

OUTSIDE THE FLAGS

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SEPTEMBER 2014

The Curve Ball

There's a school of thought that the best way to manage a fixed income portfolio is to base your investment decisions on where you think interest rates are headed. But what if expectations are changing all the time?

Market expectations about interest rates change because of news. This makes it very, very difficult to build a coherent investment strategy around a forecast.

In a recent article, Bloomberg News noted that the rally in the US Treasury market in 2014 was stronger than every economist surveyed by its journalists had predicted.¹

US 10-year yields were around 2.3% at the end of August, down from just over 3% at the end of 2012. Yields fall as prices rise, so those who heeded economists' forecasts and backed out of bonds have missed part of this capital return.

But this isn't just a US story. Japan's 10-year government bond yield hit its lowest levels in 16 months in late August, European bond yields tumbled to record lows and Australian bond yields were close to their lowest levels this year.

Why did many economists get their interest rate calls wrong? It could be due to a variety of reasons. Economic growth and inflation may have been below their assumptions. Geopolitical strains may have dampened risk appetites. Central banks may have adjusted their timetable for withdrawing monetary stimulus.

The important point is that market prices change on news and unless you have a way of forecasting news, you are unlikely to enjoy consistent success in basing your fixed income strategy on anticipating changes in interest rates.

Luckily, there is another way of managing fixed income, one that doesn't require predicting interest rates. It involves diversifying globally and using the information in the market at any one time to work out which parts of the market to invest in.

¹ 'Treasury Market Rally Stronger than Every Economist Predicted', Bloomberg, Aug 30, 2014

The benefits of diversification come from the fact that interest rate cycles can vary across economies, reflecting differences in expectations for inflation, economic growth and other indicators.

For example, while benchmark rates in many economies remain at record lows, New Zealand raised its cash rate four times since March. Elsewhere, while markets anticipate the Bank of England raising rates, there has been speculation the European Central Bank will announce further stimulus to ward off deflation.

The non-correlated nature of interest rate movements implies that spreading fixed income risk globally can reduce volatility in an overall portfolio. This is the argument for global diversification—not betting everything on a single market.

The second part of this non-forecasting approach is to vary maturities in a portfolio depending on the state of the yield curve today. The yield curve is a graph that compares the yields of similar sorts of bonds of different maturities.

A normally sloped yield curve is upward sloping—reflecting the additional return investors require for committing their capital for longer periods. This is called “term risk”. Sometimes, yield curves can flatten or invert. This is when there is little or no premium on offer for tying up your money for longer periods.

So if the yield curve is upward sloping, it may pay to take more of this term risk because you are being compensated for it. Conversely, if the curve is flat or inverted, there is little or no compensation for taking on the term risk, so you may stay in shorter-dated bonds.

This approach uses no forecasting or market timing or assumptions about the direction of interest rates. It uses today's yield curve to work out where to allocate term risk in a portfolio. And treating bonds as a global asset class provides a larger set of yield curves to choose from—more opportunity, more diversification.

Dimensional employs this approach. Essentially, we are using today's market prices to form efficient strategies based on the information that is already out there. There is significant evidence that correctly forecasting interest rates with any consistency is impossible. But we *can* control risk, cost and diversification.

Of course, everyone has an opinion about the interest rate outlook. That's fine. The problems arise when we base long-term investment decisions on expectations for interest rates, only to see them confounded by the curve ball of new information.



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