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Income Investing To Beat The Banks

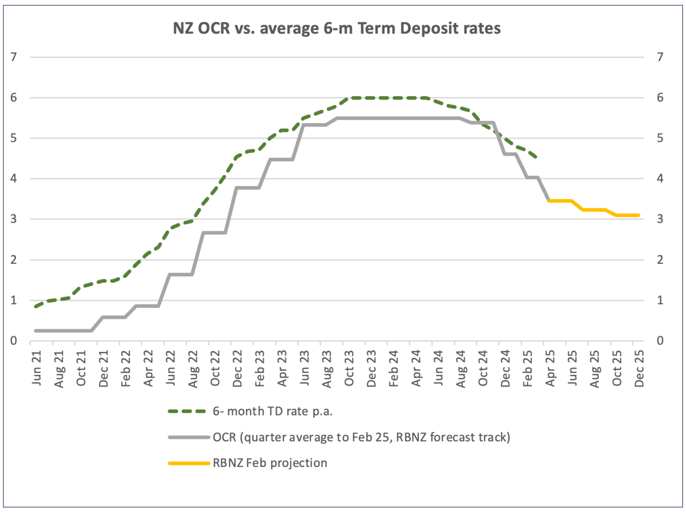
New Zealand Term Deposit Rate Cuts Are In Full Swing For 2025

Real Income Preservation Requires An Enhanced Asset Set

Diversified Income Funds Can Continue To Beat Bank Deposits

More Official Cash Rate Cuts Scheduled – What To Do?

In 2025, New Zealand interest-seeking investors are faced with a dilemma. Many have maturing Term Deposits to roll over or re-invest soon, and - in line with the Reserve Bank's monetary easing cycle – it will be impossible for them to achieve the term deposit rates that were being offered over the last eighteen months. Banks have been swift to lower their offers, and to squeeze down the margin they will pay to depositors above the Official Cash Rate (OCR) and influential associated swap rates.



Source: RBNZ, Salt

Why do investors still utilise TDs?

Although the benefit of holding a term deposit paying 5-6% when inflation was running above 3% are very limited, many savers felt that a "real" or inflation-adjusted income stream of 2% per annum was adequate, if not optimal. Now that inflation is closer to 2-3%, will savers be happy with NZ term deposit rates which will likely converge on just 4% p.a. by year-end?

The view that doing so is acceptable is predicated on the idea that the New Zealand banks offering term deposit rates averaging around +1% higher than the Official Cash Rate are low-risk and reliable - although there is no operating formal government guarantee of depositors' funds yet in NZ. The Reserve Bank will only start introducing a "Depositor Compensation Scheme" from mid-year, and the deposits covered are expected to be capped at $100,000 per depositor per bank.

Regardless of some uncompensated deposit-taker risk in the banking sector, NZ investors definitely have to deal with risks arising from the illiquidity of their funds while they sit on Term Deposit. Banks charge substantial "break fees" to reduce and even to recover interest paid to those depositors who need to redeem their funds on deposit before the term is up. This results understandably in depositors either taking shorter deposit terms than may be optimal, to reduce the chance that they fund themselves "caught short" of funds, or in some cases, borrowing or selling other assets to cover urgent cash requirements. Neither course is prudent asset management and is often self-defeating.

What is the Income Investor's "true" priority?

Holding an asset pool that generates a regular, reliable yield which is paid out to the investor as income is at the heart of why both individuals and institutions buy bonds, bills, dividend equities, and rental properties. These are all very different types of assets, with differing drivers of their pricing and yields. However, they all have in common the feature of a known future income stream.

The question is, should it be necessary for an Income-type investor to accept potentially diminishing returns purely for the certainty of their future incoming cash flows? Note that this putative "certainty" can in fact be compromised, e.g. by changes such as distribution tax rate modifications from Inland Revenue.

In any case, it is evident that Bank Term Deposits are becoming increasingly obsolete as a useful tool in an investor's portfolio construction tool-box. Other structures can combine assets to offer comparable or superior income yields for a known future term, but also allowing for much better liquidity and flexibility within that given timeframe. Such assets may be found in Equity, Listed Real Asset and Fixed Interest markets alike.

A prudent asset manager can combine income-bearing securities from a range of investment types, always assessing if the income being garnered is sufficient to compensate for any additional risk features that asset may entail *over the relevant investment time horizon*. Note that such risk does not really include price volatility in the asset pool – from an investment management standpoint, that isn't the key consideration. The mark-to-market valuations of most traded bonds, for instance, can fluctuate substantially within the term to maturity without compromising the nominal capital worth of the security when it reaches its eventual maturity. Bond funds, by contrast, realise both gains and losses as they sell and / or roll over constituent securities, seeking better risk-adjusted yields based on credit quality and a wide range of country or industry spread premia.

More important is the real value of the investment when taking account of both its the stream of income payments across time and the impact of inflation dynamics, adding up to a real total return. Sophisticated Income investors are perpetually aware of maximising real total returns, and it is simplest to do this when the income assets relied on are well-diversified, because that allows adaptation to changing economic and market circumstances.

