Investing in a Low-Yield World

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Yields on many traditional asset classes are at or near historical lows. Low yields imply that related asset prices are already high, which suggests low future returns. Investors need to lower their return expectations. Rather than chasing yield with higher risk to boost returns, they should seek investment opportunities in specific industries throughout Asia, particularly those industries with the fastest rise of the middle class and a related increase in consumer spending.

Given the vagaries of investment markets in the short term, my remarks will focus on the longer term issue of investing approach and orientation. The "end game" 5 to 10 years out is what I am concerned about. But I will apply my remarks to the current conditions of low asset yields and high uncertainty.

Let me start by defining some key words:

- **The first word is Investing.** By that I mean "not speculating", and here I adopt Benjamin Graham's distinction, being the ***basis*** of achieving a return goal. Investing is about buying an asset at a price below its intrinsic value, whereas speculating is about getting ahead of others in the investing market. In other words, investing is the weighing machine, as opposed to speculating the voting machine.
- **The second word is Low** - low is a relative word, in this case relative to history and probably fundamentals

- **The third word is Yield** – yield is a measure of income on asset price in percentage terms. I will examine later if it says something about prospective return
- **The last word is World** – by this I mean global financial markets, which are very well connected these days. The underlying economies may be moving at 3 different speeds as described by the IMF, but there is only 1 speed for the flow of capital and ideas - fast. Still, there are big players and small players. We need to take the cue from the big ones, particularly when the policy linkage is or near direct e.g. the quasi US Dollar zone in Asia. So I will be using largely US data to illustrate my points.

I will not dwell on how we have ended up in such a low yield world, given your familiarity with what happened in the last few years. Suffice to say that what we are witnessing is the **latest part of a 30-year credit expansion cycle with ever lower interest rates.** This 30-year secular decline in global interest rates was initially led by a long dis-inflation trend stemming from Volcker Fed's anti-inflation policy, aided by the supply shocks of China, globalization and technology; and in the last few years by big policy efforts to ease deleveraging. The sub-par growth, high debt burden and weak private credit growth in many advanced economies necessitate these drastic moves. They are to stimulate aggregate demand to get to sustainable growth but without triggering an inflation problem, so goes the theory. It is a difficult balancing act.

For investors, **the last 30 years have seen largely good returns.** For stocks, and using US stocks as an indicator, the first 10 years ('80s) saw very high real return (12% or 17% nominal). The next 10 years ('90s) saw more outsized returns (15% real or 18% nominal). The last 10 years ('00s) gave back some (-3% real or -1% nominal). So for the 30-year period we saw an average annualized return of more than 6% real and 10% nominal respectively. To be sure, there were periodic large mark-to-market losses like 1987 crash, 2000 dot-com bust and the 2008 GFC, so it was not exactly a smooth ride.

But the eventual outcomes were good. For US bonds, the ride was equally good, if not better. All the 3 decades saw positive real returns, 8%, 5%, 4% respectively. In hind sight, a simple 60 stocks - 40 bonds portfolio would have produced very attractive investment returns. This is in hind sight, of course.

Interest rates are at historic lows. Long term interest rates are negative in real terms in many countries. In some countries, even nominal interest rates are negative, albeit in shorter maturities. Given that these risk free interest rates form the basis of risk asset yields, systemically all asset yields are reduced. 10-year US Treasury bond yield is 1.9%, US stocks' earnings yield is around 7% (dividend yield is about 2.5% with additional earnings growth likely around 4.5%), most non-investment grade bonds and emerging market bonds yielding less than 6%, and core real estate cap rates are 4% on average.

