Investing in a low-yield environment

Overview
Bond yields are the total return to investors on fixed-income securities such as government and corporate bonds. Bond yields in Australia are currently at historic lows due to a combination of quantitative easing programs among the world’s core developed economies, soft domestic economic growth and a record low official cash rate.

Although these factors have combined to reduce income for bond investors, these assets continue to play a valuable role in an investment portfolio in terms of diversification and capital preservation.

Featured interviewees

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Elizabeth Moran • Director of education and fixed income research • FIIG Securities

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Stephen Miller • Managing director • BlackRock

Learning objectives
After reading this article you should be able to:

• Explain the concept of bond yield and the different ways to measure it
• Describe the determinants of bond yields in Australia
• Discuss the current low-yield environment in Australia and overseas
• Outline fixed-income strategies for a low-yield climate.

Knowledge areas and accreditation
Knowledge area: Fixed Interest (60 minutes/1.0 point).
FPA CPD points 1.0 Dimension: Capability (FPA 007388).
AFA CPD points 1.0 (AFA 01022009).
What is bond yield?

A bond yield is the return on investment into fixed-income assets such as sovereign and corporate bonds.

The yield or rate of return can be described in a number of ways:

- **The coupon** — the rate of interest paid on a fixed-income investment or bond
- **Yield to maturity** — the total expected return on a bond bought and held until maturity
- **Running yield** — the income expected in the next 12 months.

**For example**

**Coupon rate**

A $100 Australian Government Bond that pays a $2.00 coupon every six months would have a coupon rate of 4% \[\frac{($2 + $2)}{100} = 4\%\].

There are three types of bonds:

1. Fixed rate
2. Floating rate
3. Inflation linked.

The most commonly issued bonds are fixed-rate bonds whose yields have an inverse relationship to price — as bond prices rise, yields fall and vice versa.

**For example**

Using the preceding example, if interest rates rise above 4%, the price of the bond will fall below $100. If the price falls to $95, for instance, the bond holder will still receive a 4% coupon rate, however the yield on a price of $95 increases to $4.21 \[\frac{($4/95)}{100}\] from the $4.00 it returned on the original $100 face value.

In addition, if the bond redeems at par, the investor will get the benefit of the price appreciation from $95 to $100 at maturity.

The market’s expectations for interest rates are shown by the yield curve, which plots the yield for a particular type of fixed-interest security (for instance, a government bond) against its term to maturity. A positive, or normally sloped, yield curved (see Figure 1), indicates that the market expects interest rates to rise in the future and/or some uncertainty associated with “time premium”.

The current yield curve in Australia is positive — that is, the longer the maturity of the bond, the greater the yield. As stated above, this may mean that markets expect cash rates to rise, but it can also reflect greater uncertainty about the future. Yield curves can also be negative, or inverted, reflecting an expectation that rates will fall, or flat (neither negative nor positive), which usually indicates a yield curve in transition.
Figure 1: Positive yield curve

FIIG Securities’ director of education and fixed income research Elizabeth Moran explained that there are two bond yields that fixed-income investors should consider:

- Yield to maturity
- Running yield.

**Yield to maturity**

“If you buy a bond in the secondary market and hold that bond to maturity, that gives you the yield to maturity of the total holding,” Moran said.

“Of course it depends on what price you buy the bond at because bonds, typically, are first issued at $100 and then they trade above and below that. So, if you buy a bond for more than $100 that was paying 6% at first issue, the yield will be lower on that bond on an ongoing basis.

“If you pay $105 for that bond, you will only ever get back $100 at maturity, so there is also some capital loss there at the end — and the reverse is true. So, the yield to maturity includes the difference in the bond price above or below its $100 face value and the coupon, or the interest payment that you get going through.”

**Running yield**

Moran explained that running yield is the interest calculation for the next 12 months.

So, what interest you earn on the bond if you hold it for 12 months — that’s different again from yield to maturity,” she said.
“For fixed-rate bonds at the moment, often you’re getting a higher running yield than yield to maturity because those issued a few years ago were actually earning higher rates of return that have come down. The bond price has gone up, but you’ve still got that fixed-interest payment or coupon, so you often have higher yield on fixed-rate bonds at the moment.”

