Considering the impact of rising interest rates on our portfolios

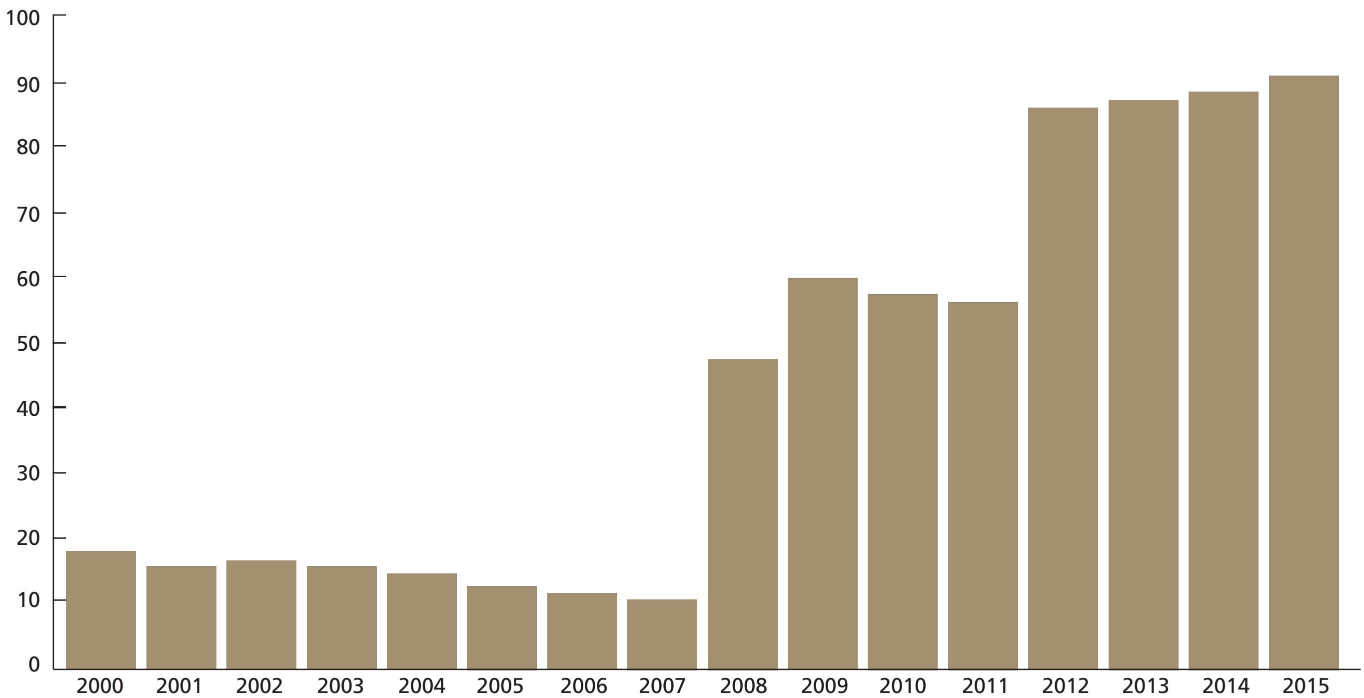
Shaun Le Roux

Shaun is a CA (SA) and a CFA charterholder. He has been managing the PSG Equity Fund since 2002.

'I don't know whether to feel good or uneasy about the fact that 90% of the industrialised world economy is now anchored by near-zero or negative short-term rates. At one level, this should be supportive of risk assets; at another level, it is a symbol of how fixed income investors and central banks see the world.'
David Rosenberg, Gluskin Sheff