I would suggest that **BEGINNING YIELD LEVEL MATTERS**. It is critical to recognize this. For bonds in particular, starting at 1.9% means a very high likelihood that the average annual returns in the next 10 years will be 1.9%. The correlation between beginning yield and eventual return is almost 1. For non-investment grade bonds, with a beginning yield of 6% the prospects of repeating recent double digit returns are very poor. For equities, the prospects are less certain because besides the beginning yield, *earnings growth* and *ending earnings multiple* matter too. Earnings growth may change, although they tend to track nominal GDP growth over time, which is not promising given the economic head winds and already high corporate profit share of GDP. How about the ending earnings multiple? Earnings may be valued differently in the future. Here, using a long term valuation indicator like the Shiller PE multiple, which is at 23.2 times or in the 9th decile of historic outcomes, it is pointing to a 1.6% median real return per annum in the next 10 years if it reverts to historic mean.

This is important. In investing, we are always concerned about the prospects of "fundamentals" – growth, inflation, quality of assets, cash flows, etc. We pour in a lot of resources trying to assess the "intrinsic value" of assets. This is rightly so, and particularly critical in this time of great uncertainty. But equally important is the **PRICES at which we buy assets**. **The surest way to lose money is to OVER PAY for assets**. I described earlier the 30 years of good returns since the '80s – the seed of those returns were not just the economic improvements since, but the low beginning prices. Bonds and equities were offering high yields then. 10-year US government bonds were yielding low teens and US stocks had price earnings multiples of 6 to 8 times. The subsequent reduction in interest rates helped to elevate asset prices, perhaps sowing the seeds of future disappointments.

It seems more and more investors are being "crowded into" searching for yields and taking risk. It is useful to understand the reasons for investors doing what they do – chasing yields. There seem to be broadly 3 reasons:

First, **a belief that the current low interest rates will prevail for a long time**. Today's bond prices reflect so, with long term bond yields at very low levels. Forward real cash rates backed out from long rates are negative up to the next 10 years. If this holds, the elevation of asset value from the lower discount rate will be supported. It makes sense then to own spread assets; indeed to leverage up if the belief is strong. The problem is - it is hard to know. Bond yield forwards are historically not great at predicting future interest rates.

Second, **a belief that even if interest rates were to rise, cash flows will rise to at least compensate for the rise in discount rate**. The idea is that central banks will only raise interest rates when growth returns to a sustained level. This is more applicable to "growth assets" like equities. In this case, the rise in cash flows will need to be very substantial or lasting, given that discount rate changes apply to all future cash flows. This reflects an optimistic view on future growth, certainly not bad outcomes like stagflation which some quarters are worried about.

Third, **not quite believing**, but needing to avoid accruing negative real yield in the short-term, and perhaps crisis fatigue too. This is particularly so if there is a need to show good short term performance. “Handcuffed volunteers”, as investor Howard Marks[1] call these. Here it plays to the peculiar behaviour of investment market participants. Higher prices can beget more demand because expectations rise that capital gains are trend-rising, begetting more demand and higher prices. There are worries of missing out. If capital gains are expected to trend rise then it is always cheaper to buy today. Along with that, there may also be a belief that one can get out in time when things change, which requires superb market timing skill, which is very rare.

So, there are no easy answers, only difficult choices. That is why many investors are only gingerly committed, evidenced by the outperformance of defensive assets such as credit, core real estate and defensive stocks. But as prices of risk assets improve, there are more pressures and temptations to reach out. Indeed, there are signs of more aggressive risk taking recently, in the form of cyclicals outperforming.

No one can predict when the end game will be, but we can prepare for it. I would like to share a few thoughts on how one can go about **meeting the challenge** by doing a combination of these:

To prepare for the end game, first, **tease out the systemic risks in the portfolio**, identify the reliance on and exposures to big market betas especially interest rates. Run factor analysis to identify common drivers, and scenario analysis to identify tail risks. Beware of beta or short volatility products which come packaged as alpha strategies. Required returns should be adjusted accordingly. Watch out for supposedly low risk corners over reaching for yields, like what many learned during the GFC of their money

[1] Howard Marks, *Ditto* (memo to Oaktree Capital clients, 2013)

market and securities lending programs. Structurally, build up more of *true* idiosyncratic and exotic beta returns.

