

HEALTH WEALTH CAREER

INVESTING IN A LOW (OR NO) YIELD ENVIRONMENT

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EXECUTIVE SUMMARY

- Negative interest rates have gone from being a theoretical construct, perceived by most as an absurdity, to being a reality in a number of developed economies. Bond yields almost everywhere in the developed world are at or near historic lows.
- Although it is possible that negative interest rates could become more extreme, there is now an increasing recognition of the potentially damaging side effects of such policies.
- As a result, there has been discussion about other extraordinary policies (generally involving some degree of fiscal monetary coordination) that could be used either instead of, or to reinforce, the monetary stimulus provided to date.
- Investing in negative or zero-yielding nominal bonds makes little sense from a long-term absolute return perspective. Although there is clearly a degree of feed-through of low yields into many other asset classes, long-term absolute return investors should consider a combination of credit, real asset, hedge funds and “cash plus” exposures that might offer a more attractive risk/return profile than nominal sovereign bonds over the medium to long term.
- For liability-relative investors, the risk remains that yields could fall further. However, investors with a long time horizon and a high tolerance for mark-to-market volatility may wish to consider reducing holdings of nominal government bonds and (in particular) leveraged interest rate exposure while recognizing the impact that such changes would have on their overall risk profile.

HOW DID WE GET HERE?

Even before negative interest rates became a widespread phenomenon, sovereign bond yields in the developed world were already extremely low by historical standards, having been in long-term decline for over 30 years. Falling bond yields in the post-crisis environment have largely been due to short-term interest rates being held close to zero and large-scale bond-buying programs implemented by central banks in response to stagnant growth and below-target inflation.

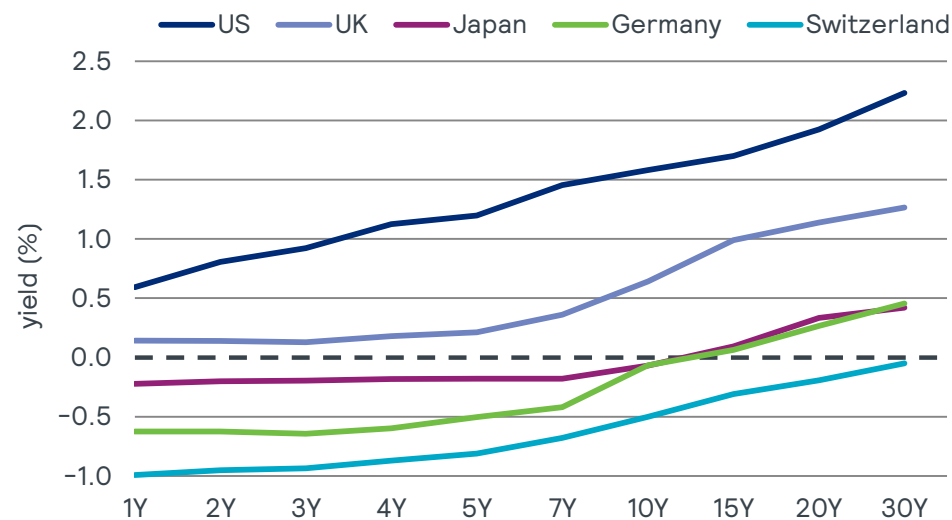
In response to falling inflation and falling inflation expectations, central banks in Switzerland, Denmark, Sweden and the eurozone cut their policy rates below zero in 2014. The expectation of a prolonged period of negative interest rates gradually became priced-in further along the curve, resulting in negative yields for government bonds across a range of maturities. On 29 January 2016, the Bank of Japan (BoJ) joined its European peers in cutting interest rates below zero, triggering a sharp repricing of Japanese government bonds and substantially expanding the global universe of negative-yielding government securities to roughly one-third of the developed-world global sovereign bond market.

Central banks have pushed interest rates close to zero to simulate growth and inflation

As a result, investors in developed world government bonds now face one of three different situations:

1. Negative/near zero yields across the curve in the eurozone, Denmark, Sweden, Switzerland and Japan.
2. Yields in positive territory but with 10-year yields below 1%, as in the UK.¹
3. Yields in positive territory, with 10-year yields above 1%, as in the US, Canada and Australia.

