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Investing in a low growth environment.

Asian Fixed Income

Dealing with negative yielding markets

The current low growth environment has led to low and even negative interest rates in some bond markets, which has consequently created issues with benchmark construction. As stewards of our client's assets, we strive to invest where we think opportunities, risk and cost have beneficiary outcomes for clients. Traditional benchmarks have not evolved to address the current reality of low and negative yields, and as such, they penalise bondholders. We strongly believe that constructing dynamic and transparent new benchmarks that can adapt to changing yield levels gives us the opportunity to truly become responsible investors.

Background

Global government strategies can generally invest in government-issued securities located anywhere in the world, including the investor's own country. These strategies provide more global opportunities for diversification and return and act as a hedge against inflation and currency risks.

These strategies typically are managed against a benchmark provided by key benchmark providers. These benchmarks measure the performance of securities that are usually fixed rate, denominated in a multiple currencies issued by as many as 20 different countries. These benchmarks are constructed using criteria such as minimum maturity, minimum market size, minimum credit rating of the issuing country, criteria for accessibility and are weighted by market capitalisation. Several of these commonly used benchmarks have been in existence for multiple decades, providing important and credible guidance to investors as to performance of asset managers and providing to fund managers frameworks for portfolio construction.

However, in our opinion, the current methodology for constructing these benchmarks is failing the end users with regards to their saving objective. We trace the origins of these failings to the early 2000s in Japan.

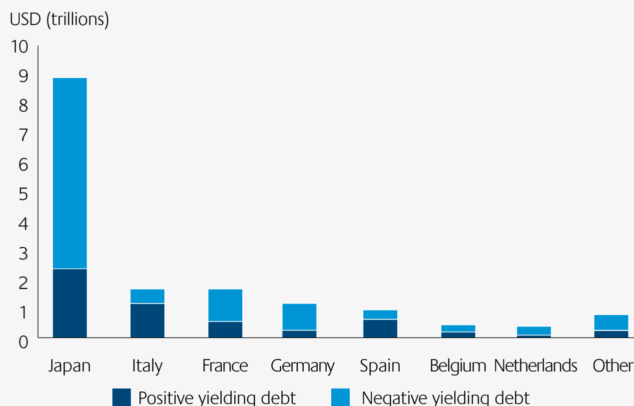
Quantitative easing

A policy termed 'quantitative easing' was first used by the Bank of Japan (BoJ) in an attempt to arrest deflationary pressures. This policy flooded commercial banks with significant liquidity, in an attempt to stimulate commercial lending. During the 2007-08 financial crisis and in the years after, central banks in the United States, the United Kingdom and the Eurozone joined the BoJ in this policy experiment as disinflation and deflation spread.

In mid-2014, one of the two policy tools used by the European Central Bank (ECB), the ECB Deposit Facility, introduced negative rates as a method to stimulate. In January of 2016, the BoJ Policy Rate moved into negative territory. Unsurprisingly, later in the year, financial market conditions globally had changed to such an extent that increased monetary policy action from central banks had driven lower bond yields globally, with significant parts of the yield curve negative throughout various European markets and the Japan bond market. Yet what does this actually mean? Investors who purchase negatively yielding government bonds, who are lending money to a government (through the purchase of these government bonds) are now effectively paying the government for that right. This is clearly a complete reversal of the principles of bond investment where bondholders are typically compensated for lending money to a government (or company) in return for interest in the form of a positive yield.

This current reversal in yields in several key markets represent a significant portion of these market capitalisation benchmarks. Often as much as 30 percent of the benchmark comes from countries where a large part of their yield curve is negative.

Chart 1: Negative sovereign yields worldwide



Source: Barclays 12 Sep 2016.

In fact, a recent research piece[1] published by Fitch estimates US$11 trillion bonds globally are negative yielding.

Yet the question remains, is anyone doing anything about this dislocation? We have asked ourselves whether using savers' money to pay for the right to lend a government money is true to our responsible investment principles. Unsurprisingly, it is not.

While there may be some unique circumstances (e.g. sharp slowdown and deflation) where a negative yielding bonds may make sense, this phenomenon is typically not in our clients' best interests over the long term. Simply, investors could store the money in a safe (or under the mattress) relatively cheaply and achieve a higher 'real' return over the term of an equivalent negative yielding bond. Additionally, the definition of speculation is buying an asset with the expectation of a return solely from someone else repurchasing the asset at a higher price, not dictated by its intrinsic value (i.e. the 'greater fool' theory). As prudent allocators of capital, not speculators, we do not feel this is a responsible investment.

So rather than remain tied to these unrealistic benchmarks that penalise savers, what can be done?

1 http://www.cnbc.com/2016/06/29/there-are-now-117-trillion-dollars-worth-of-bonds-with-negative-yields.html

Seeking alternative ways to protect saver's money, whilst delivering an alternate solution

We philosophically take issue with having to pay a fee (negative yields) to lend a government money (buying government bonds). Yet with the industry tied to the use of these (historically) credible benchmarks, what else can be done?

Never one to accept what is not true to our principles, we have been exploring various alternative solutions in dealing with the prevalence of negative yielding securities in benchmarks, whilst protecting the important attributes such as diversity, credit quality, yield and duration.

Constructing a new benchmark

An alternate approach is to construct a dynamic benchmark more relevant to investor needs. Investors invest in fixed income global rates products for (inter alia) market beta, diversification, performance and yield. Our analysis suggests that it is possible to construct benchmarks where the considerations such as market capitalisation are removed and criteria such as minimum credit rating (to maintain credit quality), market size (setting minimum market size to ensure the market is investible), market accessibility (not all markets are freely investible and may have restricted access to global investors or are unsophisticated) and exclude those markets that are consistently yielding negative.

The outcome of this analysis ultimately reallocates index weighting away from the low growth, heavily indebted regions of the worlds (and unsurprisingly yielding negative); and favours those countries with higher growth and positive demographic outlook. Unsurprisingly, this research has created a benchmark with a heavy focus on what remains the growth engines of the world, the Americas and Asia, whilst delivering a better yielding benchmark with a similar duration.

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