



MiFID II stay compliant program: Search for Yield

Hello everyone, my name is Cees Harm van den Berg, board member at CFA Society VBA Netherlands and Director of Investments at Willis Towers Watson.

In this part, we will address the impact of a change in interest rates on the fixed income portfolio. We zoom in on duration as well as spreads on corporate credit and high yield bonds. A major part of investment portfolios consists of fixed income securities, ranging from relatively safe assets like government bonds, to the more exotic assets like structured credits and leveraged loans. Decreasing interest rates have led to a search for yield. This has pushed yields and spreads of all these assets down, and consequently pushed prices up.

An important aspect in this discussion is duration. Duration can be explained in two ways. First of all, it is a measure of price sensitivity to interest rates of a fixed income instrument. It can therefore be calculated by calculating the price before and after a small interest rate shock: usually 1 basis point or 0,01%. Secondly, it measures how long it takes, in years, for an investor to be repaid the bond's price by its cash flows. It can therefore also be calculated by taking the average time until the remaining cash flows are paid.

Duration is a useful measure as it helps investors calculate the interest rate sensitivity of any asset or liability. It will also show a possible mismatch between the two. For Dutch pension funds it is often the case that the duration of the assets is lower than the duration of the liabilities, which causes the interest rate risk. Besides interest rate sensitivity, fixed income investors are also exposed to spread sensitivity. This is also known as credit spread risk.

A credit spread is the difference in yield between a "risk free" government bond and a risky fixed income instrument. This premium reflects the extra risk the investor is exposed to. As investors are risk averse they want to be compensated for this risk. The spread or premium investors require on investment grade debt is usually low (1-2%), but can increase significantly in times of stress. For example, credit spreads on Euro investment grade credit moved up approx. 4%-points during the Great Financial Crisis (GFC). With the Corporate Sector Purchase Programme (CSPP) from the European Central Bank credit spreads have come down again.



Spreads on high yield credit are higher, reflecting the higher risk. These spreads have also come down as the search for yield pushes all yields down. Sensitivity of debt prices to spread levels can be measured similarly to duration for interest rates, often referred to as spread duration.

Monetary policy of central banks and the resulting search for yield have pushed interest rates and credit spreads down and prices up to historically high levels. There is considerable risk for investors in rising rates. Investors usually have a large proportion of their portfolio in debt: government debt for capital preservation or interest rate hedging, and corporate debt, for additional return.

But as yields have decreased, investors have also moved down the capital structure to higher yielding debt. This has caused the total credit spread risk in portfolios to be substantially higher than in the past. When the economy starts overheating, central banks need to increase interest rates. This can cause financing costs of companies to increase. Despite the positive impacts of an accelerating economy for companies, this might result in rising credit spreads as markets anticipate a higher chance companies will default in the near future, due to higher financing cost and decreasing revenues. Holders of corporate debt and especially high yield debt will experience large declines in portfolio values, in line with the spread duration of the portfolio.

Government bonds will also decrease in value, but as these have less spread duration, the impact is usually smaller. Also, government bonds are often used to hedge the interest rate risk in liabilities, thereby the decreasing market value is offset by the decreasing value of the liabilities.

Hello everyone, my name is Jacco Heemskerk. I am a board member at CFA Society VBA Netherlands and Head of Investment at Willis Towers Watson.

In this part I will discuss risk arising from the search for yield.

Interest rates in developed markets have been coming down for a long time now and many investors expect rates to remain lower for longer. Lower rates are challenging for investors who target sufficiently high returns. Think of pensioners that depend on the investment performance of pension funds. Or insurance companies for their income.

Interest rates remain at historic lows and the economy is moving towards the end of the cycle.



Investors respond by reverting to alternative strategies and asset classes. By doing so, they hope to capture alternative risk premiums.

What do I mean by risk premiums?

Investors expect risk to be rewarded. This translates into expected positive returns over time. Sovereign debt, think of Dutch government bonds, can be viewed as 'risk-free'. Typically most other assets classes are priced at a 'risk premium' over the nominal risk free return. So for instance, the expected returns for credit, high yield and emerging market debt are based on the risk free rate of return plus a credit risk premium. For more illiquid asset classes, such as private loans or mortgages, an illiquidity premium is added. Contrary to this, returns on inflation linked bonds can be calculated by adding their real return, plus expected inflation, and inflation risk premium.

We are currently in a low yield environment with record amounts of sovereign fixed income products having negative yields. These low yields, being the inverse of high valuations for fixed income, are partly due to loose monetary policy and solvency regulation.

But not only fixed income as an asset class has become expensive. Many publicly listed asset classes, including equities, corporate credit and listed real estate, have seen valuations increase.

As a result of these valuations, relative of course to the financial markets outlook, investors may expect modest returns in the years to come. So, there is yield scarcity in the market and it is likely to worsen in a scenario where central banks become even more accommodative.

