Sionna
Investment Managers

Investing in a Low Interest Rate Environment
Kim Shannon – Oct, 1999

Global inflation has been in secular decline since its peak in the early 1980's. Hyper inflation had been such a dominant difficulty worldwide for so long that it shouldn't be surprising that it took a long time for us to believe collectively that it had been beaten down. Investment markets are very good at coming to understand the most recent big "bogey" that hurt them. As managers, we spent much of the 1980's worried that inflation might just return to haunt us. In my opinion, it wasn't until we entered the 1990s that we let down our guard and began to believe that global central governments were not only dedicated to keeping inflation down to an acceptable level, but were knowledgeable and capable and dedicated to doing so. Thus, during the 1990s, as these beliefs took hold, we have seen long interest rates decline dramatically and a commensurate increase in stock market Price to Earnings (P/E) multiples.

There has always been a trade-off between the two major asset classes, stocks and bonds. As bond yields rise, bonds become relatively more attractive than equities and, through the forces of supply and demand, equity prices weaken, leading to falling P/E multiples. The reverse is true as bond yields fall.

Since 1926, Canadian equities have returned on average a 9.5% nominal yield while 10-year Canadian bonds have tended to return 6%. In Canada, as bond yields rise above their long-term average and approach equity returns, investors begin to prefer the perceived lower risk/return ratio in bonds. From the late 1970s through to the late 1980s and at times into the early 1990s, we have 30-year Canada Long Bonds on average trading above the long-term return for equities and we had individual investors as well as institutional investors heavily committed to the fixed income market. It was not until the early 1990s as 30-year bond yields fell below the long-term average equity return that investors decided that they would accept the extra short-term risks in stocks in order to gain more return than they perceived they could get in fixed income.

This sentiment was echoed in equity mutual fund flows. When rates rose above 6% to 8% in 1994 and 1995 we saw contributions to Canadian Equity funds drop off, only to rise again when rates fell below 6% and 5%. Furthermore, it appears that as inflation expectations gradually change to adjust to a continuing lower interest rate environment, the "turning point" to fixed income could occur at a lower level of interest rates if rates are perceived to stay low over the foreseeable future. This results in rising demand for stocks in a low interest rate environment that leads to rising equity multiples and prices. During the early readjustment period, the returns to equities can be dramatic, as we have seen over the last four years in the US where equity returns were in the double digit area.

So where are we today? We have equity P/E multiples in North America at record highs that have never been sustainable in the past, and we have most fixed income yields not far off their lows. As recently as a year ago, there was much talk of deflation, but currently all eyes seem to be on the lookout for any resurgence of inflation pressures in the US and whether (and to what degree) the Federal Reserve Board will need to increase interest rates. So what is going on? Are we at risk of facing inflationary pressures again? (Making the premise of this article irrelevant?)

We don't think so. We still believe that the overall global secular trend is one of disinflation/deflation. Monetary policy in major world economies is geared to curtail inflation. Global governments have learned the follies of large deficits and are paying down debt burdens relative to GDP and are seeking to keep inflation moderate. However, the US economy, in particular, is currently experiencing some cyclical inflation which was exacerbated by 1997's Asian Crisis that weakened global demand for commodities and led to a rise in the US dollar as a currency of last resort. These factors drove inflation below its natural rate. As the Asian Crisis unwinds, the US is temporarily experiencing a rise in inflation. In order to cool down the economy, the Fed is stepping up short-term rates, but we do not expect that they will need to increase rates significantly. Structural factors such as the new Era economy with rising productivity and continuing merger activity are also counterbalancing any inflationary forces. We believe that once cyclical inflation has been shut down, the forces of global disinflation will reassert themselves to bring global interest rates down again. We believe that the "itsy bitsy" interest rates that James Grant observed could be with us for some time. Thus, low interest rates are likely to continue to be an issue we need to address. (This is why you can't assume that the markets of the 1980s and 1990s and the successful investment strategies of that period will continue)

What does this mean for the management and asset allocation decisions of pension plans? It appears that the "easy money" disinflationary push to equity P/E multiples has mostly run its course. The yield shift from 18% to 6% is much greater than any subsequent drop from the 6% area. If we remain in a low interest rate environment we will be facing lower total returns from both stocks and bonds given their trade-off relationship. The back-to-back double digit returns both asset classes experienced in the late 1980s and through the 1990s are probably over. We expect that returns will revert back to their historical norms.

