SWAN GLOBAL INVESTMENTS

Chasing Yield

Why Investors Should Seek an Alternative to Fixed Income

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Investors have been accustomed to very low yields for the past decade.

The last time the Federal Reserve implemented a program increasing rates was June 2006, over a decade ago. The period of loose monetary policy following the Global Financial Crisis was one of the longest and steepest in history.

The Federal Reserve started cutting the Federal Funds Rate on September 18th, 2007 and didn't start raising rates again until December 16th, 2015. One-month T-Bill yields were close to zero following the Lehman Brothers collapse in September 2008 and ten-year Treasury bond yields were mostly in the 2%-3% range for the last decade.

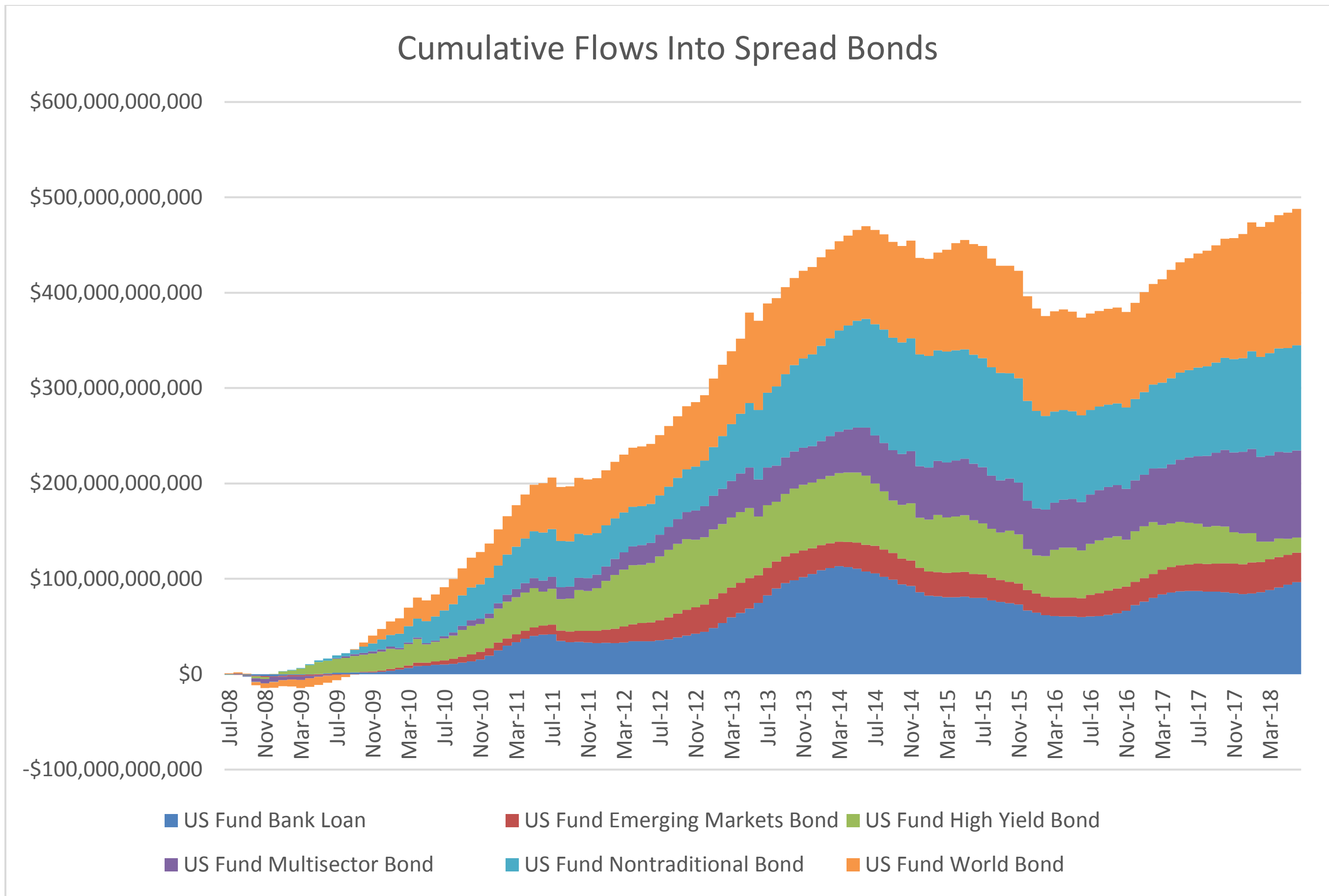
With rising rates and talk of a flat or inverted yield curve, it will be helpful to revisit the impact these environments have on yields and investors' plans for consistent, reliable income.