**FIGURE 1: GOVERNMENT YIELD CURVES
(31 AUGUST 2016)**



Source: Bloomberg

At the start of 2016, the UK situation was arguably much closer to the US than Europe and Japan, both in terms of growth trajectory and expected path of monetary policy. However, it is now hovering somewhere between the two, in part due to the expected slowdown caused by the Brexit vote.

¹ We note that UK gilt yields have, on occasion, dipped into negative territory at short maturities.

LIMITS TO NEGATIVE INTEREST RATES AND BOND YIELDS

The effective lower bound for negative interest rates is reached when hoarding physical cash becomes more attractive than holding bank deposits or bonds where the interest rate is less than zero. It is difficult to state with any precision the point at which a large shift to physical cash might occur, but it is likely to be related to the transport, security and storage costs of holding large amounts of physical cash. Most estimates suggest that a shift to physical cash might start to occur with interest rates somewhere between -0.5% and -1.5%. Some reports indicate that investors in Switzerland have started to hoard cash in order to avoid the impact of negative rates on cash deposits.

Another important limit on the use of negative interest rates is the impact on the banking sector. It is typically assumed that banks will be reluctant to pass on negative interest rates to their depositors.² As a result, negative rates (and a flatter yield curve) erode bank profitability, by reducing banks' ability to lend at materially higher rates than they offer to depositors. In recognition of this issue, the Bank of Japan (BoJ), European Central Bank (ECB) and Bank of England (BoE) have all introduced schemes that attempt to mitigate the impact of close to zero or negative base rates on the banking sector.

Finally, in recent months policymakers and market participants have expressed increasing skepticism over the efficacy of negative interest rates.³ Arguments have typically focused on the impact on the banking sector (as noted above) but also on unintended consequences, such as increased household savings rates (due to the lower expected income from existing savings), which act in the opposite direction to the desired stimulus. Mark Carney (Governor of the BoE) essentially ruled out the use of negative interest rates in a press conference on 4 August, stating that "the MPC is very clear that we see the effective lower bound as a positive number, close to zero, but a positive number."⁴

So although further cuts to interest rates that are at or already below zero are clearly possible, it seems likely that central bankers will rely more heavily on other policies (such as asset purchases) to stimulate growth and inflation in the months and years ahead. This arguably creates some degree of asymmetry in bond yields as they approach and fall below zero – although it is clear that bond yields can go some distance below zero (as we have already seen in Europe and Japan), central bankers will likely find it difficult (and probably undesirable) to drag nominal bond yields far into negative territory (say below -1%) for a sustained period.

Negative rates encourage cash hoarding, erode bank profitability and create unintended consequences

² However, it is worth noting that some banks in Europe and the UK have started to impose negative rates on some of their customers.

³ For example: <https://www.pimco.com/en-us/insights/viewpoints/viewpoints/negative-interest-rate-policies-may-be-part-of-the-problem>

⁴ <http://www.bankofengland.co.uk/publications/Documents/inflationreport/2016/conf040816.pdf>

WHERE NEXT FOR MONETARY POLICY?

If negative rates are to be of limited additional use to central banks in stimulating their economies, where else might they look? One idea that has received an increasing level of attention this year is fiscal-monetary coordination (often described as “helicopter money”). The basic idea is that a government would decide to issue debt in order to fund some spending (for example, on public infrastructure) and the central bank would purchase (or “monetize”) that debt. In many ways, this is not so different from quantitative easing (QE) – however, the primary distinction is that with QE the asset purchase is expected to be temporary (that is, the central bank is expected to sell the asset back to the market at some future date), but with fiscal-monetary coordination the asset purchase would be permanent. In addition, fiscal-monetary coordination is likely to be more directly targeted at spenders (via fiscal stimulus) rather than investors/savers (via asset purchases).

