Russell Investments

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Title: **Fixed Interest Investing in a Low Yield Environment**

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Date: May 2012

MAY 2012

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EXECUTIVE SUMMARY

An increasing number of investors are predicting an end to what has been an impressive three-decade-long bull run for debt markets. Investors have benefited from a persistent decline in yields, making fixed income a top-performing asset class over this timeframe. However, the fact that current yields are low by historical standards should not necessarily worry investors. In particular, investors should consider the following:

- Rising yields are not synonymous with negative returns. Rather than forecasting the absolute level of yield increases, investors should assess yield increases relative to the yield changes already factored into current bond prices.[1]
- Active bond managers have several tools at their disposal to mitigate some of the negative implications of rising yields. For instance, if rates were to rise as a result of improving economic fundamentals, corporate bond spreads would most likely narrow and would help to dampen the effect of unexpected rising interest rates. There are numerous other strategies managers can use to enhance returns and reduce risk, independent of the yield curve environment, including credit as well as sovereign strategies.
- A market consistent asset-liability management approach highlights how future funding requirements actually decrease as yields rise, a positive for many institutional investors, as well as individuals at or approaching retirement. In the case that investors are fully matched, an increase in rates should have no impact on the overall asset-liability position.

In this paper we shall broaden our view and discuss key themes that should frame how investors think of the asset class in the future:

- **The crucial role of fixed income as a diversification tool:** Fixed income continues to be an important diversifier. It functions as an important offset to some of the risks that drive equities and other growth assets. In addition, despite the current low yields, it will most likely continue to be a good source of steady income.
- **Historical perspective on returns and thoughts on the future:** Fixed income has shown impressive returns over the last 20 years as shown in Figure 1. It should be noted, however, that this was also a capital appreciation story. In the present low yield environment, the potential for capital appreciation is likely to be limited.
- **The role of active management in fixed income portfolios:** With government bond yields in major markets at historical lows, it will become vital to take advantage of a broader investment opportunity set. Exposure to off-benchmark assets can play a crucial role in enhancing income. However, this needs to be balanced with risk-tolerance objectives.

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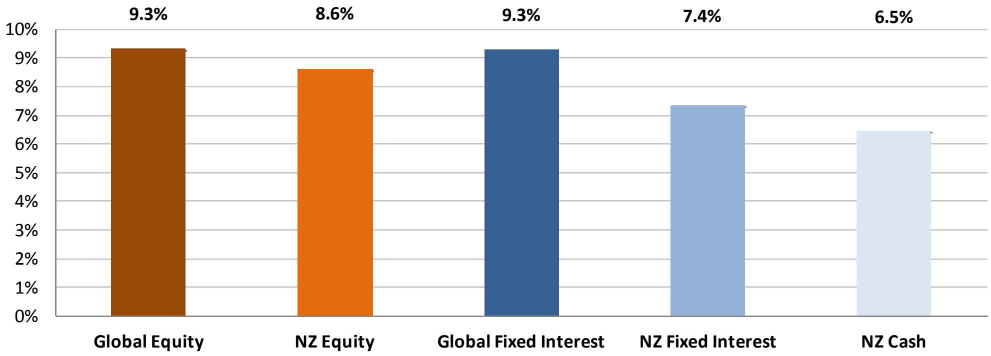
[1] A more detailed technical discussion of this can be found in Collie, B. (2012), *The implications for bond prices of changes in interest rates*, Practice Note, Russell Research, January 2012. The paper is available for download on our website: http://www.russell.com/nz/research/RussellResearch/default.asp

Figure 1: Annualised Pre-Tax Asset Class Returns June 1992 – March 2012[2]



FIXED INTEREST AS A DIVERSIFIER

Using the same indices as in Figure 1, we can demonstrate that in recent times, fixed interest has helped to stabilise and improve returns in portfolios with allocations to both growth and income assets. To illustrate the point we compare three typical splits of bonds and equities with a pure bond and pure equity portfolio. In this analysis we ignore domestic asset classes[3] and assume returns are hedged to the New Zealand Dollar.[4]

Table 1: Diversification effect of Global Fixed Interest vs. Global Equities in the last 20 years[5]

	100% Fixed Int	75% Fixed Int, 25% Equities	50% Fixed Int, 50% Equities	25% Fixed Int, 75% Equities	100% Equities
Annualised return	9.3%	9.5%	9.6%	9.6%	9.3%
Frequency of negative returns	2.7%	4.9%	17.7%	22.1%	26.1%
Largest negative annual return	-1.8%	-4.8%	-18.6%	-30.8%	-41.5%

While the figures in Table 1 are historical, and therefore cannot be relied upon as an accurate projection of the future, the numbers nevertheless illustrate that the diversification effect of global fixed interest has been strong. In this time period, a portfolio comprising 50% bonds and 50% equities would have resulted in the highest annualised return among these options, with a much lower drawdown (largest negative annualised return) and less frequent negative returns than a pure equity portfolio.