Low Yield Environment

With yields at rock-bottom levels since the Global Financial Crisis, bonds have been failing to deliver the income many investors need.

This has forced many advisors and investors to take on more risk in high-yield bonds or other riskier investments to satisfy living expenses. While this may fit the bill in the short term, it is an unstable and unsustainable long-term income plan.

With investment grade rates barely keeping pace with inflation, investors have been "chasing yield" wherever it might be found…high yield bonds, emerging market debt, world bond funds, bank loan funds, "non-traditional" and "multi-sector" bond funds, et cetera. The graph below shows a cumulative estimated flow of almost half a trillion dollars into these "spread" asset classes over the last ten years.



Morningstar Category	Ten Year Flows: Jul 2008- Jun 2018
US Fund Bank Loan	$ 96,521,892,751
US Fund Emerging Markets Bond	$ 30,841,921,583
US Fund High Yield Bond	$ 16,030,960,837
US Fund Multisector Bond	$ 91,280,002,448
US Fund Nontraditional Bond	$ 110,175,313,280
US Fund World Bond	$ 143,056,891,174

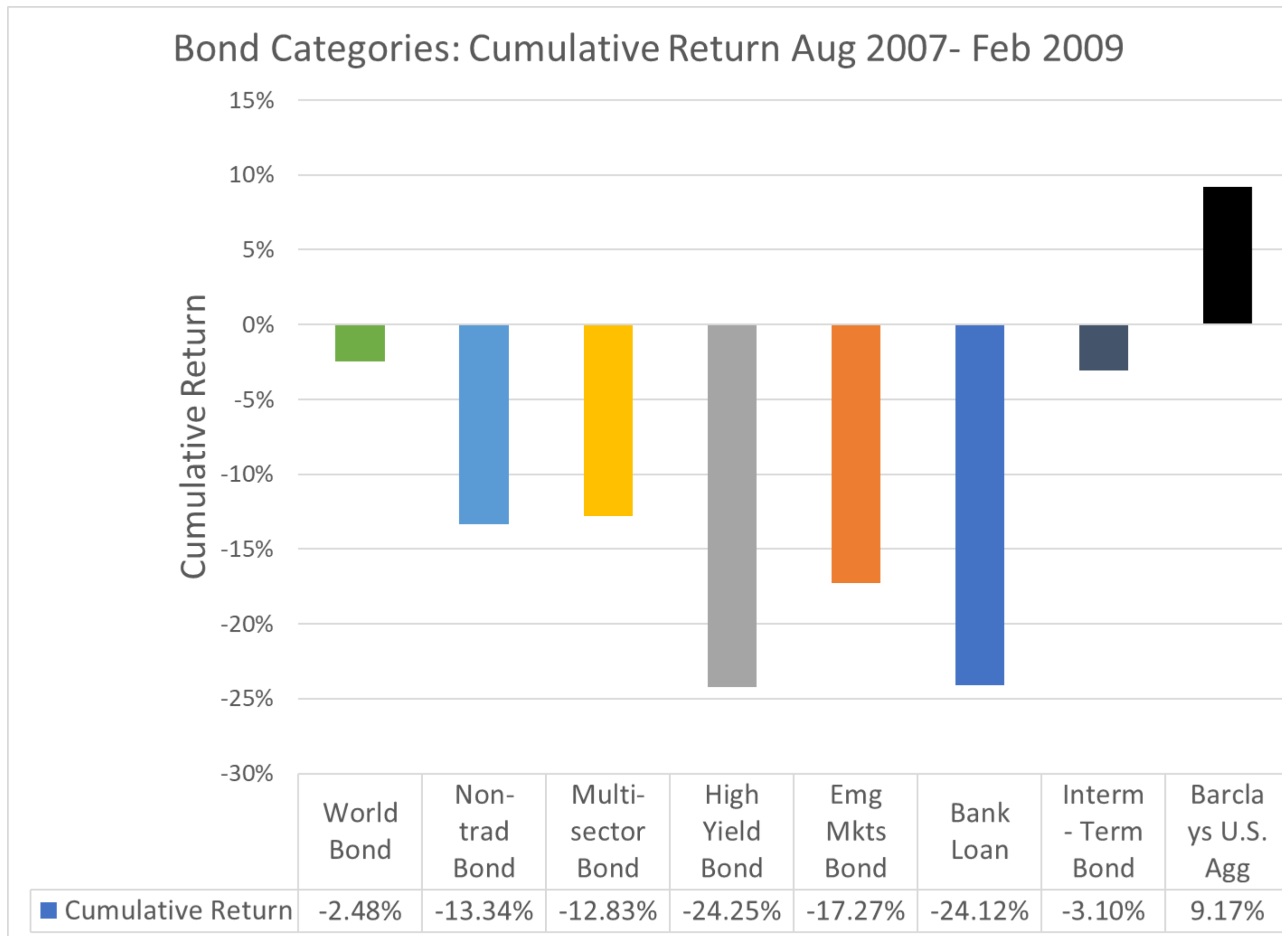
Source: Morningstar Direct

Pursuit for high-yield bonds is all well and good when fixed income markets are calm. But let's not forget the other reason investors include bonds in their portfolios: capital preservation. The moment equities sell off, these types of investments will have a hard time keeping the portfolio steady.

The Consequences of Chasing Yield

Prior to the Global Financial Crisis, yield had been low and suppressed for quite some time following the Dot-Com Crisis. With yields low and markets benign during the middle part of the 2000s, many investors dialed up their risk exposure to chase after yield. When markets reversed, they paid the price.

During the Global Financial Crisis, these spread asset classes typically lost between 15% and 25% of their value, shown below.



Source: Zephyr StyleADVISOR

Based on these numbers, these types of bonds should be viewed as a "risk" asset, not a "protection" asset. Those chasing yield in High Yield Bonds would have suffered losses in the neighborhood of 24.25% during the crisis.

Another subtler but perhaps even more worrisome point to note is regarding investment grade bonds. The two columns on the far right display the Morningstar category average for Intermediate Term Bonds and the Barclays U.S. Aggregate Bond Index, respectively. In theory, both are meant to represent safe, investment grade bonds.