This movement will affect corporate contributions to pension funds. Instead of experiencing contribution holidays, you will likely be required to make contributions. This will likely attract greater scrutiny of investment policies, approaches and total returns. We suspect this will also lead to greater examination of defined benefit plans, and a desire to consider switching to defined contribution plans where performance shortfalls are not the burden of the corporation.

In Canada over the last few decades a substantial commitment to fixed income on the grounds of preservation of capital and safety was rarely questioned given the long-term average returns derived from both high coupons and the "easy money" disinflationary capital gains which fell out of rising bond prices. However, as we pointed out earlier, the future potential rate decline from 5%-6% will offer fewer spill over benefits than the significant decline from 18% to 6%. Not only will you be clipping smaller coupons, but capital gains are likely to be less significant. Investors will be forced to accept more risk in their fixed income portfolios as the supply of government debt diminishes and they move into corporates to pick up a bit more yield. As bond portfolio total returns fall to a more normal 6% level, it is likely that the significant asset allocation to fixed income will be questioned more and more.

It appears investing could become a lot trickier and riskier than it used to be. These shifts in the investment environment suggest that a change in your notion of what a balance of risk should be in the portfolio is called for. Let's look to very long-term history to provide us with some guidance.

If you haven't already read it, I highly recommend a look at Jeremy Seigel's book "Stocks for the Long Run". He is a finance professor at Wharton who has painstakingly compiled US market data dating back to 1800. No reader will be surprised that equities have significantly outperformed all the other asset classes in the long-term. From 1800, US stocks have returned about 7% *real* return (after inflation) and despite mammoth changes to the basic factors generating wealth for investors, equity returns have shown an astonishing persistence and stability. Purchasing power for stocks has, on average, doubled every 10 years. Fixed income *real* returns on the other hand have been significantly lower and not nearly as stable. It would take nearly 40 years to double one's purchasing power in bonds. On average, stocks outperformed bonds by and average of 2.8% per year, and that difference compounded into a dramatic difference over nearly 200 years.

We are used to thinking that fixed income is more secure, safer, and lower risk than equities, but Seigel has shown us this is not necessarily true. Although stocks are unquestionably riskier than bonds in the short run, in the longer term they become *less* risky than bonds. Over the last two hundred years, for holding periods of ten years, the worst stock performance has been *better* than the worst performance for bonds or T-bills! He uncovered that stocks, in contrast to bonds and bills, have never offered a negative *real* return over periods of 17 years or more. Thus, we need to develop a more balanced view of the true riskiness of bonds relative to stocks. "Unfortunately fear has a far greater grasp on human action than the weight of historical evidence," says Seigel. Investment decisions are often anchored by the norms of the most recent investment period and the returns to bondholders since the peak of interest rates in the early 1980s has been the strongest in 200 years! The most recent investment period has been the exception, and can not be a reliable indicator of returns going forward.

Globally, many stock markets are trading at multiples that have not been sustainable in the past, causing some investors to attempt market timing and avoid overexposure to equities. However, most investors have been shown to underestimate their true investment time horizon. Seigel demonstrates that thirty-year real returns after market peaks so significantly overwhelm the alternative asset classes that "there is no compelling reason for long-term investors to significantly reduce their stock holdings, no matter how expensive the market seems." Further, he notes that, since 1945, the longest it has ever taken to recover an initial investment in the US stock market (including reinvested dividends) was the three and one-half year period from December 1972 to June 1976. (It took 15 years to recover the money invested at the 1929 peak) Further, all investors are (intentionally or not) dollar cost averaging. Very few pension plans will have invested *all* their wealth on the peak day of the market. "Unfortunately, fear has a far greater grasp on human (and pension committee) action than the impressive weight of all historical evidence." (Seigel)

In a stable low interest rate environment, both equities and fixed income will return less than we have seen over the last two decades. But equities will earn more than fixed income, and over a long time horizon will earn more with lower levels of risk. Investment committees facing higher contribution levels will find that an increased weighting to equities will be the prudent course of action. Over the last decade we have seen a modest shift in favour of equities in Canadian pension fund portfolios, and we have certainly seen a more dramatic shift in mutual fund portfolios.

