canberra times: q&a

Q 1: With so much volatility in the sharemarket wouldn't investing in term deposits with a guaranteed return on my money be a better place to invest?

Withheld, Canberra

A 1: Your question reflects the feeling many investors are having in the current investment environment and it highlights exactly why financial advisers would recommend that share investing is only suitable for long term investors. Absolutely for a predictable investment return, term deposits with a fixed interest rate of return are more reliable for short term planning purposes (particularly when covered by the Government Bank Guarantee). And if this reliability allows you to achieve your financial objectives then it should certainly be considered. However, a better return will be achieved by the broad sharemarket over time. Over what period of time it takes for the better results to be seen is the challenge as we simply do not know. The reason for this is due to the way money moves in a capitalist economy.
To explain:

A financial institution can only pay you a fixed interest return on your term deposit – say 5% pa – if the institution can lend the money out at a greater interest rate – say 6% pa. They do this by lending money to people to buy houses for example, and to businesses to finance their operations. So, if enough people can't finance their mortgage loan and if enough businesses can't finance their debt, then the financial institution cannot pay you the interest on a term deposit. These components are all intertwined and rely on each other.

So, in simple terms, individuals can only afford to finance their mortgage if they have a job. And businesses can only afford to exist if they can pay their wages to employees, finance their loans and make a profit. Profits lead to dividends paid and share price increases for shareholders.

In a slow economic environment where consumers are cautious and spending less, then profits will be down. Businesses may then need to shed staff to keep making a profit. This then leads to people spending even less and being under pressure to meet mortgage repayments etc. A potentially dangerous downwards spiral!

To combat this, the Reserve Bank would lower official interest rates to make financing debt more affordable for businesses (leading to higher profits which benefits shareholders) and individuals (lower mortgage costs). Remember that falling interest rates also lead to lower interest rates payable for term deposits!

Further, if expected share investment returns were lower than fixed interest investments available, then no one would invest in shares rather they would invest in term deposits, which would drive down interest rates even further.

So, in summary, term deposits should certainly be considered as appropriate investments for a predictable return, however you need to remember that interest rates can fall over time

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lowering your return on investment, particularly after tax and inflation is considered.
And, in time, share and property investing will produce a higher return than fixed interest investments because on the whole they need to so they can continue to exist. You simply need to make sure that you can hold your share exposure long enough through the volatility to reap those additional returns.

It also needs to be remembered that whether investing in shares, property, fixed interest or cash, you need to have a well diversified portfolio (ideally thousands of individual assets backing your portfolio) to reduce the risk of permanent capital loss.

Phil Thompson is a certified financial planner and authorized representative of Rise Financial Pty Ltd (ABN 86350987645), AFSL 311718, an Approved Financial Planning Association Professional Practice. Answers should be used as a general guide only and professional advice should be sought before making investment decisions.

Send your financial questions to phil@risefinancial.com.au

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