However, the performance gap between the two is quite large—over 12%. During the Global Financial Crisis the Barclays Aggregate Index was indeed up 9.17%, offsetting equity losses if used in a balanced portfolio. However, the average Intermediate Term Bond fund fared much worse during this period, losing over 3%. it is fair to assume a lot of active managers went chasing after yield, even though their mandate might have been investment grade bonds.

Barron's recently ran a thorough and worrying article called "Where the Bond Market's Next Big Problem Could Start" by Vito Racanelli. The author explores the large "bulge" of corporate debt sitting right on the investment

grade/speculative grade cusp and wonders what might happen if this BBB-rated debt tips over into BB-range. For those looking for icebergs on the horizon, it is a good read.

How will such assets fare in another downturn when spreads have been squeezed to razor-thin margins? Time will tell, but the forecast is not favorable.

Low Yields and Limited Options

These ultra-low yields for the past 10 years limit advisors' and investors' options. They can either take on more risk going after yield and set themselves up in a precarious position for a future downturn or they can remain conservative and sacrifice income.

But there are other ways to get income.

An Alternative to Yield: Total Return & Systematic Withdrawals

With bonds failing to provide the necessary income many require, it's time to redefine how we think about income. Bonds aren't the only way.

We argue the focus should be on total return on an investment. Too many investors focus just on the yield component of total return and miss the importance of capital gains. Instead of reaching for yield and risking principal, advisors and investors can widen their options and limit the amount of risk they take.

At the end of the day, a dollar gained is a dollar gained and one shouldn't care how that dollar is generated. Moreover, by leaving gains invested one could reap the benefits of compounding returns.

And when it comes to taking out income, you will just need to implement a systematic withdrawal plan.

About the Author:

Marc Odo, CFA®, CAIA®, CIPM®, CFP®, Client Portfolio Manager, is responsible for helping clients and prospects gain a detailed understanding of Swan's Defined Risk Strategy, including how it fits into an overall investment strategy. Formerly, Marc was the Director of Research at Zephyr Associates for 11 years.

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