

MARKET DISTORTIONS AND FINANCIAL REPRESSION:

Implications of Persistently Low Yields

RISK-FREE INVESTMENT RATES IN THE U.S. AND OTHER DEVELOPED ECONOMIES HAVE BEEN DISTORTED BY POWERFUL FORCES UNLEASHED IN THE WAKE OF THE 2007-09 FINANCIAL CRISIS. Investors have consequently lost a critical guidepost to gauge risk and relative asset valuation. This issue of Strategic Perspectives considers the implications for investors if the current environment of negative real yields persists over a long period of deleveraging.

Introduction

Powerful forces unleashed by the Fed and the deleveraging process following the 2007-09 financial crisis currently distort the basic building block of capital markets: the risk-free rate. As a result of these forces, yields all along the U.S. Treasury yield curve are at artificially low levels in nominal terms, and are below the inflation rate in the case of Treasury notes with maturities of up to 10 years.

The initial impetus for the Fed to push rates to historically low levels was to restore financial stability and promote recovery from the recession that followed in the wake of the crisis. The crisis and the economic slowdown it triggered also pushed government debt levels to peaks previously associated with global calamities, such as the two world wars and the Great Depression. Cutting public debt peaks down to size has historically been accomplished through a combination of faster economic growth, fiscal adjustment, debt restructuring, inflation, and financial repression – a form of stealth restructuring that uses regulations to engineer very low or negative real interest rates.

None of the approaches to cutting high levels of accumulated debt is easy. Faster growth is the most desirable approach, but difficult to achieve in the wake of a large debt overhang. Fiscal retrenchment forces politically unpalatable choices and undercuts the very growth needed to restore debt sustainability. An inflation spike is tough to engineer and, once unleashed, even harder to tame. Debt restructuring or default impairs a country's future access to credit markets. And financial repression penalizes savings through a sustained artificial compression of real interest rates.

Among these approaches, financial repression has a long pedigree. Most prominently, it was used after WWII to reduce the cost of servicing and ease the repayment of war debts of advanced economies. From 1945 to 1980, average real interest rates on Treasury bills were negative, a factor that contributed significantly to the liquidation of war¹. The

current prevalence of negative real interest rates in the U.S. and other heavily indebted developed economies suggests that a form of financial repression will be resorted to yet again to liquidate the current large debt overhang.

The prospect of financial repression to help reduce the large public sector debt overhang suggests that the powerful forces currently distorting the risk-free rate will persist. As discussed in greater detail below, investors may well be faced with a long period of artificially low risk-free rates, and will need to adjust their assessment of relative valuations across investment possibilities accordingly.

Persistent Distortions in Treasury Yields Will Tax Future Investment Returns

The financial crisis of 2007-09 presented challenges to investors, but it was the official response to that crisis that has truly turned the world upside down. As a result, fiduciaries responsible for guiding the investment decisions of pensions, endowments, and other long-horizon institutional funds cannot rely on long-term capital market return patterns and market signals to form judgments on expected returns, relative asset valuations, and asset allocation.

In particular, investors can no longer trust the signals provided by the fundamental cornerstones of financial markets, by which the relative valuations of other assets are judged: the risk-free rate and Treasury yields. The signals emanating from these key indicators have been severely distorted all along the maturity spectrum by the Federal Reserve Board's extraordinary intervention. Fed policy has pushed nominal and real

Financial repression is a form of stealth debt restructuring.

¹ Carmen Reinhart and M. Belen Sbrancia consider past manifestations of financial repression and their contribution to debt reduction in "The Liquidation of Government Debt," NBER Working Paper 16893, March 2011.

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interest rates to record lows in a bid to provide support to a faltering economy. Furthermore, the Fed expects that it will need to maintain rates at these exceptionally low levels through 2014.

The impetus for Fed action in the wake of the credit crisis has been to maintain financial stability and help the economy recover from recession. It is possible, however, that real yields on U.S. Treasuries will remain depressed well beyond 2014 as a result of a policy of financial repression designed to ease the reduction of the large debt that has been accumulated as a result of the crisis.

The means of implementing financial repression vary across countries and throughout history, but typically include interest rate caps, capital controls, and prudential regulations to create captive demand for government paper. In the U.S., for example, Regulation Q prohibited banks from paying interest on demand deposits and limited the interest rate on savings accounts, creating an incentive for savers to hold government bonds, and pushing down the cost of debt.

The negative real interest rates engineered by

financial repression are, in effect, a very significant tax on savers. But this form of taxation is opaque, not publicly debated, not well understood, and, consequently, less likely to meet the political resistance a more overt tax increase would encounter.

Faced with this prospect, investors need to rethink capital market expectations informed by long-run historical experience. Yields on 10-year Treasury notes are currently negative in real terms, and if a policy of financial repression is pursued, real short-term interest rates are likely to remain in negative territory well beyond the Fed's stated target of 2014. Yields held at these levels call into question the role of Treasuries in an institutional portfolio and overstate the relative attractiveness of other assets.

As a result, long-term investors need to reconsider the usefulness and appropriateness of government bonds in their portfolios. A case can be made that such instruments should be reduced to the minimum required to provide adequate liquidity to meet rebalancing needs and flows out of the portfolio, and to hedge the risk of disinflation and depression. Warren Buffett

TABLE 1:
Real Annualized Returns of a Constant Maturity Portfolio of 10-Year Treasury Notes Reverting to Normal Yield

Source: Strategic. Data as of June 2012.

