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Insights

Hunting for yield? Be careful what you wish for!

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"Mountains of junk bonds were sold by those who didn't care to those that didn't think – and there was no shortage of either." Warren Buffett

Living in a low yield environment

It was only in the mid-2000s that some investors were beginning to doubt whether it was worth all the risk of owning an investment portfolio, given that they could get around 5-6% by placing cash on deposit with their local bank branch (or higher with Northern Rock or Icesave – but we all know how that ended).

Today, things are very different. The credit crisis and the ensuing recession has resulted in yields on lending (placing money on deposit and owning bonds) being driven down to all time lows, as the UK and other world governments dropped short-term interest rates and bought back bonds from financial institutions (quantitative easing) to try to stimulate the economy and to help the indebted masses – individuals, companies and banks – out of a big hole. The result has been a transfer of wealth from prudent savers to less prudent borrowers. For many retirees, particularly the less well-off, who supplement their pension income in part with interest from deposits, this has meant a dramatic fall in living standards.

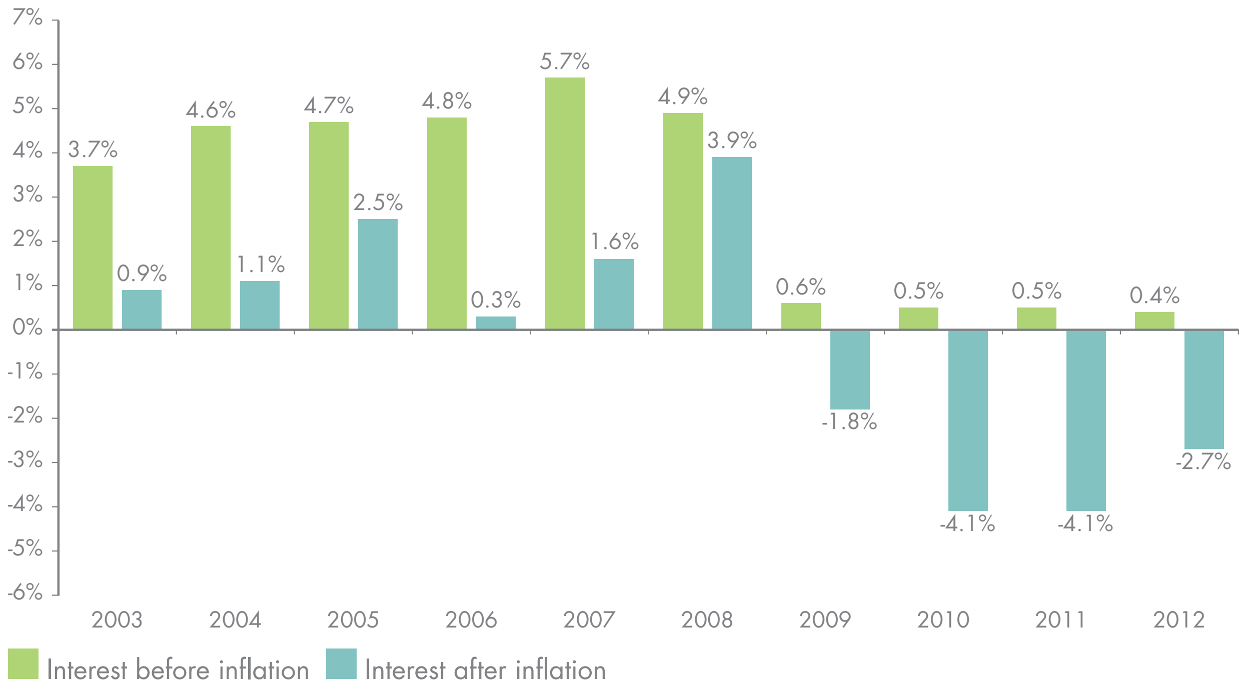
The challenge for savers

Looking at the effect of inflation on depositors' cash makes for an even grimmer story – its value has been shrinking quite dramatically. Take a look at the chart below which shows the trend in interest paid on deposits over the past 10 years, both before and after inflation.

