HISTORICALLY LOW INTEREST RATES

SHOULD INVESTORS STILL CONSIDER TRADITIONAL US FIXED INCOME?

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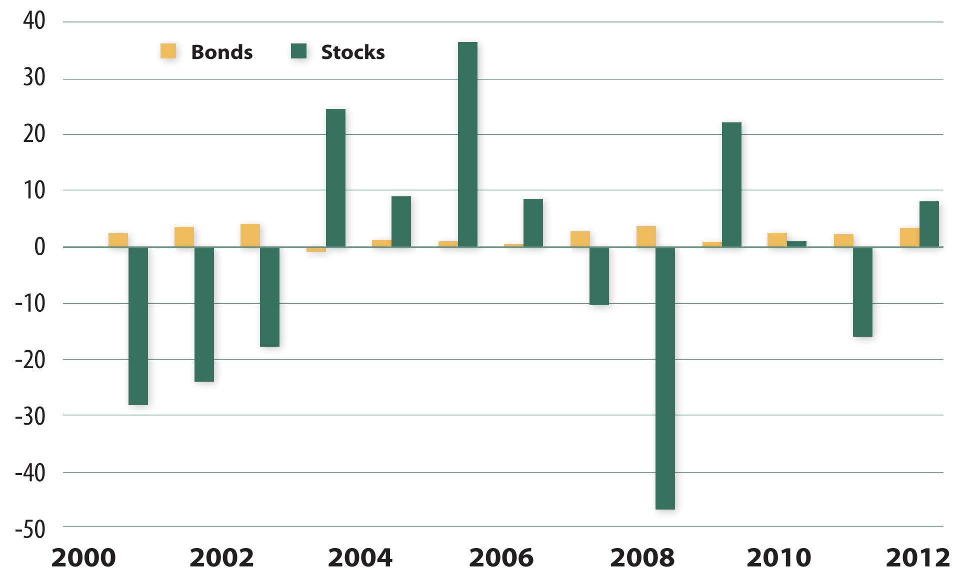
The historic low levels of interest rates have brought into question the appropriateness of using fixed income in the overall asset allocation. Several informed and not so informed voices have advocated abandoning investment grade fixed income in favor of other asset classes such as equities, high yield, commodities and emerging markets.

The cornerstone of modern portfolio theory has been the utilization of many less than perfectly correlated asset classes in constructing a portfolio that lies on the efficient frontier. This has been in place for several decades now, but it is only recently that the voices of the sirens luring investors to potentially high returns, instead of the meager 2% yield available in the overall domestic high grade market have intensified. Desperate to enhance returns in individual retirement accounts, institutional pension plans, and in opportunistic investors' trading accounts the investment grade market has often been neglected, or underallocated at best.

For the discussion below, we are going to disregard the investor with the perfect asset allocation timing skills to switch in and out of bonds and stocks and instead focus on some actual experiences from the past that might better serve as a guide in the current environment and offer some lessons to be learnt from them.

The Japan experience

By 1997, Japanese government bond market yields had fallen to levels comparable with the current US government levels. After spending the next couple of years at these low levels, they ended that decade at 1.18%. An investor frustrated with these low yields might have been tempted to switch to Japanese stocks. Here is how things would have looked:



On the average, our bond investor would have produced a meager 1.98% per annum over the next 12 years. But compare that with an average 3.1% annualized loss for the equity investor, and our equity investor would wish he had owned some bonds during the period. Unless of course our investor was savvy or lucky to exit the Japanese stock market in 2007 and buy again in the beginning of 2009 and exit again at the end of 2010 and buy again at the end of 2011 and … Realistically, nobody is that lucky (or smart for that matter) and since portfolio allocation decisions tend to be longer term, the presence of fixed income in that portfolio would have had a powerful stabilizing effect.

But what if rates go up? Wouldn't fixed income produce losses?

Well yes. But these losses have to be looked at within the context of the overall portfolio.

If rates go up because the economy picks up, then the equity part of the portfolio will produce returns to more than offset the impact of rising rates. Case in point, the period from 5/31/03 to 6/30/06, the yield on the U.S. Government Index rose from 2.75% to 5.26%, a 250 basis point increase. During that period, a bond investor would have produced 1.1% annualized, but a balanced portfolio owner with bond and equity exposure would have been happy despite the bond allocation, as his S&P 500 exposure would have produced 11.1% annualized.

But what if rates go up because of concerns regarding the escalating US deficits? Let us look at another case of study: Spain.

The chart below shows the Spanish government yield to maturity. By March 2010, the reach for yield and the convergence trade had brought Spanish government yields to 2.8%. Two short (or long depending on perspective) years later, the hollowness of the Spanish banking system became evident and rates shot up to nearly 6%. A Spanish bond investor would have averaged 1.6% annualized losses on his investment. Quite bad! But a Spanish equity investor would have averaged annualized losses of 18.6%. Despite the loss, the Spanish investor would have been happy owning bonds rather than equities during this lack of confidence induced rising rate environment.

SPANISH GOVERNMENT **YTM**

Source: Bloomberg

Conclusion

Despite the historic low US yield levels, avoiding traditional US fixed income in the overall asset allocation process will produce a suboptimal investment portfolio. The volatility dampening effect, and the negative correlation of fixed income with equities (-0.33 for the last 12 years) make investment grade fixed income an important asset class for inclusion in a portfolio. Even investor fears about rising interest rates (whether from economic growth or a deficit crisis) should not dissuade investors from utilizing fixed income in their portfolios.

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