Yields Go Low, We Go…

Excerpted from the Alternative Investment Analyst Review, Volume 6, Issue 4

The Alternative Investment Analyst Review is the official publication of the CAIA Association. Access to the most current issue is an exclusive benefit of CAIA Membership while archived issues are available to the public in the Perspectives section at CAIA.org.

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Central Issue of the Paper

In 2016, bond yields fell to unprecedented low levels in major markets — below zero, in some cases. This phenomenon challenged long-held assumptions about asset allocation. Many investors asked themselves whether holding very-low-yielding bonds was pointless, especially given expectations of future rises in yields.

Does this exceptional environment demand exceptional action? AQR has long argued for strategic risk diversification across many return sources — including bonds — with, perhaps, modest tactical tilts. In this paper by AQR titled "Asset Allocation in a Low Yield Environment" they question the premises behind that preference in light of the low yield environment and find that they continue to be sound.

Approach Employed by Paper

It's a common assumption that, over a long period, a bond's yield is equal to its expected return. So, if yields are zero or less, the total return on bonds should be no better. Despite this being roughly true, yield levels are astonishingly not as relevant for asset allocation as you might think! To demonstrate why, they separate investment returns into two parts:

Total Return = Risk-Free Rate + Excess Return

The above formula is just a tautology, but it's crucial to understanding the implications of the current environment. The risk-free rate, as its name suggests, is what you get as basic compensation merely for saving (rather than consuming), but it does not include the return on taking risk. Excess return, on the other hand, is the return for taking the risk associated with investing, and potentially the return on investment insight or acumen. Since excess return is the only part of the equation which differs among assets, it is also the key consideration when allocating among them. The immediate implication is that, all else equal, if either the risk-free rate or excess returns are particularly low, then it's likely that the total return on the asset will be low as well. In a world of exceptionally low risk-free rates, whatever the return for risk-taking might be, the return for taking no risk (i.e., the return for saving) is so low that the sum of the two, the

total return, is starting at a disadvantage. This applies equally to all investments, including equities. In other words, for asset allocation decisions, what matters is expected return in excess of the investor's risk-free rate, not expected total return. Expected total return matters more broadly, of course, but asset allocation decisions only act directly on excess returns.

Another question the paper attempts to answer is what is driving the difference between how excess returns and total returns are related to yield levels? What they conclude, mechanically and empirically, is that positive long-term excess returns in bond markets are not generated by high (or low) yield levels but rather by the average upward slope of yield curves. Furthermore, the paper points out that tactical timing has an unimpressive track record, especially when based solely on valuation, and humility is therefore warranted in sizing tactical tilts. Even in the current low yield environment, there are plausible scenarios where yields could go much lower.

Lastly, the paper explicitly notes that they do not consider bonds to be a "hedging asset." That is, they don't need bonds to exhibit negative correlation with other asset classes to add value as a diversifier (although in recent years they have indeed acted as valuable safe havens negatively correlated to equity markets, especially in difficult market environments). Rather they expect the correlation between bonds and other asset classes to average about zero — which is plenty diversifying (and consistent with long-term historical averages — substantial negative correlations are not the norm).

Findings of the Paper

Key parts of the current environment are often misunderstood — specifically the difference between the return on savings via the risk-free rate and what we as investors earn from the risky portion of our investments, excess returns. This paper has demonstrated that low yields don't mechanically imply a low risk premium or low excess returns. They've shown that the risk premium for bonds, the term premium, has been related to yield curve slope rather than to yield level. They also have reason to believe yields can still move in either direction, and could potentially go negative again in certain environments. Finally, they've shown evidence that bonds have been diversifying to stocks and commodities, even in rising rate environments.

Low risk-free rates are a material headwind to investors' total returns, regardless of asset allocation. They say this because today's risk-free rates affect more than just bonds and investors can't do much about them. The decisions they do make, particularly on asset allocation, affect only excess returns, about which the low yield environment says little. Their conclusion then is that the low yield environment does not contradict the strategic case to maintain a diversified asset allocation. Rather, it highlights the continued need for investors to diversify across more traditional and alternative return sources and size those return sources so they matter in their portfolio.