To prepare for the end game, second, **adjust return expectations**. This is the easiest, but probably at the same time the hardest thing to do. For the capital owners, there may be spending plan, liabilities and wealth goal riding on these expectations. For the investment agents, there may be implications for the business. It requires a careful examination. But it is very important to be realistic to avoid excessive risk taking and ending up in difficult long term funding position. Walk through the maths and possibilities with your stakeholders.

Third, even without adjusting overall and eventual return expectations, it is time to review the **investment approach**, especially critical assumptions related to the need for short term returns, importance of capital preservation and peer comparison. In time of elevated asset prices, it is most important to emphasize price discipline. It is critical too to prepare the *psychology* for the end game, as more investors reach out for risk. It is time to dust off the Minskinian "*anatomy of a bubble*" [2](Displacement – Boom – Euphoria – Crisis - Revulsion).

Fourth, given the relatively high prices and high uncertainty, **consider reducing risk over time** by rebalancing, averaging out capital commitment and buying tail insurance, especially as the safety margin thins. Buying tail insurance, in particular, is useful for potential contrarian moves later. Investors recognize that most insurance vehicles tend to be very expensive because, as the research of GIC advisor Dr. Robert Litterman[3] points out, for every buyer of insurance there must be a seller; and few natural sellers of insurance are prepared to accept an exposure to large losses at precisely the worst possible time without a significant premium for doing so. Indeed in

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[2] Hyman P. Minsky, *Stabilizing an Unstable Economy* (New York: McGraw-Hill, 2008).

[3] Robert Litterman, *Who Should Hedge Tail Risk* (Financial Analyst Journal, 2011)

most cases such protections are just expensive tactical short positions. But in times of low volatility, there may be opportunities to pick up cheap long volatility positions, especially given that most investors are short volatility. Remember too another Minskinian idea - "*stability breeds instability*". Such tail risk insurance offers the real and psychological benefits of dry powder in a difficult market. Arguably, it works better than having cash, as it produces profit, making it easier to act bullish at market bottom. Look beyond general markets to build a portfolio of micro hedges as you spot them. Such hedges may have superior risk/reward profiles.

Finally, to prepare for the end game, **watch your portfolio costs**. When yields and returns are low, every cent counts. Fee structures prevalent during high interest rate times should be reviewed. Beware of paying performance fees linked to low rate fixes like LIBOR, or turnover costs of extremely low return instruments like money market instruments.

Beyond these mostly defensive prescriptions, there are offensive moves one can make. Here I offer some ideas for your consideration.

First, the world of **technology** continues to throw up new opportunities, especially in the area where the virtual meets the real, such as e-commerce or e-tailing. According to a recent McKinsey report[4], e-tailing has grown strongly and in particular China's e-tailing grew at a compound rate of 120% per year in the last 10 years, reaching USD200bn in sales last year and expected to reach up to USD650bn in 7 years. Importantly, these trends have matured sufficiently to now offer large investable stakes in key players.

Second, there is the mega trend of the **rise of the middle class** in many emerging economies. I will not belabour this point since many speakers would have dwelled on it, but just to highlight an OECD forecast - Asia Pacific's share of global middle class consumers will rise from 28% in 2009 to 54% in

[4] McKinsey Global Institute, *China's e-tail revolution : Online shopping as a catalyst for growth* (McKinsey & Company, 2013)

2020 and then 66% in 2030. In other words, in less than 7 years, one in two middle class consumers will be found in this region, and in 17 years, two in three. It is an opportunity not to be missed by any investors, even as occasional setbacks are inevitable. To be clear, this does not necessarily mean making a large allocation to the assets domiciled in this region. One has to assess where value is created and pick the right exposure vehicles accordingly e.g. in multinational consumer companies.

