THE HUNT FOR YIELD

By Charles Marché

On 16 March, during the height of the Covid-19-induced market meltdown, the Federal Reserve announced a drastic cut in the fed funds rate, lowering it to 0.25% from 1.25% (upper bound) – a rate not seen since 2009, during the Global Financial Crisis. The Fed's massive quantitative easing programme not only pledged to buy vast amounts of government debt, but also included riskier securities such as non-investment grade notes and municipal debt.

A glance at the FOMC members' interest rate projections suggests no rise in policy rates until at least 2023. The move brought the Fed closer to the policies of the European Central Bank and the Bank of Japan, which began to use negative rates in mid-2013 and 2016 respectively.

As a result, the US$60 trillion global bond market had a record 60% of bonds with yields below 1% as of mid-December, with US$18.4 trillion actually showing negative yields, according to Bloomberg.

With cash deposits now paying close to zero and high-quality liquid assets having seen their yields compress sharply, the question is now: where can investors get any yield?

Cash rates at zero mean that the 'risk-free' benchmark rate is now at or very close to zero. By definition, obtaining any yield above this means accepting some degree of risk – be this in the form of credit, duration, volatility or currency risk (or any combination thereof), or through leverage.

Credit Risk: In financial circles, credit risk is used to refer to a higher probability of default than that of ultra-safe government bonds. Usually, moving down the credit curve enhances returns as weaker issuers need to compensate investors for the extra risk taken. After the Covid-19 crisis, aggressive buying led by central banks of safer bonds has compressed investment-grade yields, while the lower-rated BB and B segments continue to offer similar yields to before, due to a sharp spread widening (higher perceived risk). The difference is even more pronounced in the weaker segments of high-yield debt.

Within lower-rated debt, differences persist between sectors and individual companies. Despite immens liquidity and the search for yield, some firms remain locked out of the market and have been unable to refinance.

Duration: Longer-maturity assets generally offer higher returns, but also tend to move more sharply in reaction to changes in benchmark interest rates. Over its lifetime, even a risk-free 10-year US bond can experience sharp price movements as a result of changes in the interest rate environment.

Currency risk: Investors may be tempted to look at countries where local deposit rates are still high, such as Russia (4.25%), India (4%) or Turkey (15%), for example, and invest in local currency debt offering high returns. Nominal yields, however, can be quickly wiped out by currency moves, unless the exposure is hedged. The cost of hedging also generally levels the playing field and makes investing in many of these local markets less attractive than in developed ones, despite the low yields in the latter.

Perhaps tempting to some, parking deposits, even in US dollars, in certain countries due to attractive funding rates should also be approached carefully. There is always a reason for higher rates being offered, and it can often be linked to some form of risk, with the recent example of Lebanon serving as a clear warning.

Leverage Risk: Lower rates mean lower leverage costs. Such cheaper funding can be used to boost returns, but investors need to be aware that the inherent volatility of investments also increases with leverage. As such, leverage needs to be considered in light of:

1. its cost, and;
2. the assets being leveraged.

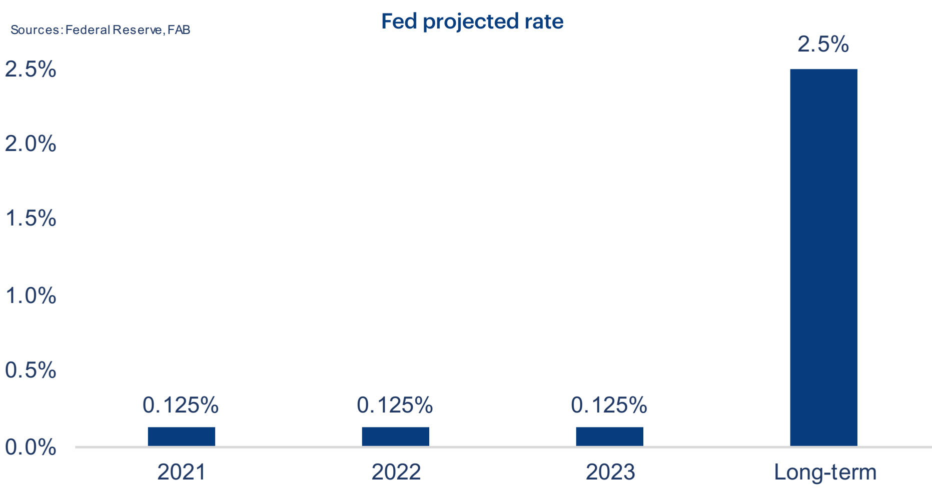
Paying 1% for leverage against assets earning 1.5% could make little sense, as a 50% loan-to-value ratio (1:1 leverage) only raises expected returns from 1.5% to 2%. Doing so for assets earning 4%, however, moves the returns on equity invested to 7%. Leverage also increases portfolio volatility, and in times of sharp drawdowns, can lead to margin calls, hence it is best applied to assets that tend to see smaller moves, such as fixed income.

Liquidity: Some illiquid investments, such as private equity funds or real estate, can offer better returns than traditional government bonds. The main risk here, however, is that if investors suddenly need cash they cannot simply sell their positions, hence this option should be adopted only by investors who can afford to have the money tied-up for a long period of time. Liquidity risk also makes some less-frequently traded bonds and stocks more attractive than others, but, again, the realised price when it is time to sell may significantly differ from market quotes. At the bottom line, with low rates here to stay, the duration of portfolios can be extended, and with high liquidity and supportive central banks, taking a bit more credit risk can be warranted. It is all about striking the right balance. When used wisely, leverage can be a good way to boost returns. However, investors should accept the increased risks and understand how the leverage is being used. Leverage is not inherently bad, it is all about how much you borrow, what the loan costs, and your confidence about the investment idea.

Finding yield in equities

Reaping long-term dividends

Equities, and particularly dividend-paying stocks, can be a useful source of both income and capital appreciation, especially over the long term. Well-managed, cash-generating companies with growing businesses have been able to offer this.



Dividend-seeking investors should be aware of certain risks, however:

1. Dividends are not set in stone. Last year was particularly revealing, as numerous 'dividend darlings' cut their pay-outs (or cut dividends outright) to preserve cash. Failure to pay bond coupons triggers a default; dividends, however, can be cut at any time and are entirely discretionary.
2. Underlying equity volatility remains. Dividend or not, equity holders are ultimately exposed to the company – along with the associated risks – they are holding.

Investors should carefully assess the sustainability of a company's business model as part of the company's ability to maintain cash dividends. Usually a very high dividend yield suggests something is wrong, and that problems have a higher chance of arising. Typical recent examples of these concerns include oil companies, European banks, or retailers.

Besides, headline dividend yields are simply the last dividend paid, divided by the current price of the stock. So, a sharp drop in share prices artificially boosts the stated yield. Future dividend payments may be cut due to financial difficulties, so investors should be careful and not blindly screen equities based on backward-looking data.

Volatility: sell it when it's high

Volatility is the financial definition of risk, but investors can make good money if they learn how to harness it. Volatile markets lead to higher put option prices, so, selling them (receiving the 'premium' for doing so) during periods of high stress can be lucrative and generate income. Investors, however, need to be comfortable with the risk that the option gets exercised. While that scenario is rare, it happens.

Many investors may be familiar with reverse convertibles, whereby a premium (income) is earned in exchange for assuming the risk of buying the stock if it drops below a certain price. Such products can complement traditional bond and equity portfolios.

Yield earned to sell a January 2021 put on S&P 500 ETF SPY