For that reason investors are increasingly broadening their scope in their search for yield. Initially they looked at listed alternatives, corporate credit, high yield debt, emerging market debt and commercial real estate. By now these asset classes too have become richly priced compared to their own history.

Investors therefore are increasingly forced to accept higher risk in return for yield. They have turned to private and more illiquid markets. Examples are disintermediation assets such as balance sheet replacement, bank capital trades, residential mortgages, residential and commercial bridge financing, consumer debt and trade finance. Also insurance linked securities such as catastrophe bonds and weather bonds fit this description.



In itself these assets are all part of the investable universe. They may provide an attractive yield by picking up illiquidity premium and may well have a diversification benefit. However, they should fit the asset owner's investment beliefs and the asset manager should have the knowledge & competencies as well as sufficient governance budget. This governance budget relates to the financial means required to accommodate an organizational set-up, with sufficient knowledge, experience & competencies of its staff, for the board of trustees to remain in control when adding illiquid assets to the portfolio.

Alternative assets also come at a cost and there are several risks an investor should bear in mind. These markets are private, traded volumes are lower and price discovery is less efficient than in many public markets. Private markets suffer from information asymmetry to a larger extent than public markets, certainly more than highly liquid markets such as U.S. equities. Pricing is not continuous, leading to lower observable volatility. So called illiquidity risk is especially prevalent in times of market turmoil. Investors can get stuck in an asset class or have to accept a deep discount to trade out of the asset class.

Subscription and redemption of illiquid funds is different from funds invested in more liquid markets. Entry and exit could both take considerable time and price impact may be significant. In contrast, more conservative highly liquid short term government debt can rise in value during times of crisis.

Many alternative assets have higher degrees of complexity. This is also a risk factor that needs to be taken into consideration and the investor should have the proper governance budget for it. The search for yield can also lead to investments in undeserving companies, whether equity or debt securities. Leverage in the system will increase and this may result in a typical boom and bust cycle. So, the search for yield could undermine financial stability.

Due to the lack of continuous pricing, less liquid fixed income products such as residential mortgages, may not move in sync with more liquid benchmark products. If such product is part of a matching portfolio of a pension fund, this may lead to less than perfect duration hedges.

Final risk that may surface has to do with the mandate given to the investment manager.



It may be required to give managers more degrees of freedom to best manage in a challenging environment for that market, for example allowing managers to make active credit and sectors calls, and allowing some to take active short positions. This may impact solvency requirements for institutional investors like insurance companies, banks and pension funds. Risks may be mitigated by staying higher in the capital structure, being aware of subordinated lending at an advanced part of the credit cycle, and implementing a bias portfolios towards secured, collateral backed securities.

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In this part I will discuss the liquidity aspects of the search for yield.

As discussed in the previous section private and illiquid markets can offer attractive returns. It should be noted though that these asset classes are by definition less liquid than many publicly listed asset classes like equities or fixed income products.

For institutional investors like insurance companies and pension funds, liquidity and, linked to that, capital requirements, determine the appetite towards illiquid assets. These investors require liquidity to pay out pensioners, for cash expenses and collateral requirements for derivative overlays. Solvency requirements curb the ability of insurance companies and pension funds to invest in certain illiquid assets.

A portfolio of residential mortgages, unlisted real estate, infrastructure debt or private equity may take time to liquidate. Depending on supply-demand dynamics there may also be a price impact. Given their long term horizon, many institutional investors can sustain periods of market turbulence and therefore cash-in on the illiquidity premium. There may be situations where a less liquid component of the portfolio becomes problematic. This could be the case when a pension fund decides to terminate its activities and transfer its assets to a third party provider.

In this situation either a mark-to-market valuation needs to be given to the assets or the assets need to be converted into cash. It may prove difficult to do this, and this adds risk exposure to the transaction.

Another aspect of liquidity problems surfaced recently with open ended investment funds.



The European Securities and Markets Authority ('ESMA') made this one of their priorities and deems illiquidity a risk that may lead to systemic failure.

During 2019 Neil Woodford's Equity Income Fund suspended trading. The GAM Absolute Return Bond Fund managed by Tim Haywood was liquidated and Natixis affiliate H2O Asset management managed by Lars Windhorst witnessed large outflows. ESMA indicated 40% of high yield bond funds have insufficient liquidity. Various national regulators have taken steps to curb the risk of open ended funds that offer daily redemptions to its clients. In case of large outflows, clients cannot be accommodated and managers revert to 'gating' or suspend trading. 'Gating' is the practice of temporarily blocking withdrawals from an investment fund.

Last element mentioned here is that when shifting from high grade sovereign debt and credit into private, lower grade and less liquid credit, the stock of securities that can be converted in cash quickly decreases.

This may impact the ability to provide cash collateral for overlay portfolios. Especially in times where interest rates rise, interest rate derivatives used by pension funds will decrease in value.

This will require collateral to be paid, of which there is less in the portfolio, causing forced sale of already depressed assets at a discount in an extreme scenario.
