Investors look to diversify beyond cash, bonds - AFR

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With cash returns on par with the cost of living and government bond yields at near record lows, many investors are facing the dilemma of where to get better returns from uncorrelated assets without increasing the risk. **Photo: Glenn Hunt**

BINA BROWN

Low risk, low returns, the saying goes, but risk-free shouldn't have to mean no return. In the current environment that's an unpalatable possibility, however, and investors are looking beyond the traditional diversifier asset classes of bonds and cash.

With cash returns on par with the cost of living and government bond yields at near record lows, many investors are facing the dilemma of where to get better returns from uncorrelated assets without increasing the risk.

"Uncorrelated assets are ones that dance to their own tune and are not related to economic growth," says Jeff Rogers, AMP Capital chief investment officer of ipac Portfolios. "But they are only truly attractive if they have good return prospects as well."

The prices of uncorrelated assets respond to different news from Australian shares, which makes them attractive for diversification.

In recent years bonds and cash have been good sources of income with returns of 6 per cent, particularly for yield-hungry investors such as those in or close to retirement.

But as the global hunt for high-yield investments has gone on, the prices of most assets has gone up – notably bonds, equities and property – and in an environment where future growth is less than certain and volatility levels are expected to increase.

With almost everything correlated to the economic drivers of return, finding truly risk-free, uncorrelated assets offering good returns is a bit like hunting for unicorns, says MLC's head of investments Susan Gosling.

"It is a very difficult environment in which to control risk because central banks have really taken away safe assets for us. Part of the redistribution of wealth from savers to debtors has taken away the opportunity for having a safe investment," she says.

Central banks around the world have been cutting interest rates in an effort to stimulate economic growth. At 2.5 per cent the Australian cash rate is one of the higher global offerings but with the inflation rate at 3 per cent there is the real prospect of zero returns.

It is a similar story with bonds. At 3.5 per cent, the Australian 10-year government bond looks attractive against the 2.5 per cent equivalent in the US and less than 1 per cent offerings in Europe and Japan.

With interest rates so low the expectation is that they will eventually rise, presenting the fear that the price of bonds will drop, further eroding investor returns.

While there may be only one way for interest rates to go, few expect they will go far fast. However, the prospect of change is fuelling ongoing financial market volatility as investors ponder the possibility.

CATASTROPHE BONDS ATTRACT INTEREST

Multi-asset fund managers searching for uncorrelated investments offering decent returns are focusing on everything from inflation-linked bonds to catastrophe bonds, foreign exchange and unlisted property as alternatives.

Rogers says catastrophe bonds have been one area of interest to AMP, thanks to their pattern of historically high returns being linked to the occurrence of hurricanes and windstorms rather than economic conditions. But they, too, have become expensive.

"If you had the view that inflation is the next risk that will hurt bond prices and share prices at the same time – which is not our view at present – then you would seek to invest in a basket of energy and agricultural commodities," Rogers says.

Investors may not be happy with the potential returns from government bonds or cash in the short to medium term, but these are being recognised for what they are: bonds for their mostly negative correlation to equities, and cash as the means to opportunity rather than decent returns.

Nick Bishop, Aberdeen Asset Management head of Australian fixed income, says investors wanting diversity and lower correlation have to be prepared for lower returns.

"It is a lower growth world and unfortunately there comes a point where you just have to come to terms with that as an investor. If you have an end investment goal in mind and returns are lower from all asset classes, that just means you have to save more," Bishop says.

“There is no magic formula that suddenly gets you back to the nirvana of mid-teen returns.”

But lower returns doesn’t necessarily mean major adjustments to the asset mix. Nor does it mean giving up on bonds.

“The central tenet of having a balanced, diversified exposure to a range of asset classes still prevails, and bonds have proven time and time again that they retain the negative correlation to the risky assets you want protection against,” Bishop says.

He says the response from bond yields to heightened volatility in the equity markets earlier this month was a perfect example of how bonds can work, even with yields at multi-generation lows.

“If you are a balanced fund with equity exposure there is no easy substitute for having vanilla fixed income to provide the insurance against that,” Bishop says. “You struggle to find other assets that will react in the same way as vanilla bonds will to a down draft in equity prices.”

If risk-free is something that protects purchasing power then inflation linked bonds – which as the name suggests are bonds with returns or cash flows linked to inflation – are a possible alternative to government bonds, says MLC’s Gosling.

“Inflation is something we haven’t had to worry about for a while and we feel there is too much complacency. Some early warning signs are labour markets tightening up,” she says.

FOREIGN CURRENCY

Another MLC diversifier, while not risk-free, is foreign currency exposure based on the high value of the dollar against the US dollar, Gosling says.