The data is based on UK 1-Month Treasury Bills, which may be regarded as the short-term risk-free rate available on one's money. In the real world, the numbers would probably look slightly different to this, but the rates available for savers on the High Street reflect the basic story.

It is quite sobering to see that from 2009 to 2012, due to inflation many savers holding cash will have seen their purchasing power and the real value of their money eroded in double digit proportions (very few people are financially well organised enough to mitigate this as far as possible).

Figure 1: Holding cash is a painful place to be



Data source: UK 1-Month Treasury Bills (i.e. depositing money with the UK Government for one month)

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The challenge for investors

The challenge for investors i.e. those who own long-term, well-structured investment portfolios balancing bonds and equities, is a little different. A bit of insight into how bonds work will help to explain why. Bonds are essentially IOUs where the borrower – a government or a corporation – promises to pay investors their money back at a future point in time (the maturity date) and a fixed level of income in the meantime (the coupon).

The bond market, which is made up of buyers and sellers trading bonds, decides the level of return that is required to own the bond (its yield), given the current, perceived risks of lending the money. Because the coupon is fixed, the price of the bond must move to accommodate the new level of yields demanded by the market. If bond yields rise, prices fall and vice-versa – this is sometimes referred to as the bond see-saw. Broadly speaking, the longer the time until a bond matures, the more the price moves in response to a specific movement in yields.

Since the credit crisis began bond yields have been falling for a number of reasons including: the flight of investor money to safer investments, weak economic growth, reduction in the Bank of England's base rate, a glut of global capital from cash-rich emerging economies and the impact of quantitative easing. This has been good for bond prices and short-dated (lower risk and expected return) bond returns have outstripped the returns from deposits after inflation, as the diagram below illustrates.

While all of this may sound like a cause for celebration as it has protected investors wealth, the challenge is that, today, bond yields stand at an all time low. If they stay where they are then returns going forward will be low and if they rise, then returns will be poor due to capital losses eating up, and very possibly exceeding, the income paid on the bonds. So what should investors do?

Figure 2: After inflation returns from short-dated bonds and cash

Data source: Dimensional Global Short-Dated Bond Index (hedged in GBP), UK 1-Month Treasury Bills

Temptations abound

The temptation and danger is that investors go on a hunt for yield, scouring the investment world for investments that are delivering higher yields. This is a route often taken by more traditional advisers and investors who think in terms of 'natural yield' or the cash income that a portfolio produces by way of coupon payments from bonds and dividends from equities. Let's focus on the bond side of things first to see why this might not be such a good idea.

