STEP JOURNAL

Downloaded on 14th August 2024 - 08:18

Beyond bonds

Mark Despres and Paul Garrard discuss fixed-income investing in challenging times.

Conservative investors tend to invest in portfolios comprised entirely or mainly of bonds, because they find the risk of a high level of equity investment unacceptable. Among the advantages of a bond portfolio are that future cash flows are predictable, volatility is lower than with equities and, over the long term, they are expected to outperform cash. Investors who are even more risk-averse often combine bonds and cash to reduce volatility further. However, bond markets have not faced the current economic conditions before, and investors are starting to question whether they will outperform cash in the future.

The state of the market

Over the past 30 years or so, investors have achieved good returns, as bonds have been in a long-term bull trend. Even those investors who remember what was perceived as a very difficult time between February 1994 and mid-July 1994 were well rewarded for their patience. Returns have outperformed cash, and bonds remain considerably less volatile than equities. In general, an investor committed to the fixed-income markets for any reasonable length of time during the past 30 years could not have failed to make money.

Bonds have fixed-rate coupons (interest rates) and pay for a fixed period of time (they mature on a specific date). When interest rates are trending lower, as they have over the past 30 years, this makes the fixed coupon that the bond pays look more attractive. Either you can sell at a higher price or hold the bond and receive more interest than new investors for the rest of the bond’s life. Either way, you outperform cash.

However, when interest rates begin to rise, fixed coupons become less attractive because, if you hold on to your bond, the interest received does not change, whereas other investors start to benefit. That reduces demand for your bond and the price falls. The alternative is to hold the bond until it matures, and earn a lower rate than everyone else. The dynamics are, rather intuitively, the opposite of a falling interest-rate environment – either way, you underperform cash. There is a slight caveat to this in that it is interest-rate expectations that really drive markets, rather than actual rates. As a result, an environment in which rates are going up more slowly than expected can be good for bonds. However, rate rises are usually accompanied by an increase in rate expectations.

Therefore, if you think that interest rates are likely to rise, especially in the near future, the risk is that bonds, while still a lower-risk investment (as measured by volatility), will start to fall in value and pay lower interest rates over the longer term than variable-rate assets, such as cash. The concern is that the traditionally conservative world of fixed income may be about to enter a longer-term bear phase. Certainly, interest rates in the major economies cannot go much, if any, lower, so the additional outperformance of cash generated by interest rates trending lower must disappear. Longer-dated bonds do pay higher interest rates than cash, so, if interest rates do not move, they may still offer some value, but the risks are now significantly skewed in the opposite direction.

Looking to the future

So, are there likely to be benefits in holding fixed-income securities during the times ahead? Undoubtedly their key features will remain the same, and these may be attractive to some investors. Yields at present are significantly higher than cash rates: 2.7 per cent on ten-year gilts, compared to three-month Libor at 0.55 per cent. The greater income may be attractive for some and the fixed rate beneficial for those who have fixed outgoings. Additionally, in the case of high-quality government bonds, investors can be fairly certain they will be paid their dues.

There are, however, some risks attached, especially for investors who just wish to make money. In the foreseeable future, if interest rates begin to rise, especially more rapidly, then prices (and hence values) could fall. The fall could be more than income received and total returns could be negative. A good manager might do better than the market, but this may still mean negative returns.

Perhaps it is time to begin thinking more laterally about the fixed-income sector and introducing alternative strategies that are less dependent on broad market direction.

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