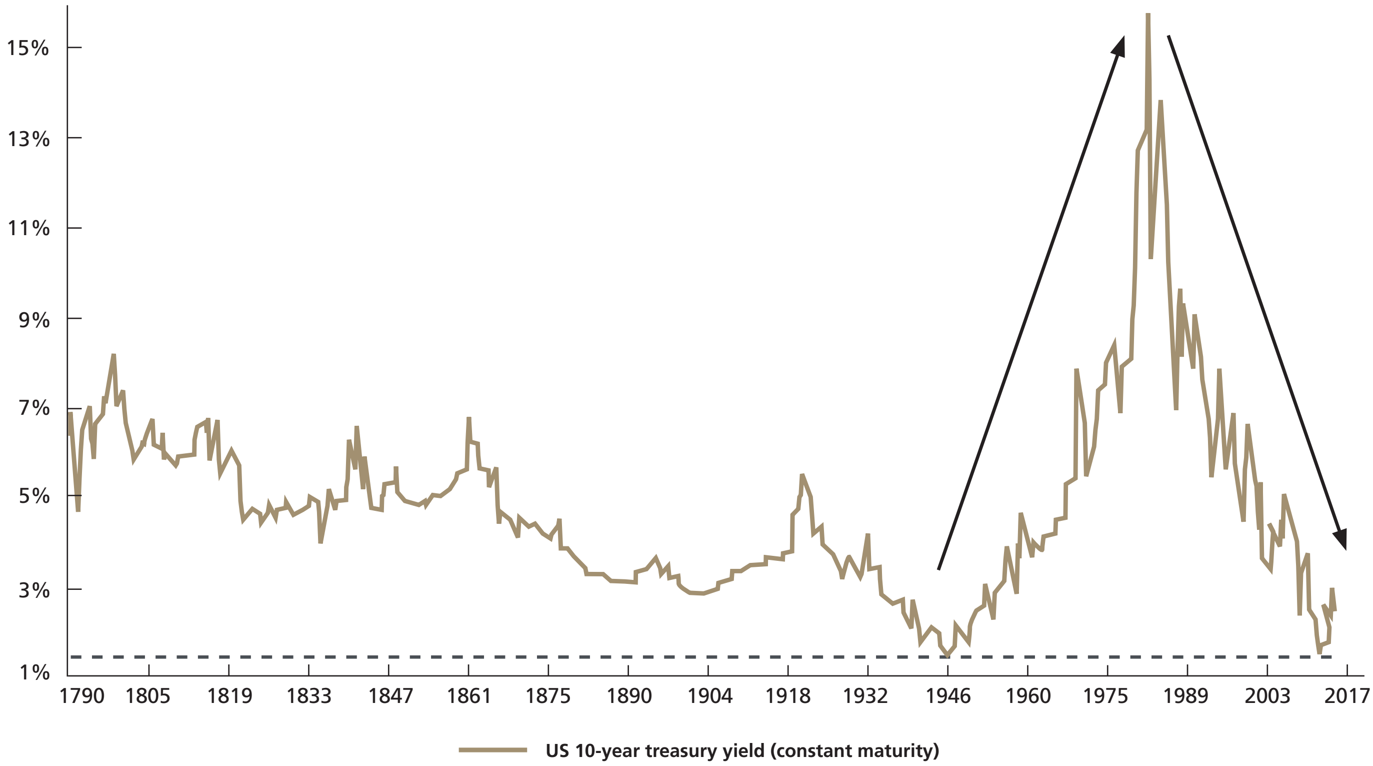
Most interest rates are at multi-generational or all-time lows
We find ourselves in extraordinary times. As Chart 1 shows, 90% of the industrialised global economy is subject to near-zero interest rate policy. Central banks have adopted extremely accommodative monetary policy to counter the effects of the global financial crisis and the unwinding of a debt 'super-cycle'. In recent times, G7 countries have gone as far as buying government bonds (quantitative easing) to inject liquidity into economies where demand for credit has been lacklustre or absent. As a result of these interventions, today we find most interest rates in developed markets, both short- and long-term, at multi-generational, or in some cases, all-time lows.

Chart 1: Global share of industrialised economies' GDP with policy rates near or below zero (2000-2015)



Sources: International Monetary Fund, Bloomberg, Haver Analytics, Gluskin Sheff

Graph 1: US 10-year treasury yield (1790-2017)



Sources: Bank of America Merrill Lynch Global Investment Strategy, Global Financial Data, Bloomberg

The consequence of very compressed yields on cash, government bills, treasuries and investment grade credit is that investors requiring income from their investment portfolio have been forced further out on the risk curve, into things like property, high yield credit, equities and emerging markets. To maintain yields, investors have had to move into riskier assets and securities.

The key question that investors should be asking themselves today is: am I being compensated for the risk that I am taking?

In other words, am I being compensated via current yield and sustainable future growth thereof for the risk that, at some stage, the world economy reverts to looking more normal? (with some inflationary pressure, less accommodative central banks and higher rates).

This may seem like a less relevant question in today's world, where all the current trends are pointing to less rather than more inflationary pressure, with lower oil and commodity prices playing their part. But it is worth remembering that in this world of ultra-low yields, a small positive increase in inflation expectations could have a pronounced impact on asset prices in some areas. For example, Table 1 explores the impact of a reversion to historic yield levels for highly priced G7 bonds, South African listed property and the FTSE/JSE INDI 25 Index.

Table 1: Capital return – reversion to historic average yields

	10-year average	20-year average	20-year high
INDI 25	-33%	-48%	-64%
Property	-15%	N/A	-44%
G7 bond yields	-18%	-26%	-60%

Sources: PSG Asset Management, Bloomberg, I-Net
Calculated 10 March 2015

Should G7 bond yields revert to their 10-year average, investors in those bonds, typically the lowest risk investors, would suffer an 18% loss. If the price-earnings (P/E) ratio of the FTSE/JSE INDI 25 Index were to revert to its 10-year average, the capital loss would be in the order of 33%.