Third, this particular region of 600 million people, **ASEAN**, offers significant opportunities. Beyond the continued rise in income, it will benefit from the ASEAN free trade area coming into being in two years (2015) and China's transformation from being an FDI competitor to being an export customer. While valuations are not low currently, the longer term prospects are not to be missed.

In conclusion, I have highlighted the importance of looking at beginning yield level, and suggested that the current low level of asset yields is a concern. It leaves little on the table to cushion adverse outcomes. As John D. Rockerfeller allegedly said: "*More money has been lost by chasing yield than at gun point.*" Instead, it is time to prepare for any eventuality, by forging common beliefs with stakeholders and clarifying responses to different market outcomes. It is also time to keep working on new opportunities, there too looking beyond the immediate. After all, investing success lies not in the *now* and *here* (*no-where!)* but good preparations for the end game.

Question and Answer Session

Lim Chow Kiat, CFA

Question: Could you provide some perspective on China versus India as an investment opportunity and the relative risks?

Lim: China and India are, of course, a very important part of the emerging markets' investment story. There are some significant differences. China's reliance on the central government planning its economic strategies has worked really well for the last 30 to 40 years. It has turned up good opportunities but also has created some challenges. In China, it is important to differentiate between the state-owned enterprises, which participate in the country's trend of rising growth, **and the privately owned enterprises**.

In India, the private side of the market has many good investment opportunities, despite the fact that the government's side of things has not been working out as well as hoped. India, despite the many pessimistic and negative headlines, remains an important investment destination with many good companies and good management teams taking advantage of the underlying growth trend. The trend in India is not as impressive as that in China, but India is also still creating a significant number of new middle-class households and hence opportunities for companies and investors.

Question: What is your view of gold as an asset class?

Lim: Gold is a difficult asset class because its price often deviates from its as an industrial or consumer product. Based on cash flow discounting, gold ought to have fairly low intrinsic value. Many investors have been looking at gold as a hedge—either against some sort of hyperinflation outcome, against the financial system collapsing, or against a paper money system that no longer works. I think portfolio diversification is important and that, at the right level, gold can be a useful hedge for some of these outcomes.

Question: How do you feel about the ability of central banks to manage their exit strategies related to quantitative easing?

Lim: It is a really challenging task. Many market participants regard what the central banks are doing as almost the only game in town**, which increases the central banks' burden to keep it going.** I think central banks will find it hard to exit from quantitative easing without risking relapse and severe economic problems.

Many central bankers are very sensitive about this issue. I believe that they are working hard preparing **for this eventual exit**. For example, in the United States, higher interest rates can be paid on bank reserves as a way of slowly draining liquidity; banks will accordingly reduce their lending. This situation is unprecedented so substantial risks remain. It is important to watch the economy side to see whether the credit system has regained its health and whether the real economy is seeing the kind of growth that supports central banks' adjustments from these very accommodative monetary policies.

Question: Where are you finding the greatest opportunities for income—in infrastructure, emerging markets, or other areas?

Lim: At GIC, we do not specifically focus on yield. Ultimately, the important goal is to generate total return, which is composed of yield plus capital gains. However, yield as an indicator of valuation, as an indicator of how the markets are likely to behave, is an important measure.

We are clearly concerned about the low level of yields. We are getting yields from our stocks, bonds, and real estate holdings, but unfortunately, they are not as high as we would like. Compared with history, the yield level is clearly not good. We are becoming more cautious in terms of reaching out for higher-yielding assets.

Question: What are your thoughts on impact investing compared with socially responsible investing (SRI)? Is impact investing a component of your strategy?

Lim: Yes, impact investing is a relatively new idea. It is an important trend that we have to stay on top of, but thus far, we do not have dedicated a pool of capital to pursue opportunities in that area. Impact investing is different from SRI. Both impact investing and SRI focus on delivering a financial return and a social return. Impact investing has clear, upfront, and measurable objectives, whereas SRI employs filtering criteria to avoid companies that operate in morally questionable areas, such as arms, alcohol and gambling, and child-labor exploitation.