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Good Yield Hunting

ZIRP, NIRP, TINA are three acronyms that you may never have heard of, but they explain a change in the risk characteristics facing investors in 'the new normal' low interest rate environment that we live in.

Following the financial crisis, central bank policy has been highly accommodative. In the first instance, a combination of Zero Interest Rate Policy (ZIRP) and Quantitative Easing were implemented as a support to asset prices and growth. More recently, ZIRP has given way to Negative Interest Rate Policy (NIRP) and there are now over $12 trillion of bonds globally that are trading at negative yields, and this is now forcing investors to chase yield where they can. 'NIRP refugees', a phrase coined by Wolf Richter, are escaping their own domestic bonds as they are guaranteed to lose money if held to maturity.

The US has been a happy hunting ground for foreign institutional investors as the 10 year yield is currently around 1.7%. However, this insatiable demand for yield is causing the flattening of major curves around the world, and is forcing investors with yield expectations entrenched in a higher interest rate environment to chase yield where they can find it, in dividend paying stocks, emerging market bonds, and even junk bonds.

So, investors are being forced further and further out on the yield curve to maintain their desired returns, but as these investors flock to longer dated, higher duration bonds, prices become more vulnerable to a rise in interest rates. (Rule of thumb: low coupons, long maturities – long duration). The 'lower for longer' interest rate narrative would suggest that this may not be an issue, but this assumes that central banks will not have inflation to contend with over the coming years, or that if they do, they will simply accept it, in order to attempt to support asset prices. However, the reputational damage from this could be irreparable, and all a central bank really has is its reputation.

It is also important for investors not to bucket all bonds together: high risk bonds are exactly that and can behave like equities during times of uncertainty. The higher yields that these bonds offer is compensation for the higher risk, and investors flocking to emerging market bonds are potentially failing to appreciate the much greater likelihood of the likes of Argentina defaulting (again) over the US or UK. Increasing allocation to higher yielding fixed income securities in portfolios, while ostensibly maintaining the asset class as a low risk element of a portfolio, is currently causing a divergence between perceived and actual risk.

So, ZIRP has given way to NIRP, which has given rise to TINA; due to negative yields in major bond markets, investors in search of yield are forced into more risk and duration – 'There Is No Alternative.'

But we would argue that there is: at Bordier UK we are currently positioned defensively in our portfolios. This positioning places capital loss considerations ahead of apparent income gains and, at a time where we believe that there is a dislocation between fundamentals and valuations, we are happy not to chase dividend yield. The natural yield on a portfolio is the percentage of the capital value one can expect to receive as income. Chasing yield figures that might have been normal 10 years ago, before ZIRP & NIRP, can put capital values at risk. A 4% yield on a portfolio that is worth 30% less than it was is no good to anyone.

Bordier & Cie (UK) PLC | Wealth Management since 1844
23 King Street | St James's | London SW1Y 6QY | t : +44 (0)20 7667 6600 | bordieruk.com

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