3 How can we add value in an environment of low short- and long-term interest rates and tight credit spreads?

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The low interest-rate environment has led us to lower our projected returns for fixed-income assets and, as a result, for all portfolios that include bonds by design or as a precaution. However, a number of approaches can increase portfolio returns. The purpose of this text is to present them[1].

We believe that 11 distinct and non-mutually exclusive approaches represent possible ways to add value to portfolios in a low interest-rate environment:

SOLUTION # 1 The first solution is to **extend durations** in order to generate returns, but this amounts to increasing the portfolio's risk. In addition, yield curves are relatively flat, which means that the premium for additional risk (term premium) is also relatively low.

SOLUTION # 2 The second solution is to **invest in lower quality credit**, but that is also more complicated, not only in terms of risk but also in terms of opportunity: despite the recent increase in credit spreads, two months ago, when spreads were tighter**,** nearly 25% of the credit market provided a negative yield, and now more than 50% offers yields lower than 0.50%. As with duration, low spreads represent a reduced premium for the additional risk (spread premium).

SOLUTION # 3 A third solution is to **add leverage to our positions,** a dangerous solution if you believe that risk on interest rates and spreads has become more asymmetrical;

SOLUTION # 4 Another way of increasing returns is to **add leveraged overlay positions through distortions in the yield curve and changes in inter-curve spreads.** The 2-year – 5-year – 10-year or 2-year – 10-year – 30-year curves, as well as the US T-Bonds vs. Bunds curve or, even better, the US T-Bonds vs. peripheral eurozone bonds curve, have changed considerably for the last three years across all maturities. Focusing on changes in intra-curve and inter-curve spreads is clearly the best way to make use of divergences and decorrelation. The divergence in monetary policy cycles between the Fed and the ECB has therefore been a real performance driver (additional alpha through positions on respective curves) over the last two years.

SOLUTION # 5 **Search for assets that are undervalued because they are being shunned.** For the most part, shunned asset classes are attractively priced, and they are usually significantly underweighted in portfolios. At present, such asset classes include emerging assets (debt, equity and currencies), as well as inflation-linked assets. For emerging markets, the sharp decrease in capital flows to these countries (rumours of the end of US QE, the effective end of US QE, the slowdown in China, the fear of Yuan devaluation, the downturn in global growth, concerns over the first Fed interest-rate hikes, etc.) destabilised a substantial number of currencies, including some that did not deserve it. The same can be said for the equity and debt markets, where the downshift was too indiscriminate in some cases. Rebuilding long positions on these assets could be beneficial over the medium term.

SOLUTION # 6 **Seek out assets with higher yields and lower volatility.** When people mention such assets, they immediately think of infrastructure,

The essential

The low (or even negative) interest-rate environment has led us to lower our projected returns for fixed-income assets and, as a result, for all portfolios that include bonds by design or as a precaution.

To generate returns, we should 1) extend portfolio durations, 2) accept more credit risk (more credit, lower ratings, etc.), 3) add leverage, 4) take advantage of distortions in the yield curve, 5) search for assets that are undervalued because they are being shunned, 6) seek out assets with higher yields and lower volatility (ABS, infrastructure, private debt, etc.), 7) add a forex component to portfolios, 8) capture liquidity premiums, 9) review the construction of the benchmarks we use ("Smart Beta" strategies), 10) better assess investment factors ("factor investing" strategies) and finally 11) allocate more to absolute return strategies.

> "The longer the duration, the lower the credit rating, the higher the leverage..."

> "Search for assets that are undervalued and shunned, as well as assets with higher yields and lower volatility"

[1] *This text is a part of a presentation entitled "The low interest-rate environment: what impact is it having on asset management firms?" made by Marie-Anne Allier and Philippe Ithurbide in March 2015 to the AMF's Scientific Advisory Board.)*

private debt, private placements, ABS, etc. However, we should not forget one subtlety: some of these assets have low volatility because they undergo infrequent valuation. Low volatility is sometimes an illusion. This is what the 2008 financial crisis taught some investors that had too many illiquid assets.