MOVING FORWARD WITH FIXED INTEREST INVESTMENTS

Simplified analysis might lead one to believe that rising yields equate to negative returns for bonds. However, this is not always the case. The total return for a bond portfolio is comprised of two key components:

1) Capital return, which is generally challenged in a rising yield environment, and

2) Income return, which usually benefits from a rising interest rate environment over time.

[2] Global Equities: MSCI World NZD hedged (gross), NZ Equities: Russell/JB Were Tradeable Gross Index, Global Bonds: Citigroup World Government Bond Index NZD hedged, NZ Bonds: NZX Government Stock Index, NZ Cash: ANZ 90-day Bank Bill Index.

[3] The question of how much of a fixed income portfolio should be allocated to the domestic market is beyond the scope of this paper. This will be covered, however, in an upcoming New Zealand research paper.

[4] It should be noted that most global bond portfolios today invest in and are benchmarked against a mixture of sovereign and corporate / credit exposure. However, we do not consider that this would change the conclusion materially for this time period.

[5] Same time frame as in Figure 1, assuming monthly rebalancing without any transaction costs.

While rising yields are therefore often a headwind for fixed interest investments, investors should not ignore the returns accruing from the cumulative impact of coupon and maturity payments being reinvested at the higher rates.

For a simple explanation of this, we can start with a basic representation of how rising yields affect a bond portfolio over time as illustrated in Figure 2. Dissecting this reveals how rising yields inversely impact the capital return, shown as Part A and how, in contrast, it enhances the income return over time, shown as Part B.

Figure 2: Effect of rising yields on a bond portfolio[6]

	A	B
Total Bond Portfolio Return =	- Change in Yield * Portfolio Duration	+ Portfolio Yield (on reinvested funds)

It is the magnitude and the time frame of the rise in yields that will ultimately determine what the overall return for the portfolio would be.

Current pricing in major markets suggests that there will be a modest increase in yields, which in turn suggests that investors expect a rather slow economic recovery over the next few years.

But the recovery might not be uniform across all economies. Therefore, a global allocation could be a further source of diversification and protection against yield increases for investors, notwithstanding the fact that rates have tended to move in harmony over the past 20 years in major markets.

THE ROLE OF ACTIVE MANAGEMENT

In today's market there are, unfortunately, additional concerns for investors beyond low yields. Distress in asset-backed securities, turbulence in European sovereigns, and geopolitical instabilities affecting emerging market debt, create a challenging environment. But it is exactly during such periods that active fixed interest management, undertaken by managers with superior research capabilities, can flourish. The challenge is to implement strategies like emerging market or high yield debt into a global portfolio without taking too much risk. Furthermore, managers need to have the infrastructure in place to execute the desired trades in these markets effectively.

The new world of fixed income demands that investors think more actively in terms of bond investing. The twin tailwinds of high absolute levels in yields, coupled with a declining yield environment, no longer apply. This structural shift might be the greatest barrier facing passive strategies, as they do not have the dynamism required in this new, low yield environment.

CLOSING THOUGHTS

The relationship between bond prices and interest rates is more complex than a first glance would suggest. When bond yields rise, fixed interest returns are challenged but coupon income will increasingly contribute to total return over time, providing some offset.

Investors will need to consider a more active approach to fixed interest investing to address the threat of rising yields, but should also never forget the overarching principle of managing assets and liabilities in tandem. Some investors may find that rising yields do not necessarily worsen their overall economic position.

It would be a mistake to overlook the long-term diversification benefits of the asset class, and the possibility of rising yields should not push investors out of global fixed interest investments. It should, however, remind us of the importance of selecting a skilled manager. This is particularly relevant in today's challenging environment.

[6] Pricing is simplified by disregarding convexity, the non-linear effect of rising yields: convexity means that duration (the first order change in price from rises in yield) changes when interest rates are changing.

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First used: May 2012

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