**Fixed- versus floating-rate bonds**

The supply of bonds in the market has a direct relationship with yield. That is, as supply goes down, the price is forced up and the yield is reduced. However, floating-rate bonds do not have the higher-price/lower-yield relationship that is a feature of fixed-rate bonds.

Moran explained that the interest rate for floating-rate bonds is benchmarked to the fluctuating bank bill swap rate (BBSW) which is the rate at which banks will lend to each other. Interest is calculated quarterly in advance by using BBSW and applying a set margin above the benchmark.

“With the expectation of higher rates, the income you would receive [on floating rate bonds] would go up over time. Some people will talk about that straight [price/yield] relationship that is applicable to fixed-rate bonds, without understanding there are different products available,” she said.

**The determinants of Australian bond yields**

The determinants of Australian bond yields are many and varied. They include:
- US interest rate expectations
- Domestic interest rate expectations
- Supply in the market
- Time to maturity
- Creditworthiness of the issuer
- Ageing population.

**US interest rate expectations**

Moran identified US interest rate expectations as a primary determinant of local bond yields.

“We saw just recently an increased expectation of the US lifting rates this year and we saw our yield curves rise,” she said.

“A yield curve projects interest rates over time in future and bonds are priced off the BBSW (Bank bill swap) curve — that curve moved up [see figure 2].

“The whole curve moved up, so bond yields in Australia actually went up over that period. It’s interesting because that yield curve changes on a daily basis but it’s very much forward expectations of interest rates, which really impact bond prices.”
Domestic interest rate expectations

Domestic interest rate expectations also impact Australian bond yields. Moran noted that there is still an expectation in the market that the Reserve Bank of Australia (RBA) will cut interest rates again this year.

“Our exchange rate is still too high, and that’s really one of the only mechanisms at the moment that we’ve got to lower the currency,” she said.

Supply in the market

Since the 2008 global financial crisis (GFC), the stimulus programs implemented by major central banks around the world such as the US Federal Reserve [the Fed], the Bank of England, the European Central Bank (ECB) and the Bank of Japan have had a significant impact on the supply of bonds and, therefore, yields.

BlackRock’s director Stephen Miller noted that central banks consumed much of the sovereign bonds on issue, which drove yields down.

“Typically it would be fundamentals — growth, inflation, supply and demand, the nature of issuance and so on [that would push yields down]. But more recently because central banks have been such a big demand agent, they’ve had a disproportionate influence — disproportionate compared to the history on the yield of a bond,” he said.

Time to maturity

Moran highlighted time to maturity as a primary determinant of bond yield.

“If you’ve got a shorter-dated security, you’d expect a lower return. Conversely, for the longer-dated ones — some are out to 20 years plus — you expect a higher return because there is greater uncertainty over time,” she said.
Creditworthiness of the issuer

Miller noted that frequently, purchasers of corporate bonds have to consider the possibility of the issuer defaulting on the bond. This can also be true for sovereign bonds, with markets now contemplating that possibility in Greece.

“It can be that the creditworthiness of a particular issuer — that’s corporate or sovereign — can have an impact on the level of yield. So, if a corporate is perceived to be not that creditworthy, other things equal, the yield on their bonds will be higher,” he said.

The most high profile corporate bond default in Australia was by investment firm Babcock and Brown which collapsed in 2009 with more than $3 billion dollars of debt.

Moran commented that the class of issuer also affects yields in the government bond sector.

“The Commonwealth Government, for example, is what we call a ‘zero-risk issuer’, so it has very low overall yields. But as you invest in state government or semi-government bonds, or corporate bonds, you’re being paid a higher return for that higher risk of the issuer,” she said.

Consider

Bonds issued by the Commonwealth Government are considered low risk, given that it levies the major taxes in Australia. State government economies are more vulnerable to the adverse influences of their major industries, thus state government debt is higher risk which is typically reflected in higher yields on their bonds.