Future-Oriented Thinking

In NZ, the small set of "Diversified Income Funds" available are structured with a sizeable exposure to New Zealand and International bond securities, supplemented by higher-dividend yield paying Australasian equities. During the "three years of global yield dearth" paid by Fixed Interest securities worldwide that prevailed between mid-2019 and mid-2022, one solution for asset allocators has been to seek out parts of the equity investment universe that offer a stable dividend yield, paid out in cash. That worked fairly well, though it led to a crowding into yield payers such as utilities and energy companies, as well as (for ethically-unconstrained investors) into tobacco, materials and mining or aerospace/defence companies, all of which can offer high yields.

In New Zealand, higher dividend-payers tend also to be concentrated in a small number of industries, operating with similar business models – limiting the diversification that is available for investors. When the Reserve Bank has engaged in a monetary policy tightening cycle, the advantage of those equity dividend yields when compared to less-volatile securities shrinks. However, in an accelerated easing cycle, the yield advantage will once again be revealed and such equities become very attractive. An eye on the future, however, does counsel against relying on permanently-elevated NZ equity dividend yields.

Internationally, partly due to lower money market yields, partly to typically lower dividend yields, and partly to deep, complex capital markets, the last couple of years has seen another innovation in cutting-edge Income Fund design. The so-called "Covered Call Option" strategy generates income to a portfolio (which is then distributed to fund investors) by selling call options on some of the stocks already held within the fund. A supplementary income stream is thereby generated, to adds to the dividend yield received from the equity holdings within the fund. There being "no free lunch except diversification" in finance, such funds do take on counterparty risk as well as potentially wearing losses on the portfolio if the equities selected drop in value. Covered call strategies, though innovative, do bear embedded risks, including limiting upside capital growth potential, downside equity price risk, unanticipated options exercise, and the triggering of taxable income in international jurisdictions. For domestic assets in New Zealand, our options markets are far too rudimentary to apply such strategies.

Looking Wider For Stable Income Yield

Salt Funds Management takes a broader view of the desirable investment universe, for New Zealand investors who seek reliable investment income. We believe that all evidence points to the conclusion that to identify and preserve a source of steady income that can keep pace with, or offset, medium-term inflation, investors need to accept within their portfolio a somewhat greater level of pricing volatility than a traditional bond-based fund would demonstrate. Having said that, conventional bond fund volatility has itself been elevated in the years since 2022, and some sovereign bond markets have accrued negative total returns in the last 3 years. There is no absolute guarantee that this won't recur.

The basis of our thinking is that bond markets function poorly when the future path of inflation is uncertain. Even during the "diminishing inflation" phase, the total returns from a bond-based Income fund can remain anaemic and will likely leave an investor with diminished purchasing power at the end of a specific investment horizon – say, after 3 or 5 years. Accruing multi-year capital gains from participating in the post-1980 global bull market for bonds is no longer available as an element to buttress portfolio total returns. More likely (as has in fact been seen recently) is a bond market trading range, with yields see-sawing within a band while the capital value of bond holdings lifts and sinks from month to month, or from quarter to quarter. This may camouflage an inferior investment outcome, but it cannot prevent such an ultimate outcome for investors utilising the traditional bond-dominated Income Fund structures.

Three Pillars Of Income Fund Design

There is a better way, in our view. We have structured our in-house **Income Fund** around three basic pillars:

- A targeted, international Bond foundation which is unconstrained by benchmarks.
- Global listed Infrastructure, plus Global and Domestic listed Property allocations.
- Equities listed in New Zealand that may pay high and sustainable dividends over the cycle.

These three fundamental asset types held within the Sustainable Income Fund are complimentary, and they are sufficiently different from one another to defend the Fund's income distribution track through a range of economic conditions. Furthermore, the equity components are included to offer scope for medium-term capital growth. That is particularly important, because a positive after-inflation return objective increasingly relies on a capacity for the enduring price gains that are best achieved through equities.

We consider that a properly-constructed and actively-managed Income Fund in New Zealand should be able to pay investors an annualised distribution in the 4.75% - 5.5% range for the remainder of 2025. By mid-year, this yield level could be 1% or more higher than banks' best 6-month deposit rate.

Active Income Sourcing Is Key To Success

We believe that active management provides significant advantages in steering investor's assets through periods of disruption and those distortions to reasonable valuations which are occurring with greater regularity. All the components within the Salt Sustainable Income Fund are actively selected and monitored by specialist portfolio managers within their asset classes. The Income Fund manager should adjust asset allocations to capture opportunities and to reduce downside risks at the asset-class level. With the medium-term investment horizon in mind, it is better to accept an explicable level of asset price volatility, than to miss opportunities by retaining high Cash levels for extended periods.

Volatility is likely to remain elevated in the year ahead, and relying on the traditional diversification features of simple domestic, or international government bond securities will continue to prove inadequate in an era of severe fiscal challenges. Robust income-oriented portfolios can now be built without such reliance on sovereign debt as the primary source of yield, by looking more broadly at real assets and at specialised Fixed Income securities which align with multi-decade global structural trends.