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Investing in a Low Yield Environment

IAPF Investment Committee
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Background

At its meeting in June 2014, the ECB responded to ongoing weakness in the eurozone through a number of targeted measures. These included a widely telegraphed cut of the main interest rate to 0.15%. Although the ECB president, Mario Draghi, indicated that this is most likely the end of the rate cut cycle, he gave very clear guidance that rates will stay lower for longer than previously envisaged. The prospect of continued low cash deposit rates and 10 year German government bonds yielding 1.25% (as at 30th June 2014) is a challenge for trustees and members of pension schemes as long term investors. While cash or bond holdings would not have been huge drivers of yield in the past their diversification benefits and the protection that they were perceived to offer in times of market stress were benefits to a multi-asset portfolio. However, given that these benefits could now potentially come at a cost in terms of extremely low or negative returns, investors are unsurprisingly looking elsewhere for sources of return/yield.

Issues to Consider

Set out below are some of the other avenues that pension investors are considering more carefully, given the low yield environment:

Bonds

In an effort to retain an existing allocation to bonds (or to move to a greater allocation in bonds in line with a DB pension proposal), investors have been looking at options other than euro government bonds within this asset class.

- **Investment Grade Corporate Bonds:** These are obvious options for investors, particularly as many corporates are in stronger financial positions than governments. Indeed euro corporate bonds, as measured by the Barclays Euro Corporate Bond Index, had a return of 6.9% p.a. in the year to the 30th June 2014. This strong performance drove a considerable narrowing of yields (i.e. the spread) between corporate and government bonds to approximately 0.8% from over 3.5% in early 2009.

- **Emerging Market Bonds:** There has been considerable discussion about investing in EM markets over the last number of years. Much of this discussion relates to EM equities but bonds issued by developing countries have also attracted interest as some commentators have noted that many EM governments now run disciplined fiscal and monetary policies and are fiscally in better shape than their more indebted developed market counterparts. There is also the added benefit of an enhanced yield; the Barclays EM Local Currency Liquid Government Index had a yield of 5.72% as at 29th July 2014.

- **High Yield Bonds:** High yield bonds are also beginning to feature more in investors' minds and portfolios. These are high paying bonds with a lower credit rating than investment-grade corporate bonds. Such is the demand for these bonds that the BofAML Euro High Yield Index is currently trading on a yield of approximately 4%, down from a peak of 27% at the time of the crisis - offering a spread of approximately 2.9% over government bonds.

- **Absolute Return Bond Funds:** While investors may see the benefit of having an allocation to EM or HY bonds in their portfolio (and there are plenty of funds available to access these investments), it is often a decision that investors are nervous about taking in terms of an allocation of capital, what funds to use, currency considerations etc. Therefore, an attractive alternative for many investors is the inclusion of an absolute return bond fund into their portfolio. These are funds where managers seek to achieve a return in excess of cash by investing in a diversified range of global government bonds, corporate bonds and currencies. While the strategies employed by managers seek to deliver a positive return in all market environments, this is something that cannot be guaranteed.

Absolute Return Funds

These investments are similar to those just described but managers use broader range of asset classes than just bonds and currencies. Again the objective is to deliver a return in excess of cash and managers tend to use more sophisticated financial instruments than traditional multi asset funds to protect against downside risk. These funds have become much more prevalent since the financial crisis but there is a very broad spectrum of funds in this arena and investors should understand the strategies used by a particular fund before investing.

High Yield Stocks

In the low-yield environment we've experienced in the last few years, investors have been increasingly attracted to those stocks/equities that pay a consistent dividend. For example, the S&P High Yield Dividends Aristocrats Index measures the performance of companies within the S&P Index that have a policy of increasing dividends every year for at least 20 years. There have been increased money flows into such stocks and to such an extent that some investment managers have expressed caution on the valuations of some of the underlying stocks.

Property

Property investments were particularly impacted by the crisis and, in countries such as Ireland, were seen as contributing to the crisis. As a result, yields increased substantially (yields on Dublin city centre offices rose to 7.5% by December 2009). At these levels, overseas investors considered the Irish property market to represent good value and their investments in the market have been well publicised, as have those of recently-established Irish REITS. Irish investors have more recently recognised the attractive yields on this asset class, particularly in comparison to other asset classes and have also begin to invest. However direct property is an illiquid asset which brings a different dynamic to an investment portfolio and, like any other asset class, it makes sense not to concentrate on just one investment market but rather to diversify.

Other assets classes

Other asset classes which pension schemes (particularly the larger ones) have considered include the following:

- Multi asset credit
- Structured debt
- Reinsurance
- Infrastructure

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Summary

We are experiencing an unusual investment environment where interest rates are at all-time lows and are likely to remain that way for some time. As a result, pension investors are increasingly concerned about their portfolios' ability to generate sufficient yield/return. This is particularly the case as the strong run enjoyed by equity markets has led some commentators to express concern about equity valuations. As a consequence, investors are looking beyond traditional asset classes or funds to protect their portfolios and looking to implement a strategy that will produce positive returns (after fees) over economic cycles. However, in doing so, trustees must ensure that they understand these new asset classes and funds, how they might perform in different cycles and whether they are appropriate for their particular requirements.