The ageing population

Miller suggested that demographics could also have an influence on bond yields.

“As the population ages, there is more of a demand for income assets rather than growth [assets]. So ... an ageing population is likely to want to own relatively more bonds as part of their portfolio of financial assets, and relatively less equities. That can send the price up and the yield down,” he said.

The low-yield environment in Australia and overseas

Miller attributed the current low-yield environment in Australia and overseas to central bank quantitative easing (QE) among the world’s core developed economies in the wake of the GFC.

“If central banks are big buyers of government bonds, other things being equal, that will make the price of those bonds go up or the yields on those bonds go down. That’s happened in the US. It’s happened more recently in Europe and it’s also happened in the UK. It’s also been happening for a while in Japan,” he said.

“So, if it’s happening in those four big global bond markets, it obviously has an impact on what yields elsewhere are doing and it has an impact on the yield on the bonds issued by other governments, including Australia.”
Miller added that Australia’s record-low cash rate of 2% has also been an influence on bond yields.

“Our own Reserve Bank has cut the cash rate to 2%. If the overnight, or the cash rate, is low … that will drag bond rates down and bond yields down as well,” he said.

“Why is the cash rate low? Well Australia is going through an economic adjustment phase at the moment. We’re seeing mining investment decline quite sharply and there’s probably not enough other investment or other areas of growth happening to completely fill that gap.

“So, we are growing at around about 2.25% annually. Trend growth is round about 3.25%. We like to grow at trend. [The economy] needs to grow at trend in order to absorb new entrants into the workforce.”

Moran noted that long-term bond yields (as per the BBSW curve) remain low despite the expectation that the US will increase interest rates.

“Although we’ve seen the curve rise just recently, the 10-year Commonwealth Government bond yield is still only about 3%, so it’s still very low over the 10 year timeframe,” she said.

“So, yields are low, reflecting interest rates [internationally]. We still expect rates to be low going forward, even though now there’s an increased expectation that they will rise with the US increasing rates in the next 6 to 12 months.”

**The global climate**

Moran explained that Commonwealth Government Bonds offer a comparatively attractive yield globally.

“Interest rates are low right throughout the developed world, and Australia has still got quite a high and quite an attractive yield on Commonwealth Government bonds,” she said.

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**For example**

“Rates on German bonds, for example, are 0.5% or less and we’re still offering 2% on our bonds. Those countries [such as Germany] are still AAA rated, so if you’re looking as an investor, and we’re very much in a global environment here, investors are looking to get the most return on their investment. So, Australia at 2% versus Germany at 0.5% — it’s a big difference, even though we’re talking a small amount so we’re still very attractive.”

Moran added that approximately 40% of investment in Commonwealth Government bonds is by foreign investors.

“We’re still seeing a large inflow of foreign investors, particularly into Commonwealth Government bonds. The Japanese, with a very low interest rate economy, are big global investors. They’re investing in Australian dollar bonds as are many other sovereigns and fund managers as well,” she said.

“We’re seeing Asian private investors being big investors in corporate bonds. I know that big investors in our infrastructure bonds are Canadian superannuation funds because they like the longer dated nature, the surety of the cash flow and the repayment of capital at maturity.”
Australian issuance of Eurobonds

Europe’s low interest rates, even compared with Australia, has led to an increase in the number of Australian companies issuing Eurobonds. Moran noted that even when hedging back into Australian dollars, seeking credit in Europe is attractive for Australian corporates. “They can get longer-term funding in that market than what they might otherwise in the domestic market,” she said.

“A lot of companies will issue in foreign currencies just to diversify their funding sources and to be known in the market. Much as we might diversify our own investments, they’re looking to diversify funding sources. That’s a fairly common strategy for the bigger companies in Australia.”

Miller suggested that the greater amount of investment capital in Europe is also appealing to Australian companies.

“There might be a bigger deeper pool of investors, which means that I can get a greater amount of issuance away or, to put it another way, I can borrow more at those lower yields,” he said.

“It can be sometimes attractive to enter into transactions where Australian companies borrow in Europe and swap the exposure back by the swap market to Aussie dollars.