Japan has arguably moved the furthest in this direction, with its most recent announcement of fiscal stimulus coinciding with continued monetary easing (including central bank asset purchases). Although Japan has been careful not to break the rules of independence between the BoJ and the Ministry of Finance, Japan has also made it clear that there is some degree of coordination between fiscal and monetary policy.

Other experimental policies could include:

- Direct cash transfers to individuals funded by money printing (the original meaning of the term “helicopter money”)
- Large debt write-downs accompanied by money creation
- A “carrying tax” on holding cash or even a shift to a cashless economy (with only digital currency)⁵
- QE used to purchase a broad range of assets, including real estate, which could then be used for socially beneficial purposes
- Central bank control over certain tax policies as a counter-cyclical tool (for example, the ability to reduce income tax rates in the face of a recession)
- Explicit use of currency devaluation/intervention as a policy tool

Many of the more extreme policies listed above are unlikely to be implemented in the near term (if at all), but the fact that they are being discussed by serious policymakers and market participants is worthy of note. Perhaps the key point for investors is that experimental and extraordinary monetary policy could potentially go much further than it has already, and although the effects of such policies are highly uncertain, widespread steps toward fiscal-monetary coordination would increase the risk of inflation (and reduce the risk of deflation) in the future.

Experimental and extraordinary monetary policy could potentially go much further

⁵ <http://www.bankofengland.co.uk/publications/Pages/speeches/2015/840.aspx>

BONDS FOR ABSOLUTE RETURN INVESTORS

As nominal bond yields approach or move below zero, those bonds become extremely unattractive investments for long-term buy-and-hold investors. From an absolute return perspective, holding bonds to maturity cannot deliver a return meaningfully higher than the yield at purchase.⁶ So although developed world nominal sovereign bonds may remain a useful trading tool for short-term absolute return investors, their only investment merit for long-term investors is arguably as a hedge against a deflationary bust (under such a scenario, other financial assets are likely to do much worse).

We therefore believe that long-term absolute return investors with non-trivial holdings of nominal sovereign debt with a yield close to or below zero should re-assess the role of those holdings within the wider portfolio. Such assets will clearly fail to satisfy any need for a positive real or nominal return over the long term, so it may be that they are no longer appropriate assets from a return-generation perspective. Similarly, from a risk management perspective, the safe-haven characteristics of bonds are arguably reduced the lower their yield (if one accepts that there is a limit to how negative nominal bond yields can become).

The actions that follow will vary from one investor to the next, and there are few easy answers. Although it is clearly possible to boost the yield or expected return on a portfolio by replacing sovereign bonds with “risky assets,” it is important to note that low yields are, at least to some extent, priced in to many other markets. As a result, we would describe few asset classes (especially defensive assets) as “cheap.” Having said that, alternatives worth considering might include credit-oriented strategies (including those seeking to exploit illiquidity and complexity premia), real assets at the lower end of the risk spectrum or conservative hedge fund strategies (seeking a cash plus return). All such strategies introduce some form of investment risk in order to boost returns but, in our view, are likely to offer a more attractive risk/reward profile than nominal government bonds yielding close to or less than zero.

Absolute return investors should re-assess the role of sovereign debt in their portfolios

⁶ Technically, it is possible for the total return to be slightly higher than the starting yield if coupons are reinvested at yields greater than the starting yield.

BONDS FOR LIABILITY RELATIVE INVESTORS

The risk/return considerations for liability-relative investors (such as pension plans and insurance companies) are more complex. Investors in certain markets face material regulatory constraints/pressures associated with the mark-to-market risk arising from any asset-liability mismatch. For many investors, this is not simply a theoretical risk but rather an issue that can lead to tangible real-world financial implications, such as higher contribution levels for pension plan sponsors. In this liability-relative world, many pension plans are already significantly “short” interest rate duration — meaning they will have seen funding levels deteriorate as yields have fallen.

