



Fixed Interest Investors – a cautionary note

Investors often mistakenly believe that when interest rates begin to rise they should switch their superannuation investments to a Fixed Interest option. However, contrary to popular belief, rising interest rates generally mean bad news for fixed interest investors.

What are fixed interest investments?

Fixed interest investments comprise a range of securities that include Government bonds, semi-government bonds, corporate bonds, debentures and term deposits.

What are the risks?

As interest rates rise, the price of a bond or fixed interest securities generally decline, meaning the value of a fixed interest investor's capital falls. Instead of being a safe haven for super money, long term and short-term investors may find their portfolio under performing in a rising interest rate environment.

For example, an investor (Bob) purchased a government bond with \$100 that entitled him to interest of 5% p.a. over 3 years. i.e. \$5 p.a. interest and the return of his capital of \$100 at maturity. However, the following month the Reserve Bank announced an interest rate rise of 50 basis points (0.5%).

This rate rise was directly absorbed into the markets. Three-year bonds could now be purchased for \$100, yielding 5.5% p.a. In other words, any new investor could now receive \$5.50 each year for 3 years on a \$100 outlay.

If Bob now decides to cash in his 3-year bond, he will make a capital loss. As interest rates have moved to 5.5%, no one is willing to pay Bob \$100 for the bond, as it only pays 5% p.a. They can get 5.5% for each \$100 in the open market. As a consequence, if Bob decides to sell, only \$95.40 would be achievable. This would result in a capital loss of \$4.60.

A capital loss with rising interest rates

The risk of experiencing a capital loss in a rising interest rate environment is common with fixed interest investments. To manage interest rate risk and minimise potential losses, market participants, such as fixed interest fund managers, try to anticipate interest rate rises by managing the duration (average maturity) of their portfolio. They do so by keeping a portion of their funds in cash so they can buy bonds after an interest rate rise, as well as holding a variety of fixed interest securities with different maturities (1,3,5 and 10 years); this helps to insulate them from the effect of the decline.

Vision Super's Fixed Interest Plus option

At Vision Super our Fixed Interest Plus option is cushioned to some extent from rising rates due to its additional exposure to growth areas such as shares, property, infrastructure and cash. Growth areas often rise in value when the price or value of bonds fall. This additional exposure cushions Fixed Interest investments as interest rates rise. At times of rising interest rates, investors should therefore consider the other investment options available to them, bearing in mind the risk associated with the other options versus the risk of a decline in fixed interest investments.



We can help!

If you would like further information about fixed interest, or any of our products and services, please call our Member Services team on 9911 3222 (or 1300 300 820 for regional members).