Miller added that foreign entities seeking diversification also commonly seek funding in Australia.

“We can see some European corporates and some other sovereigns, super-nationals or agencies from other countries also borrow in the Aussie dollar market from time to time, just to diversify their funding,” he said.

“Indeed, if you looked at the conventional corporate benchmarks in Australia, some 12 or 13 of the top 20 issuers are actually foreign names, be they foreign banks or what have you.”

The role of fixed income when yields are low

Fixed income can play an important role in an investment portfolio, even when yields are low, in terms of diversification and capital preservation.

Diversification

Moran noted that fixed income can be a prudent solution to the lack of diversification that exists in many Australian investment portfolios.

“A lot of investors still only have shares, some property and cash. [Fixed income] is like the fourth asset class — so much closer in terms of dynamics to cash in that you have a known income stream and you are repaid capital at maturity, assuming the company doesn’t go into a wind up. It’s a defensive asset class with a lot of certainty, but provides a lot of diversification,” she said.

“A lot of the companies that issue bonds aren’t listed on the ASX. They could be joint venture infrastructure type bonds. For example, there’s Dalrymple Bay Coal Terminal — that’s not listed on the ASX. Equally other big corporations issue Australian dollar denominated bonds. Companies like General Electric or Morgan Stanley, Swiss Re — the
Swiss Insurer — they’re the sorts of companies that will also issue in the Australian market. So, you can get this lovely diversification without necessarily having to buy into a fund.

“We do also make foreign currency bonds available, so investors that have funds sitting in the UK or the US earning a very low rate of return can look to invest in bonds to increase their income and their overall yield.”

**Capital preservation**

Preservation of capital is particularly important for pre-retirees and retirees, as they not only require capital for income streams but have limited time to recover from any investment losses incurred.

Miller explained that bonds have traditionally played a “safe harbour” role in an investment portfolio.

“Were there to be a sudden burst of risk aversion in markets because, let’s say, the European leaders have failed to meet on an agreement for Greece or that China has a serious growth stumble, or we have a dislocation akin to the one that we had in 2008; your bond portfolio, your high credit AAA government bond portfolio would do pretty well in that environment, even when yields are relatively low,” he said.

“Your risky, more volatile growth asset won’t do as well in that environment. So, it always pays to have a bit of mix, a bit of an insurance; a safe harbour element and a riskier element where the upside is bigger but the volatility is greater.”

**Bond bubbles**

Moran noted that even if holders of bonds find themselves in a bubble situation, they are protected in the case of a sudden correction.

“There’s a lot of talk about bubbles generally in the market, and that’s across all asset classes because when things get overvalued people are worried that there will be a correction in the market and they’ll [their portfolio] be revalued and lose money,” she said.

“Whilst [a bond] bubble might hurt the valuation of your portfolio, as long as you can hold to maturity, you would expect to get your capital back. So, it’s not the complete loss that other bubbles might inflict on your portfolio, or the 50% loss that might be inflicted by a correction in the stock market. For example, the GFC saw about a 55% correction in the sharemarket.”

**Fixed-income strategies in a low-yield climate**

Moran believed that strategies focused on diversification were prudent in a low-yield environment.

“It really comes back to making sure that you’re diversified across asset classes and sectors and not having all your eggs in one basket because when interest rates do start to rise, we’ll see the sharemarket coming off,” she said.

“A lot of clients — the mums and dads out there — are still wanting an income and a cash flow and that’s really important to them.

“Some commentators are focusing on the volatility and low yields of US treasuries and the traders and the marked-to-market valuations, but they lose sight of those mums and dads that want that reliable income. Corporate bonds will give them that reliable income and a
higher return over and above term deposits. I think that’s still a really attractive feature of those securities.

“Bonds with their natural maturity dates will preserve your capital, so I think that’s a big advantage in a moving, volatile market as well.”

Case study 1

Diversifying with bonds

Katherine and Howard were feeling uncomfortable with the volatility of their share portfolio and wanted to take some profits before a feared major correction. Instead of adding to their existing term deposit investments, their adviser suggested they diversify by investing in bonds, which would be slightly higher risk with higher returns.