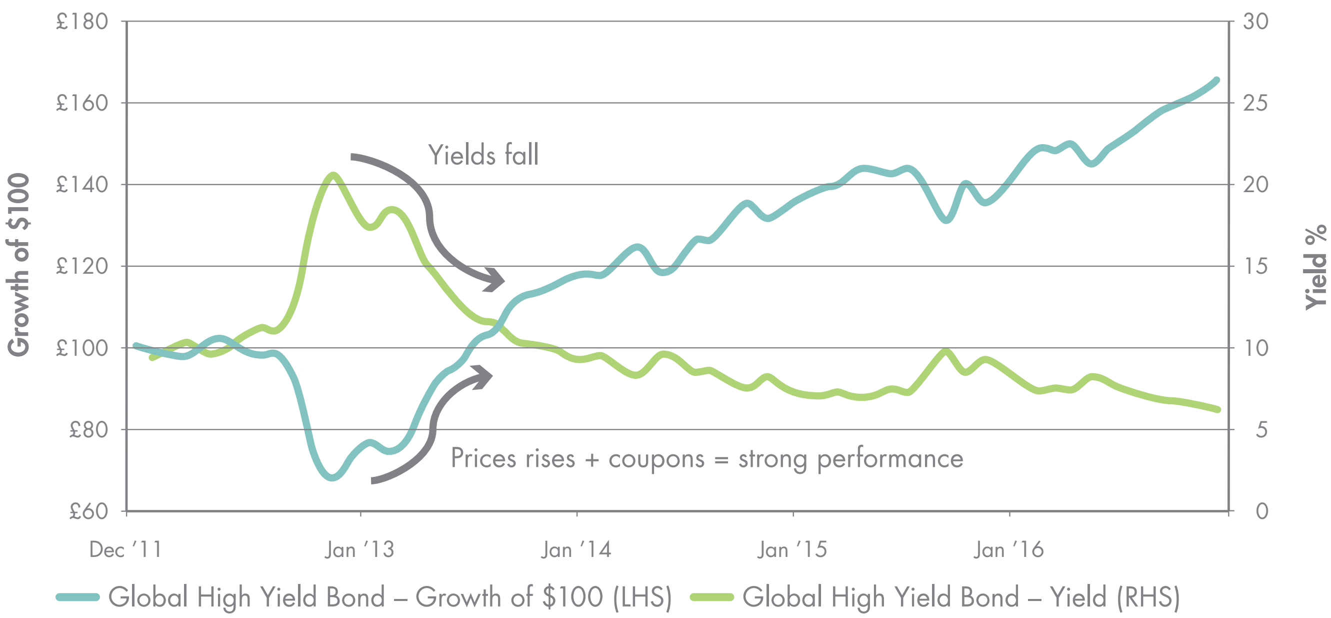
Bond investors have two key decisions that they need to make. The first is deciding on the maturity of the bonds they own[1], as longer-dated bonds are more volatile than shorter-dated bonds. This price volatility is known as interest rate risk. The second decision relates to how strong the institution is that is borrowing the money', the likelihood of being paid the regular coupons as they fall due and being repaid principal at maturity. This is commonly referred to as credit risk.

The higher the risk that an investor will not get paid back, the more return they will demand from the borrower. Bonds are categorised into 'investment grade', where credit ratings range from AAA to BBB, and 'non-investment grade', which represent ratings of BB and below. The latter are often know as 'high yield' bonds, or in a previous incarnation, the more descriptive name of 'junk bonds'.

The temptation is that the yield on a 10-year UK government bond looks pretty unattractive – around 2% before inflation – whereas the yield on a basket of high yield bonds is currently around 6% (in 2008 it was over 20%!), so one can see the immediate attraction.

So, who are high yield borrowers? Well, a few examples of sovereign borrowers with non-investment grade credit ratings are: Mongolia BB-, Albania B+, Greece and Cambodia B-, while many companies issuing high yield bonds will be names most people are unlikely to have ever heard of. The risks are therefore evident.

Figure 3: High yield bond spreads and performance.



Data source: Dimensional Global Short-Dated Bond Index (hedged in GBP), UK 1-Month Treasury Bills

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Snake oil salesmen are out-selling high yield bonds

In 2012 $30 billion of US investor cash was invested in high yield bond funds. The 'look at our (past) performance' and 'compare the yield to what you would get on a government bond' themes are superficially appealing. High yield bonds returned over 11% in 2012 and have delivered strong returns since 2009. The chart below helps to explain why. The challenge lies in understanding what the future might hold – which, of course, nobody knows for sure. Looking back at the past and gauging what downside risk high yield bonds exhibit, however, is a useful exercise. The table below provides an insight into the peak-to-trough declines that have been experienced since 1990.

The insight is obvious – higher returns come with higher risks. It would appear that market timing skill is required to pick the good times and avoid the bad times. If any individual or institutional investor had the skill to do this (and as we know, the empirical evidence suggests that very few do), then looking at Figure 3, the best time to have bought them was in 2008 at the height of the credit crisis, when everyone else wanted to own government bonds because it seemed very possible that the global financial system was going to crumble. Is now a good time to buy? No one knows, but it is definitively not as attractive as in 2008.