Time to Revert to Equilibrium (Years)	Estimated ANNUALIZED Real Return	
	10-Year Investment Period	15-Year Investment Period
1	0.8%	1.8%
3	0.7%	1.7%
5	0.4%	1.6%
7	0.2%	1.4%
10	-0.3%	1.1%

TABLE 2:
Estimated Real Returns

Source: Strategic. Data as of June 2012.

Asset Class	Estimated Real Return
U.S. Equity	6.8%
Non-U.S. Equity	6.9%
Emerging Market Equity	8.3%
Private Equity	8.5%
Directional Hedge Funds	4.2%
Market Neutral Hedge Funds	1.4%
Real Estate	2.8%
TIPS	0.2%
Commodities	5.0%
U.S. Fixed Income	0.4%
High Yield	3.0%
Non-U.S. Fixed Income	0.3%

put it bluntly: government bonds should carry warning labels.¹

Treasuries are likely to deliver less than a 1% real return pre-tax over the next 10 years, unless the U.S. economy falls into a deflationary environment in the meantime, precisely the scenario that Fed policy is trying to avoid. Postulating an equilibrium inflation assumption of 2.5%, Table 1 shows what the realized real return on a constant maturity portfolio of 10-year Treasury notes would be over the next 10 and 15 years if yields reverted to their historical norm over a period of one to 10 years. The faster yields return to equilibrium levels, the higher the expected annualized return. In contrast, protracted deleveraging, characterized by abnormally low yields over a sustained period, would result in the lowest returns to U.S. Treasuries. For example, if it takes 10 years for yields to revert to normal levels, the annualized real return would be negative 30 basis points. By way of comparison, over the last 80+ years, the real return has been 2-3%.

Bond returns over the next 10 years are thus very likely to fall well short of historical experience. Asset allocation policies based on return expectations informed by historical experience are also likely to fall short of their return objectives. On this basis, there is a strong argument that government bonds should only be held to meet threshold liquidity and portfolio rebalancing needs.

Given this, expectations for bond volatility as informed by historical experience may also be misleading. Allocations to government bonds on the basis of their historical characteristics need to be reexamined and new allocations developed on the basis of a more realistic assessment of expected returns for bonds as well as for other asset classes. Table 2 lays out our expectations for asset class returns over the next 10 years.

The impact of lower expected real returns for government bonds on a total institutional portfolio could be significant. That said, liquidity and rebalancing needs in unleveraged portfolios create a natural floor for the allocation to Treasury holdings, which varies with the circumstances of the institution and the allocation to other illiquid or volatile assets in the portfolio. A 20% allocation to

government bonds is a reasonably comfortable floor for many institutions with unlevered globally diversified portfolios and a 20-40% allocation to less liquid assets such as hedge funds, private equity, and real estate. At that level, assuming the real returns implied by our expectations above, currently depressed real bond yields would reduce total portfolio returns by approximately 30 basis points annualized over the next 10 years. Institutions with higher allocations to government bonds would see their returns reduced more significantly, as the following table illustrates.

TABLE 3:
Reduction in Estimated Return of Broadly Diversified Portfolios Resulting From Low Treasury Yields

Source: Strategic. Data as of June 2012.

Portfolio Bond Allocation	Impact on Total Portfolio Estimated Return
20%	-0.3%
30%	-0.4%
40%	-0.6%
50%	-0.7%

Those institutions counting on historical returns to pay for long-term obligations should seriously review their assumptions and constraints to make sure that they are not blindsided by the current realities of a market distorted by an uncommonly accommodative Fed policy. More precisely, a 30-70 basis point reduction in annual expected returns over a 10-year period in an environment of, say, 8% average nominal returns means a terminal wealth that is 5-13 percentage points lower than would have been otherwise realized. It also means that such institutions would have roughly 5-10% less available to spend pre-tax on a yearly basis to meet spending and other budgetary needs.

Warren Buffett put it bluntly: government bonds should carry warning labels.

¹ "Buffett Says Bonds Among Most Dangerous Assets on Inflation" by Noah Buhayar, Bloomberg, February 9, 2012.

Conclusion

History suggests that administrative actions designed to create a captive demand for government bonds and keep financing costs artificially low in real terms are likely to be in the policy mix, and that accompanying price inflation may be a consequence or even a tactic in the delevering process. In such an environment, investors will need to navigate financial markets whose relative valuations are distorted by artificially low risk-free interest rates. They should be aware of the potential loss of purchasing power that is likely to arise from investments in “safe assets” while also taking care not to reach for yield when valuations are not supported by fundamentals. An accommodative negative real rate policy may be a necessary evil to avoid worse outcomes for the U.S. economy, but the potential cost to investors and savers is all too real.

Disclosures

This information is provided for illustrative purposes only, is not intended as investment advice and is subject to change at the sole discretion of Strategic.

Estimated returns are based upon Strategic's estimates of equilibrium asset class returns.

It is important to note that the estimated returns should not be interpreted to represent a promise of future performance under any of the scenarios described herein. Because the estimated return data was constructed with Strategic's judgment and knowledge of history in mind, it may not adequately capture the influence of future market conditions on investment returns. As a result, actual returns may differ substantially from the returns shown in this analysis.

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