The couple are active investors and like to have control and transparency over the companies in which they invested, but they were uncertain about bonds and whether they had enough information and expertise to invest.

A managed bond fund seemed like a good solution, although the adviser was concerned about the lack of transparency regarding the investments held and the uncertain income stream.

Instead, the adviser offered Katherine and Howard a managed income portfolio service for a minimum investment of $250,000. The service is an individually managed account, where the portfolio manager invests and trades on behalf of the client according to four different mandates:

1. Core income
2. Income plus
3. Inflation linked
4. A customised investment option.

Katherine and Howard would remain beneficial owners of the bonds, and all the income earned on each bond would be paid directly into their nominated account. At maturity, funds are reinvested, unless they want to withdraw funds.

The clients liked the idea of a professional manager overseeing their funds while having complete transparency and access to the coupon stream for income. Their adviser suggested they opt for an inflation-linked option, as it has medium risk with a targeted return of consumer price index + 1.5%.

Source: FIIG Securities

Miller suggested that when yields are low and the direction of interest rates is uncertain, a bond strategy focused on reducing duration can be beneficial.

“When yields are at multi-decade lows, other things being equal, they’re more likely to go up rather than down so prices of bonds are more likely to decline than keep appreciating — that’s how history is,” he said.
“Bond benchmarks have something called duration, which is a measure of sensitivity to interest rates — the higher the duration the greater the sensitivity to interest rates. You want a lot of duration when interest rates are going down because your price goes up further.

“What a number of investors have done is to look at what we call unconstrained investing or non-benchmark aware investing, where we don’t take much notice of any duration benchmark.

“We look at various sorts of fixed-income issuance whether it’s governments, whether it’s investment-grade corporates, whether it’s high yield, whether it’s emerging markets, whether it’s securitised — so mortgage backed securities or commercial mortgage backed securities or asset backed securities — whether it’s inflation linked bonds. It can also include FX [foreign exchange].

“We look around the bond asset complex and choose which ones we think will do the best. We don’t worry about targeting a duration around a given duration benchmark … we still try and construct a diversified portfolio but we do it around the duration band that’s less than what attaches to the typical bond benchmarks, whether that’s a Bloomberg AusBond Composite or a Barclays Global Aggregate type benchmark in the global space.”

**Case study 2**

**Unconstrained” bond investing**

Kevin and Dimity were in retirement and decided that they wanted to increase the proportion of defensive assets in their portfolio. However, after consulting their financial adviser they realised that investing in products linked to standard domestic bond benchmarks meant that they were investing in a relatively undiversified portfolio of domestic fixed-income securities with risk heavily concentrated in the direction of interest rates.

With bond yields both in Australia and in global developed country markets at close to multi-decade lows, they were worried that if interest rates increased, their portfolio returns would suffer.

Their adviser suggested that they look at a global “unconstrained” approach to fixed-income investing, and using a large global manager with the depth and breadth of resources that would enable Kevin and Dimity to access an appropriately diversified portfolio of global fixed-income securities spread across a number of sectors.

The adviser also suggested that not only would such a portfolio be better diversified and less risky (thereby retaining the defensive characteristics desired of fixed-income portfolios), it would contain markedly less interest rate risk (so be better protected in the event interest rates increased) and, in all likelihood, would have an average yield to maturity greater than that obtained from investing in standard domestically benchmarked bond portfolios or globally benchmarked bond portfolios.

The clients liked the idea of regular monthly updates, as they could be assured of complete transparency. They settled for an option that provided them with a return of circa 4% over the current bank-bill rate.

Source: BlackRock
The next 12 months for fixed income in Australia

The local fixed-income market over the next 12 months is expected to be defined by an increase in US interest rates, low growth and another rate cut by the RBA.

Increase in US interest rates

Miller expected the US Federal Reserve to raise rates before the end of the 2015, possibly in September.

“If the Fed starts to raise rates, we’ve got to ask ourselves — it’s the first time we’ve seen this for a while — what that means for bond markets globally,” he said.

