

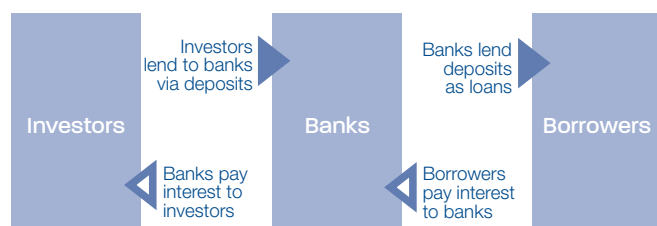
Lend like a bank – benefit like a bank

Michael Korber, Head of Fixed Interest and Credit, explains how investors can benefit by lending like a bank, rather than lending to a bank through term deposits.

How do banks make money?

A core business of banks is to borrow money at low cost and lend the borrowed funds out at higher cost (see Figure 1). The difference between banks' borrowing costs and lending rates is a key driver of their profitability. Banks source the majority of their funds from depositors through term deposits and saving accounts, shareholders through equity capital and institutional markets by issuing bonds.

Figure 1 – Lending to a bank



Banks in turn lend out the bulk of their funds to Australian residential and commercial property owners, financial and non-financial companies, equipment buyers, and other banks (see Figure 2).

Figure 2 – Who do banks lend to?

Banks lend to ...	Such as ...	For funding ...
Companies	Woolworths, Tabcorp, Origin Energy	Working capital, business expansion, capital expenditure
Property trusts	Stockland, AMP, CFS	Property purchases, redevelopment
Financial companies	GE Capital, Colonial Finance, HSBC Financial	Financing activities
Individuals	Teachers, doctors, traders, mums and dads	Buying homes, credit card expenses, car & equipment financing
Other banks	CBA, NAB, Westpac, ANZ	Lending activities, business growth

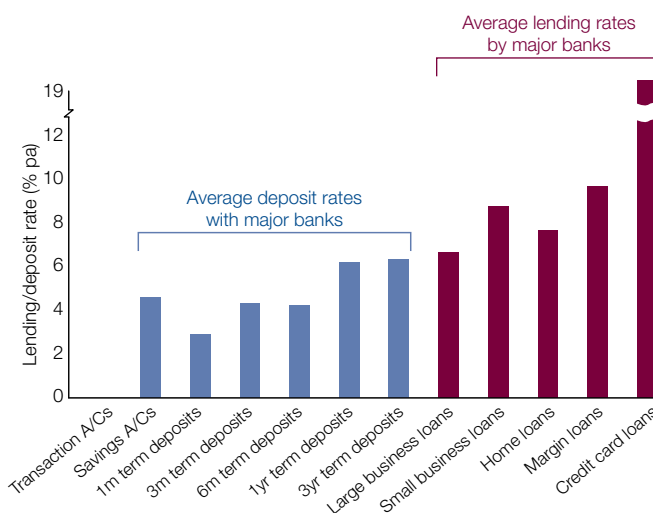
Part of the profitability of the major banks in Australia is from lending at high rates of interest, and borrowing much more cheaply. They manage their risk by attempting to be well diversified and only lending to quality borrowers who they believe will pay them back.

How can investors benefit like a bank?

Investors who buy banking shares may benefit from bank profitability, but not every investor likes the volatility of buying shares.

For conservative investors, a common approach to benefiting from banks is to invest in bank accounts or term deposits. When you deposit your money with a bank, you are effectively lending it to the banks. While it is depositors' objective to lend at the highest possible interest rate to a bank, it is in the banks' interest to borrow as cheaply as possible from depositors (see Figure 3).

Figure 3 – Average lending and deposit rates of major Australian banks



Source: RBA, as at October 2010.

Therefore, bank deposits may not always be the optimal way of generating an income while preserving capital. Conservative investors could improve their income by lending directly to quality borrowers, ie lend like a bank.

How to lend like a bank?

Investors can lend like a bank by buying debt securities in the debt markets (see Figure 4). A debt security is a loan made from the buyer to the issuer of the security. The issuer pays interest periodically and repays the principal to the buyer at a specified maturity date.

Figure 4 – Lending via debt markets



When you buy a debt security (corporate bond) issued by BHP Billiton or Westfield Group for example, you are effectively lending money to that corporation. You could also lend money to the Australian government, home owners, banks, insurance companies or commercial property owners by buying the related debt securities issued.

Lending to home owners and commercial property owners can be achieved by buying residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS) respectively. An RMBS is a debt security backed by a pool of home loans or mortgages. These home loans are secured against residential properties. The holders of RMBS receive interest and principal payments from home loan customers. As its name suggests, a CMBS is backed by a pool of loans secured against commercial properties, and the holders of CMBS receive interest and principal payments from commercial loan customers.

In addition to lending to corporations, home owners and commercial property owners, investors can also lend to borrowers who require funding for purchases of motor vehicles

and medical equipment, or for credit card expenditures. Typically, banks would pool together these loan assets into debt securities that can be bought and sold by fixed income investors. The holders of these securities will receive the interest and principal payments from these loans. Debt securities that are backed by credit card debt, leases or receivables are generally called asset-backed securities (ABS).

The benefits of lending like a bank

Investors who lend like a bank rather than lending to a bank are able to benefit from the additional income which a bank would normally earn by lending out their funds. They therefore have an opportunity to increase the returns from their conservative investments. This is not without risk. By investing in a managed fund, retail investors can benefit from experienced portfolio managers who seek to ensure funds are only lent to high quality borrowers.

The advantages of lending like a bank through a managed fund are as follows:

- potential to earn higher rates of return than bank deposits
- returns increase when interest rates rise
- access to global debt markets and institutional pricing
- active portfolio management
- risk management and diversification to minimise risk of unexpected default
- liquidity when redemptions are required
- transparency with periodical reporting.

The Perpetual Diversified Income Fund – Lending like a bank

The Perpetual Diversified Income Fund offers a diversified and defensive way of accessing the opportunities of lending like a bank. It is a fixed income fund that invests in high quality floating-rate debt securities with relatively short maturities. It aims to provide consistent income which is distributed quarterly and it offers daily redemption.

We believe the Fund offers investors the following benefits:

- potentially higher income and returns relative to the cash rate
- income that rises when interest rates rise
- highly diversified and defensive
- daily liquidity when redemption is required
- low correlation to fluctuations in equity markets
- actively managed by a professional and stable investment team.

Want to learn more?

Read the entire article in Income Examiner, available online at: www.perpetual.com.au/advisers-newsletters

For more information on fixed income markets or accessing them through the Perpetual Diversified Income Fund, please contact your Perpetual Account Executive or contact our fixed income team on the numbers below.

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