Given my contrarian investment outlook, I am delighted to report that, contrary to the current fad of shifting assets outside of Canada, a low interest environment could be positive for Canadian markets in particular. Taylor (1996) has shown that commodity-based economies such as Canada, Australia, Norway, and New Zealand have markets that perform relatively strongly in periods of slow growth and inflation. These stock markets have shown negative correlation with the behaviour of the world's other stock markets and performed relatively strongly in the 1930s, 1940s, and 1970s when most of the world markets were in bear markets, indicating that there could be a nice Canadian investment angle… finally.

Drilling down to a more micro-level, we believe that as fixed income yields decline, the relative attractiveness of dividends should rise. During this century, most of the world's stock markets have paid dividends averaging 4%-5%. (The yield on the TSE 300 today is 1.55%) More than stock price appreciation, dividends have allowed stocks to outperform other financial instruments over the long-term, accounting for over half of the total return to stocks. It is difficult to remember that the current situation is the exception for the 20th century, and a low interest rate environment is an ideal time for the market to return to its normal condition. If consumer price inflation can be successfully controlled and a stable price environment returns, dividends should play a more important role in investors' total return in the future than is the case today. (Taylor)

Also, above average dividend yielding stocks tend to be more stable in terms of their price movements as the high yield lends a buffer to any downside moves. At some point, the yield rises to such an attractive level, the stock will not decline any further, so long as the market believes the dividend is safe. Going forward, high yielding stocks and preferred shares could become more attractive. If long bond yields are perceived to stay low for the foreseeable future at 6% or less, then high yielding instruments such as income trusts and REITS with payout levels close to 10%, and some anticipation that the payouts could increase, will experience (through the forces of supply and demand) increases in their prices to bring their "excess" yields down to more normal levels.

On the fixed income side, as yields crunch down the spreads between various asset classes will shrink commensurately. As we have seen recently, managers will find it harder and harder to outperform their respective benchmarks to any significant degree. The pressure to shift to index funds is likely to increase. Investors who attempt to outperform will find themselves pushing against their risk parameters as they shift into more corporate bond weightings. Credit analysis and credit scrutiny by investment committees will become more critical as exposure to credit risk increases.

We believe that for long-term investors such as pension funds, the best asset allocation policy is to take your equity position to the highest level that makes sense for your plan, a level that the committee would be comfortable maintaining through thick and thin. Attempting to market time allocations among asset classes is so notoriously difficult that we believe it would be imprudent to suggest it. Pascal said, “Many of life’s evils come from man being unable to sit still in a room” and Kipling recommended the art of “judicious leaving alone.”

Given a top down view of secular disinflation/deflation and a low interest rate environment you must push your investment committee to challenge their previously held notions of what a maximum level of equities should be. The last two decades have been unique in terms of investment returns, so the committee should actively seek long-term data and force itself to “think out of the box” to separate itself from the anchor or recent successful strategies.

In conclusion, we believe that the long-term global secular trend is still one of disinflation/deflation. With world governments committed to maintaining stable low inflation and a new era economy with rising productivity counterbalancing any inflationary forces a low interest rate environment is likely to be a scenario we will all be coping with. We believe that it will put pressure on investment committees to commit more asset allocation to equities, for very justifiable reasons. Those committees that try to maintain the status quo that has worked well for them over the last two decades may find themselves having to play catch-up too late. The need for higher contributions into plans due to lower nominal equity returns will force more scrutiny on the quality and skill of investment committees. The trend to defined contribution plans will likely accelerate, and finally, Canada may well become a worthy place to invest assets again.