“Will it mean the bond yields do start to rise? Will it mean that US yields start to rise? We might get divergence in monetary policy where the US is raising rates, but Europe is still doing QE. Japan is still doing QE. What does that mean? What does it mean for the spread sectors? What does it mean for some emerging markets? What does it mean for investment grade corporate bonds? What does it mean for high yield?

“If the Fed is commencing a raising rate cycle ... bond yields generally tend to rise. That would mean too that Aussie bond yields tend to rise.”

Low growth and another rate cut in Australia

Moran’s view was a period of low growth for Australia over the next 12 months due to softness in a number of non-mining sectors and low iron ore prices.

“There isn’t the expectation of a breakout in growth at this point, so [my expectation is for] lower GDP, lower confidence if you like, lower spending rates,” she said.

“It’s a longer-term view that we’re not going to grow as much as we have in the past. A lot of that is down to lack of mining investment and that we haven’t really found a substitute for that.”

Moran strongly believed that the RBA would cut rates again before the end of 2015.

“My view still is there will be another rate cut. We can’t sustain the currency at the current 80 US cents or thereabouts, and [a cash rate of] 2% is still very attractive to global investors, so I think domestically we might see another rate cut or two,” she said.

“In terms of investors here, how does it play out for them? Where do you see the low point? At the low point, you certainly would change emphasis from having fixed- and longer-dated to floating-rate bonds or shorter-dated fixed.”

Miller indicated that the differences in monetary policy stances between the Fed and the RBA could create a divergence between the countries’ bond markets.

“We could find ourselves in a circumstance where the Fed is raising rates, and the RBA is either still cutting rates or at least contemplating a further cut in rates. We could end up getting quite a different performance of Aussie bonds and US bonds,” he said.

“The Fed raising rates in the US might not have [a significant] negative impact here on Australia, so we could see that spread contract even further or go to zero or — and this is very unusual — the Australian bond yield trade below those of the US. It’s a highly fluid outlook. Aussie bond yields will be affected by that, but they’ll do relatively better.”
Consider

Moran also expected increased liquidity in the world economy from the current major QE program by the ECB and, to a lesser extent, Japan to impact bond yields.

“That will tend to keep interest rates down because [central banks are] trying to stimulate economies, and people aren’t necessarily borrowing and investing as they would like. So, I would expect that we’d have a lower bond yield scenario for some time, even if we do start to see rates move up in the US and we start to see increments here,” she said.

How sustainable are low and negative yields?

In April 2015, Switzerland became the first country in history to sell a benchmark 10-year government bond at a negative interest rate. Other countries to have issued bonds at a negative rate include Germany, Austria, Denmark, Finland and the Netherlands.

Miller commented that a negative bond yield was not something he thought he’d ever see when he entered the industry.

“We’ve talked about quantitative easing. The biggest motivator of negative bond yields is central banks being big actors in those markets. We’re seeing it mainly in Europe,” he said.

“We’ve seen a deflation scare — so people were worried that prices would fall. At the same time the central banks were buying up a large part of sovereign issuance, which meant that parts of the yield curve got dragged below zero, and investors were quite prepared in some instances to pay a fee effectively to give the government some money to mind for them.

“I find that fundamentally difficult to explain. I can only see it as a function of a co-occurrence of an aberrant set of circumstances that will be, in the history of bond markets, relatively fleeting. I try to explain to my daughters how bond yields can be negative, and I struggle.

“I don’t think that negative bond yields are going to be around for a long, long time, particularly as I think there are signs that perhaps Europe is not in as dire circumstances as we thought; that the US is recovering, that Japan is doing a little better. That’s not to say things are great.

“There are still parts of the yield curve that are negative, but it’s not something that I am regarding as an ongoing and secular trend in bond markets going forward.”

Conclusion

Fixed-income securities can play a valuable role in an investment portfolio as a defensive asset, particularly for pre-retiree and retiree clients. Clients should be aware that, although these products offer diversification and capital preservation, yields are forecast to remain low for the medium to long term.

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