Liability-relative investors will therefore need to consider the merits of sovereign bond holdings and leveraged interest rate exposure in the context of their financial position, long-term objectives, tolerance for risk, yields available in their domestic market and their willingness (and ability) to adjust the magnitude of their asset-liability mismatch over time. Such considerations will necessarily be investor-specific and will vary from one market to the next (for example, long-dated yields are at present materially higher in the US than in Japan). However, in broad terms, we would expect investors with a greater tolerance for risk (for example, due to the existence of a financially strong sponsor) and where nominal bond yields are approaching or below zero to be more willing to consider increasing any asset-liability mismatch at extremely low (or negative) nominal yield levels than investors with a lower tolerance for risk (and where bond yields are higher).

We believe the key questions for liability-relative investors to address in the current environment are:

1. What is the most relevant measure of risk given the long-term objectives of the plan? Investors looking to buy out the liabilities with an insurance company or to invest in a portfolio dominated by government bonds within the next five to 10 years, will care much more about mark-to-market volatility (as a measure of the cost of achieving their objective) than an investor with a longer time horizon and a different target portfolio.
2. Assuming mark-to-market risk matters at least to some extent, how much exposure does an investor have to further falls in yields in the short to medium term? Understanding and sizing the risk exposure in the context of the other investment risks being taken and the wider context (for example, the financial strength of the plan sponsor) is critically important.
3. To what extent is the investor comfortable expressing a view on the asymmetry of future yield levels in portfolio positioning?

Liability-relative investors should review their interest rate exposure in light of their objectives and risk tolerance

The answers to these questions might differ quite radically from one investor to the next. For example, it may be appropriate for a pension plan with a weaker sponsor and a low need for additional returns (that is, with a high funding level) to retain a high liability hedge ratio, even when yields reach zero. Conversely, a pension plan with a strong sponsor and a material deficit (that is, with a need to generate significant additional returns) might choose to reduce its liability hedge ratio (or retain a low/moderate level of hedging) reflecting the limited downside risk as yields approach and move below zero. In particular, the risk-reduction benefits of leveraged interest rate exposure are reduced, from both short-term and long-term perspectives, as yields approach any perceived floor. The upside in terms of reduced liability values and improved funded status if rates rise is significant. Investors should also consider the extent to which the costs of using leverage (including management costs, funding costs and reduced flexibility due to the need to hold collateral) are sufficiently offset by the reduction in mark-to-market volatility.

In making such judgements, two important considerations will be: (i) stress testing to understand the potential impact on the financial position of a further fall in yields over a meaningful time horizon; and (ii) an assessment of the potential funding level improvement that might be achieved by reducing (levered or unlevered) liability hedges.

Finally, it should be noted that inflation hedging will also be an important part of many investors' hedging programs, due to inflation-linkage in the liabilities of many pension plans (though this is rarely present in US corporate plans). This introduces an additional layer of complexity because inflation-linked government bonds will often be used to provide both interest rate and inflation exposure. In contrast to nominal bond yields, the arguments around asymmetry of outcome are much less clear in relation to real yields, given the potential for high levels of inflation (perhaps induced by fiscal stimulus) to push real yields even further into negative territory (although this clearly depends to some extent on the central bank response to any bouts of inflation). Inflation-sensitive assets (including inflation-linked government bonds) are therefore likely to remain an important part of an investor's liability-hedging toolkit.



ACTIONS FOR DISCUSSION

Depending on investor circumstances, we believe that the following actions are worthy of consideration given the current level of yield available on developed world sovereign debt.

- Long-term buy-and-hold investors that need to generate positive real or nominal returns may wish to reassess the role of any holdings of nominal sovereign bonds in their portfolio.
- Liability-relative investors should have a clear understanding of their long-term objectives and ensure that their funding and investment strategy is consistent with those objectives. Investors should also understand the magnitude of their financial exposure to changes in bond yields — scenario analysis and stress testing may be a useful input to such discussions.
- Building on this, we would suggest that investors also consider the extent to which they might adjust their liability-hedging strategy given the significant fall in yields across many markets this year. Investors should also be clear on how their strategy is expected to evolve as their financial position and market conditions change.

Low-bond yields may be with us for some time to come, but investors should consider the extent to which the significant falls in bond yields and their changing circumstances might justify a review of their current approach.



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