Developed market treasuries have traditionally been referred to as 'risk-free assets'. Many market commentators appropriately now refer to them as 'return-free risky assets'

At PSG Asset Management, we are bottom-up investors and do not try make macro predictions. Hence, we take no view as to when and by how much interest rates will rise in the various global markets. But we acknowledge that global inflation expectations are very low and the Fed has signalled that it intends embarking on a tightening cycle this year. We do know that in a normal year, interest rates in South Africa and the US will be higher.

So, to meet our objectives of providing returns to our clients without putting their capital at risk, we think it both prudent and important to pay careful attention to ensuring that our portfolios are robust enough to withstand a variety of scenarios including rising rates. (Anet Ahern discusses how we incorporate stress testing our portfolios for various scenarios in the next article.)

How are our portfolios positioned and what effect would rising interest rates have on our portfolios?

Our portfolios are constructed in a bottom-up fashion. We carefully analyse all the securities across the yield spectrum (from cash to high risk equities) and decide whether the specific securities meet our required rate of return, given our view on the underlying risk of the security. We like to invest with a margin of safety and are happy to walk away from investment opportunities where we think that it is possible that our clients could lose money. Our summation of the current conditions on financial markets is that an investment into some of the traditionally lower risk asset classes (government bonds, property and low beta equities) carries a high likelihood of capital loss and most of these assets are overpriced. Accordingly, we do not own government bonds, property and bond-like equities.

Our portfolios are characterised by having low duration risk. In other words, they will be well protected in a world of rising rates. We have a strong preference for floating rate credit in our multi asset portfolios, and have very low exposure to fixed rate credit. Floating rate credit would benefit from higher coupon payments should interest rates rise.

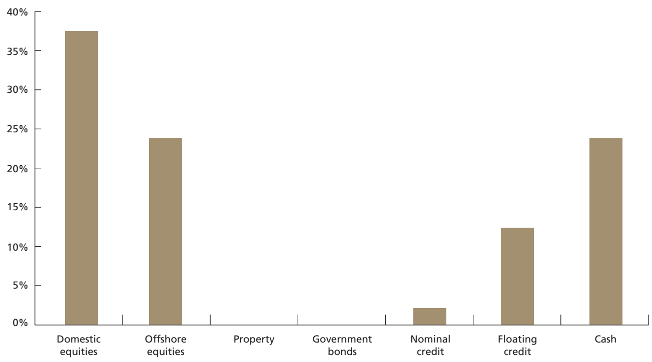
Our low exposure to duration means that our portfolios could underperform in the event of further compression in yields. But this is a risk we are prepared to endure given the low levels of yields and real chance of capital loss should financial conditions normalise. We take comfort in the fact that our bottom-up focus on margin of safety means that we have a low likelihood of losing a lot of money for our clients even if we are wrongly positioned over the short term.

Within equities, we have been finding significantly fewer opportunities to invest in higher quality businesses at reasonable valuations on the JSE. As a result, our portfolios are not fully invested in domestic equities. We can still find good long-term opportunities within the global equity universe and our domestic funds have utilised the full extent of their mandates to buy attractively priced global businesses with quality franchises. Many of the equities we do own can be characterised as being out of favour and hence trading at a wide margin of safety. They are selected in a bottom-up fashion, security by security. Some of these are tied to the global economic cycle, have underperformed in recent times, and would be expected to perform well in a rising rate environment. Examples include global financials (J.P. Morgan, HSBC, Wells Fargo and Capital One), materials (Glencore and Anglo American), US technology (Cisco), UK food retail (Sainsbury's), and automakers (Porsche and Daimler).

The result of having very limited exposure to duration assets and being less than fully invested in equities is that our multi asset portfolios sit with relatively high levels of cash. Cash holdings would become larger contributors to portfolio returns as interest rates rise. Cash also provides firepower to be employed if valuations normalise and opportunities arise to buy attractively priced higher duration assets. We think the value of cash at this stage of the investment cycle is both attractive and under-appreciated.

The asset allocation of the PSG Balanced Fund (as shown in Chart 2) illustrates the risks and opportunities as discussed above.

Graph 2: PSG Balanced Fund – asset allocation as at 28 February 2015



Source: PSG Asset Management

Financial markets in early 2015 are characterised by artificially low rates and generally inflated asset prices. Now is the time for investors to consider whether they are being compensated for the risk they are taking in their portfolios. Careful attention should be given to the impact on portfolio values should rates normalise. We are comfortable that we are not putting our clients' capital at risk by chasing overpriced assets and securities. We take further comfort from the fact that we can still find good opportunities in very specific assets and securities both at home and abroad.