO, Zenith 'Recommended')** which is a relative value fixed income manager targeting low volatility returns exceeding cash rates and inflation.

Importantly, the Ardea Real Outcome Fund carries minimal duration risk (possibility that changes in rates may reduce or increase the market value of a fixed-income investment) and hence is less exposed to any spike higher in global interest rates.

Over 12 months to August 2020 the fund is +5%, having delivered ~4.40% annualised returns since inception in 2012 and outperforming its benchmark by ~2.70%

The PDS can be found here:

https://www.fidante.com/-/media/Shared/Fidante/ARDE/AROF_PDS.ashx?la=en

This fund is our preferred fixed income play since it combines the safety of investing in high quality government and semi-government bonds with proven risk management strategies to protect investors from fluctuations in interest rates.

Legg Mason Western Asset Australian Bond Fund (SSB0122AU & BNDS)

The **Legg Mason Western Asset Australian Bond Fund (SSB0122AU & BNDS), Zenith 'Highly Recommended')** is an actively managed Australian bond portfolio that invests across Australian government and semi-government bonds, corporate bonds and asset backed securities.

The Fund seeks to earn an after fee return in excess of the Bloomberg Ausbond Composite Bond Index over rolling three-year periods.

Whilst the Western Asset Australian Bond Fund invests in predominantly investment grade securities (above BBB rating) it can hold lower rated securities, however there is currently nothing rated below BBB held in the portfolio at present.

The Fund seeks to add value through active management of interest rate risk (duration), yield curve positioning and sector breakdown with a strong focus on risk management through investment guidelines and diversification of holdings.

The fund has delivered returns of +4% in 2020 comprising of monthly distributions totalling 2.2% and growth of 1.8% and has delivered +6% annualised returns since inception in November 1998.

The PDS can be found here:

https://www.leggmason.com/content/dam/legg-mason/documents/en/regulatory-documents/prospectus/product-disclosure-statement-lm-wa-australian-bond.pdf

To discuss how best to apply this strategy to your personal circumstances your adviser will be in contact, alternatively please do not hesitate to contact your adviser on 1800 064 959 or the team below.

Mark Johnson	T: (03) 8825 4738	Cameron Morcher	T: (03) 8825 4737
Livio Caiolfa	T: (03) 8825 4748	Michelle Bromley	T: (03) 8825 4751
Marcus Ainger	T: (02) 9134 6292	Nicole Lewis	T: (03) 8825 4734
Dylan Cresswell	T: (03) 8825 4707	Garry Frizzo	T: (07) 4019 2410
Michael Cooper	T: (07) 3010 8597	Nicholas Miller	T: (03) 8825 4722
Jarrod Rodda	T: (03) 8825 4729		

Yours sincerely,

Primestock Securities Ltd
AFSL No. 239180

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