momentum

Perspectives on Fixed Income Investing: Instalment 2 – Term premium

INTRODUCTION

This series of short notes summarises our views on fixed income investing for UK-based pension funds with sterling liabilities. In the first instalment we identified the following sources of excess return that can be derived from fixed income investments:

1. Term premia (both sterling and non-sterling)
2. Credit risk premia
3. Liquidity risk premia
4. Currency risk premia
5. Active risk (alpha)

In this second instalment, we will focus on the term premium. We will take a detailed look at the other sources in future notes.

THE TERM PREMIUM

A term premium should exist to reward investors for taking interest rate risk (i.e. investing in assets providing a fixed rate of return that can underperform a floating cash rate).

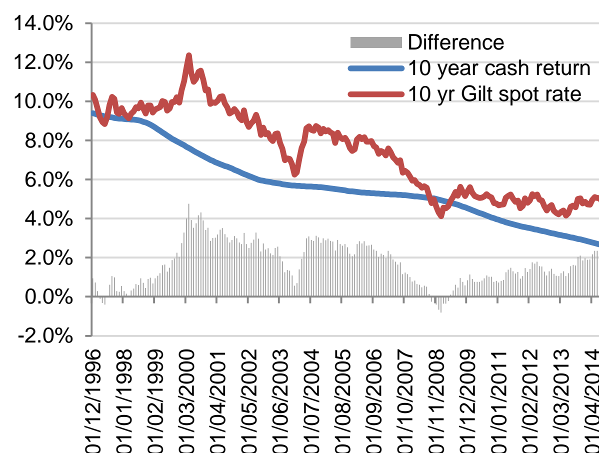
For example, the current yield on the 10 year zero coupon gilt is 2.6% per annum. If an investor buys the 10 year zero coupon gilt, and the UK government doesn't default (which we think it is safe to assume as the Bank of England can print money), the investor will receive a return of 2.6% per annum over the next 10 years. If cash rates average more than 2.6% per annum for the next 10 years, then the investment would underperform cash over the full 10 year period and investors should be compensated for taking this risk.

In addition, the value of fixed income assets can vary, and the return in any individual year could be very disappointing (and materially lower than cash). This is a mark-to-market risk that an investor needs to be rewarded to take.

Although past performance is not a good guide to the future, empirical evidence would suggest that interest rate risk has been rewarded (i.e. a term premium has existed) generally over the period since 1986.

The chart below compares the annualised return investors would have achieved from holding a 10 year zero coupon gilt or cash over rolling ten year periods. For example, the figures shown for 1 June 2014 compare the yield on a zero coupon gilt on 1 June 2004 (i.e. 5%) with the annualised return on cash over the 10 year period from 1 June 2004 to 1 June 2014.

For the vast majority of periods the fixed gilt return has outperformed the cash rate which supports the existence of a sterling term premium.



We note that the analysis is somewhat less compelling when assessed for shorter periods (e.g. 5 year terms) where the cash return outperformed the fixed rate on 22% of the occasions observed.

EXPOSURE TO STERLING TERM PREMIA

UK clients tend to overlook the term premium because for many years it has been common to assume that it doesn't exist in the UK fixed income market. Indeed, as the liabilities of UK pension funds can be represented by a portfolio of long-dated bonds, the vast majority of UK pension funds are effectively 'short' bonds, and hence short the term premium.

This is not an unreasonable position to adopt for two key reasons:

1. Gilt yields have remained extremely low, making it easier to believe that cash might outperform gilts over extended periods.
2. Institutional demand for gilts has persistently exceeded the supply of gilts, leading many to believe that the gilt market is miss-priced.

These are reasonable arguments, but they are active views, and shouldn't affect the gilt market indefinitely, which means that there could come a time when it is attractive for clients to unwind their current short positions, and even to seek to move to a position where they have a net positive exposure to the sterling interest rate term premium.

EXPOSURE TO NON-STERLING TERM PREMIA

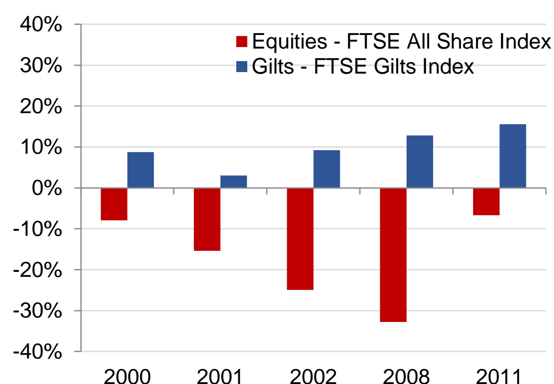
Even if investors decide that the sterling term premium is unattractive on relative value grounds, to the extent that non-sterling interest rate markets are not miss-priced, it could be attractive to seek exposure to non-sterling term premia, either strategically, or dynamically.

In recent years we have not encouraged clients to take structural non-sterling interest rate risk in their fixed income portfolios for the following reasons:

1. The focus of non-sterling fixed income portfolios has been on capturing more diversified exposure to credit markets, and to increase the opportunity set for active management. Given this primary objective, rather than complicating the proposition by bundling the credit exposure with non-sterling interest rate risk, we have encouraged clients to hedge out this non-sterling interest rate risk.
2. The existence of a term premium is not universally accepted, and if it does exist, it is far from obvious that the return available is sufficient to justify the risk which it introduces (relative to sterling liabilities).
3. Removing non-sterling interest rate risk has been relatively straight-forward to implement, and cheap to execute, so practical considerations have not been a barrier to achieving the desired exposures.