In addition, high yield credit risk tends to be quite highly correlated with equities and thus provides poor diversification in a portfolio at a time of equity market trauma. They therefore fail in a key role that bonds should play in balancing equity risk for investors who own equities and they are also too volatile for loss-averse investors.

Table 1: Drawdowns on global high yield bonds > 5%: 1990-2012

Peak Date	Trough Date	Decline (%)	Decline Duration	Recovery Duration	Recovery Date
May '08	Nov '08	-33	6	9	Aug '09
Jul '90	Oct '90	-17	3	5	Mar '91
Apr '98	Aug '98	-16	4	16	Dec '99
Feb '01	Jul '02	-12	17	6	Jan '03
Jan '94	Apr '94	-9	3	13	May '95
Jul '11	Sep '11	-9	2	5	Feb '12
Aug '00	Nov '00	-7	3	2	Jan '01

Data source: Barclays Capital Global High Yield Index. Morningstar Encorr.

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Snake oil salesmen have equity products too

The snake oil salesmen are also pedalling a focus on 'equity income' stocks that provide higher dividends, which tend to be stocks that exhibit 'value'[2] characteristics. Some investors may even contemplate giving up some of the low yielding fixed income assets held in portfolios for higher yielding equities. Yet that makes little sense as equities are equities, however much income they might produce and will fall just as far at times of market trauma. Such a move could result in investors owning portfolios that are more aggressive that they may feel comfortable with.

The other option considered by some is to switch existing equity holdings to higher yielding stocks. Again though, the argument is weak, because it risks concentrating the portfolio in terms of the companies held and also sector exposure. It is also worth remembering that the price of an equity falls when cash is distributed to shareholders, so whether a company pays a dividend or not should make no material difference to the return generated over time.

Thinking in total returns not natural yield

So what is the solution to the conundrum?

While there are no absolute right or wrong approaches to investing, there are certainly some solutions that are preferable to adopt. Chasing 'natural yield' tends to trade income today for the material downside risks outlined above. A 'total return' approach, on the other hand, delivers an income to the investor from dividends and coupon payments and makes up any expenditure gap from capital. The main advantage of this approach is that it allows the portfolio to remain properly diversified, rather than becoming concentrated around credit risk in bonds and increasing sector and company specific risks in equities. The risk level of the portfolio is also maintained where it should be.

Some investors may worry about selling equities when they are down to raise capital in place of income, but given the regular rebalancing that takes place on portfolios, the likelihood is that in this scenario fixed income assets will need to be sold to rebalance the portfolio back to its original mix between bonds and equities. If equity markets have risen, the issue is of less concern.

As an aside, it is worth noting that a total return approach is now widely accepted as a valid alternative by institutional investors. In fact, in the US, it is required by the Uniform Prudent Investment Act, which defines the standards that any fiduciary is held to, along with the ERISA legislation governing the management of pension funds.[3]

Conclusion

Sticking with a strong and flexible financial plan and a well-diversified portfolio is a better option than chasing higher yields, blind to the material risks that are taken on by doing so.

Notes

1 In fact the measure that is used is 'duration' which provides an indication of the sensitivity of a bond to a set movement in yield. It is measured in years. If one takes the duration of a bond/bond portfolio and multiplies it by a specific rise in yields, the product is an approximation of the capital loss to the price of a bond. For example (8 year duration bond) X (1% rise in yields) = -8% capital loss.

2 Value stocks have higher risks that the broader market and are expected to deliver higher returns over the longer term. As a generalisation, they tend to relate to stocks that are less financially healthy.

3 Armstrong, F. (2010). *Total Return Investing: A Superior Solution to Generating Reliable Distributions.* Morningstar website.

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In addition to being a Chartered Financial Planner, Michael holds the globally recognised Certified Financial Planner qualification and is a Fellow of the Personal Finance Society. Michael also sits on Chamberlyns' Investment Committee and helps to produce the firm's regular series of in-depth 'Insights' articles, which explore, explain and demystify often complex wealth planning issues.

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