SOLUTION # 7 **Adding a forex component when building portfolios** makes much more sense now that currency adjustments have multiplied in this low-interest rate environment. There are so many that they have created extreme valuations. This is the case for a number of emerging currencies, as well as for the Japanese yen and others (for more information on this, see our forex scorecard, Cross Asset Investment Monthly, November 2015, page 45). Without significant changes in interest rates, there is even reason to believe that currencies will be used as an adjustment variable.

SOLUTION # 8 **Focusing on illiquid assets** is an attractive option in the current context: capturing liquidity premiums (private equity vs. listed stocks, private debt vs. listed debt with credit ratings) is a way to add value. Sacrificing some portfolio liquidity can be profitable. However, be careful: we are living in a world where "liquid" assets are much less liquid than before. This effectively demonstrates both the appeal of relatively illiquid assets and the dangers of an excessive lack of liquidity in portfolios.

SOLUTION # 9 **Reviewing benchmarks** is also an interesting alternative. We have known for a long time that conventional benchmarks (based on market cap) can be substantially less than ideal. Smart beta strategies let us correct this construction bias and provide value using a more systematic approach;

SOLUTION # 10 **Focusing on factors** and not just on asset classes is a wise choice, especially considering that central bank QE, among other things, has disrupted the relative performance of asset classes, some of which tend to develop in correlation with each other. This, along with the fact that this approach cuts across all asset classes, explains the growing popularity of factor investing.

SOLUTION # 11 Finally, one way of getting around the low-interest, tight-spread environment is **to give absolute yield and allocation strategies a larger role**. Say goodbye to benchmarks and hello to highly flexible investment processes that establish constraints (maximum drawdown, concentration, etc.) that are different from those that prevail with index investing (tracking error, etc.) and also expand the investment universe to take advantage of more opportunities to generate returns.

Conclusion

The low-rate environment has been priced into all portfolios. It is a positive for the equity markets, both directly and indirectly, through impacts such as easier financing of M&A activities or share buybacks, appeal of dividend policies, stronger growth outlooks and improving earnings thanks to the impacts on the exchange rate, etc.

This environment has also encouraged downside revisions to fixed-income yield expectations and, as such, to all portfolios that include, either by construction or precaution, fixed-income assets. In order to generate yield, we need to be active and we suggested a number of solutions developed above such as:

- Increase portfolios duration,
- Accept higher credit risk (more credit, lower ratings, etc.),
- Add leverage,
- Exploit distortions in yield curves,
- Seek out undervalued assets as many of them have been cast aside,
- Look for higher-yield, lower-volatility assets (ABS, infrastructure, private debt, etc.),

> "Smart Beta and factor investing are popular for a reason"

> "Say goodbye to benchmarks and hello to highly flexible investment processes"

- Add a currency component to portfolios,
- Capture liquidity premiums,
- Revise benchmark construction (“Smart Beta” approaches),
- Better assess factors that impact investment (“factor investing” approaches),
- Accept greater absolute return portions.

All of these solutions are valid, but very different depending on whether we look at things from a yield, liquidity constraints or risk outlook point of view. In closing, we would like to remind you of two points:

- Interest rates, term premiums and spreads are low because monetary policies have exerted downward pressure on them. Of course, central banks are not the only parties responsible for the levels achieved, but they have amplified the trend. More importantly, we must not forget that the risks posed by such policies on asset values (potential bubbles) and their volatility did not hold back central banks. One of the objectives pursued and achieved was to eliminate any stress on government bonds, but this may change. We must keep this in mind later, when the time comes to return or try to return to more conventional monetary policies.
- The low interest-rate environment is becoming a negative interest-rate environment, which is a game-changer for some market participants. In addition, credit spreads and yield curves have lost some of their defensive value and include increasingly asymmetrical risk, while “classic” asset valuation models have lost their appeal.

“The low interest-rate environment is becoming a negative interest-rate environment, which is a game-changer for some market participants”

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