Although we continue to believe that it is a perfectly sensible strategy to hedge out non-sterling interest rate sensitivity, the pros and cons are now much more finely balanced for the following reasons:

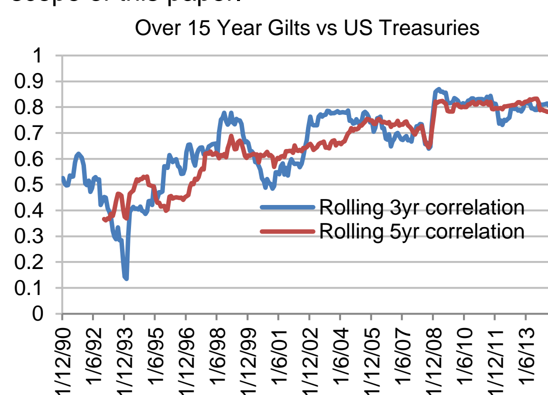
1. The move to central clearing of interest rate swaps will make hedging less efficient in future, as initial and variation margin will be required to be held in cash & gilts, increasing the proportion of the portfolio that cannot be invested in credit. This will act as a slight drag on overall return.
2. The diversification benefit of the term premium has become more generally accepted. In particular, in a risk-off environment when most risky assets perform poorly, high quality government bonds tend to perform. This puts upward pressure on all bond prices, partially offsetting the negative impact of spread widening. (The chart below shows UK equity and gilt returns for all years when equities have fallen since 1999).



This will not always be the case, but it is likely that the term premium is beneficial in an overall portfolio context, even if the risk and reward profile is not compelling as a stand-alone investment. This portfolio benefit is not new, but it has become more widely accepted, and indeed is central to most risk parity products.

3. Whilst managers have embraced the idea of benchmark agnostic credit mandates with the interest rate risk hedged out, it has become clear that both managers and clients find it comforting to have a performance comparator (if not a formal benchmark) to help assess how successfully a portfolio has been managed. Removing interest rate risk from credit portfolios makes performance comparison against a standard index much harder. Measurement should not drive investment decision making, but the ability to monitor performance more effectively would be a consequential benefit of a decision to retain interest rate risk in non-sterling credit mandates.

We note that retaining non-sterling interest rate risk would impact on target hedge ratios given the fairly strong positive correlation with sterling interest rates (as evidenced in more recent years in the chart below). However, further consideration of this point is beyond the scope of this paper.



On balance, if we were setting up a global fixed income mandate today, we would recommend retaining the non-sterling interest rate exposure, as we would now place greater emphasis on the practical disadvantages of the hedging, and on the diversification benefit provided by the term premium.

The merits of targeting additional exposure to the non-sterling term premium are more finely balanced for the following reasons:

1. The excess return is uncertain, difficult to quantify reliably and likely to vary through time. It is also likely to be modest.

2. Given the modest excess return available, accessing this source of return is relatively capital intensive (unless derivatives are used).

3. In isolation, the non-sterling interest rate exposure is risky, and it is not obvious that the expected return available provides adequate compensation for this risk. In a portfolio context the impact on risk is likely to be modest because interest rate risk has a very low correlation with the other risks that pension funds are generally exposed to (primarily equity risk and credit risk). However, correlations do vary through time, and so the merits of interest rate risk will also fluctuate.

We believe there is a theoretically sound case for including exposure to non-sterling interest rate risks in a balanced portfolio, subject to a fair value assessment of pricing. However, we also accept that the modest impact on overall risk and return (for an unlevered allocation), and/or the practical challenge of gaining enough exposure to be worthwhile (e.g. using derivatives) are good reasons for investors to decide not to make an allocation.

One convenient way of gaining exposure to this source of return is to make an allocation to a risk parity product as these products generally have a material (levered) exposure to the term premium. We acknowledge that this may be unlikely to appeal to investors in the current environment of historically low yields, but could be worth considering in due course since current market conditions are unlikely to persist indefinitely.

SUMMARY

A term premium should exist, and so adding exposure to it should enhance return (if the allocation is funded from cash). Furthermore, the risk introduced should have a very low correlation to other risks that clients are exposed to, and so the impact on overall portfolio risk should be modest (and easily justified by the expected excess return available).

Most UK pension funds have a short exposure to the sterling term premium, as their liabilities can be represented by long-dated bonds. This is generally a risk that is well understood, and which is taken in the belief that yields in future will be higher than currently implied in bond markets (i.e. a belief that bonds are over-priced). We believe clients should have a plan for unwinding this short exposure over time, as it should be viewed as an active position rather than as a strategic one.

Beyond the sterling market, pension funds have had only modest (if any) exposure to term premia. Indeed, it has been quite common, and perfectly logical, for investors to remove non-sterling interest rate risk from their global fixed income mandates in recent years.

We believe there are good reasons for reviewing this stance, and we would now favour the retention of this exposure.

Furthermore, for clients with material allocations to risky assets, and who are prepared to overcome the practical challenges, we would also be in favour of further increasing exposure to this source of return.

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