She says investors with a portion of their portfolio in cash have to expect to lose some of their purchasing power, but they could think of it as a deliberate strategy to be ready for opportunities that do come along in other asset classes.

“Cash optionality” is a concept also preferred by Perpetual portfolio manager of diversified strategies Darren Beesley, who sees the value of cash being well beyond the 2.5 per cent interest rate it pays.

“It gives you the option to buy the market at a later date, a valuable thing if markets were to correct,” Beesley says.

“As valuations become stretched in equity and bond markets, the conceptual value of cash as providing a purchasing option becomes higher because the likelihood of cheaper markets in the future becomes more likely.”

UBS Wealth Management head of investment strategy David Sokulsky advocates the inclusion of alternative assets such as a market neutral hedge fund in a portfolio, at the expense of some bonds in the current environment.

“You wouldn’t have them replace the entire bond allocation. Australian government bonds rallied 2 per cent during the recent equity market sell-off, so they did their job as a portfolio diversifier. So bonds still have a role to play in any portfolio, but when you look at their valuations and the opportunity for alternatives there is scope to reduce that weighting in bonds and pick up some of that slack with an alternatives allocation,” Sokulsky says.

“We tend to think the next six to 12 months is going to be more of a stock picker’s market. Market neutral hedge funds that can take advantage of both long and short positions should be well placed to benefit from this environment,” he says.

UNLISTED PROPERTY TRUSTS

If a key to investing in uncorrelated assets is low volatility then it is hard to go past unlisted property trusts, says Australian Unity head of property funds Mark Lumby.

Lumby says that over the past 10 years cash has returned 7 per cent with volatility of about 1 per cent while property has returned between 6 and 7 per cent, depending on the property type, with volatility of less than 1 per cent.

“In terms of providing a risk-free asset distribution return and providing income above inflation in the current environment, property has a place in a diversified portfolio,” says Lumby.

Lumby says it depends on the aims of the portfolio as to what the allocation to different asset classes should be.

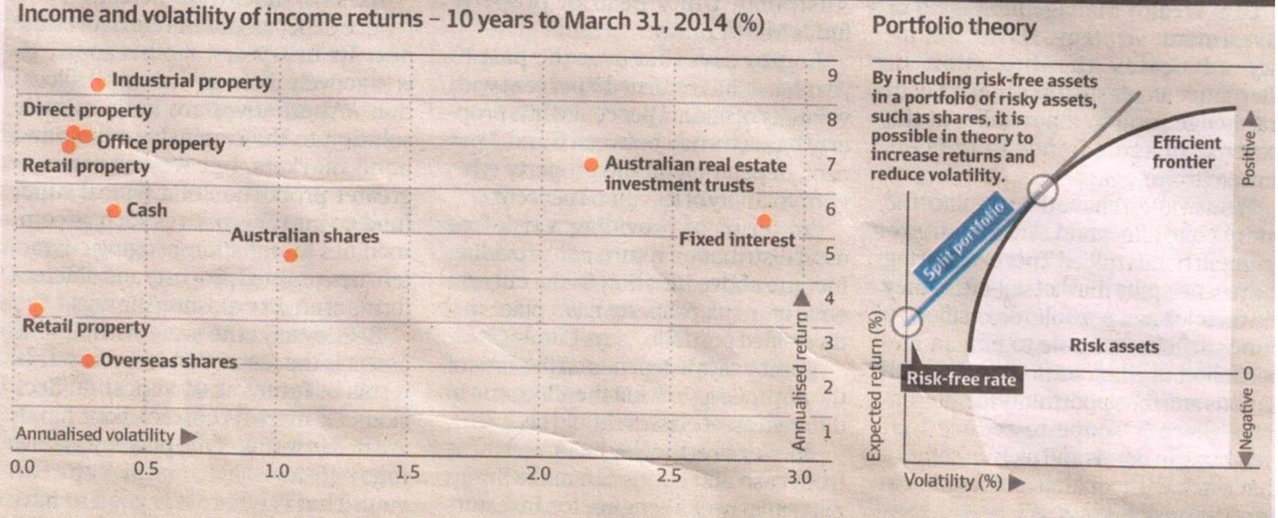
Beesley says the low income returns from cash and bonds can make things particularly challenging for investors approaching or already in retirement, where the “old fashioned” approach was the switch to these assets to de-risk.

“By de-risking your portfolio in the traditional sense you are actually taking on the prospect of poor future returns that are not going to pay you the retirement income you had in mind or deliver the investment returns you expected,” Beesley says.

He says that while investors can reduce expectations of return over the next five to 10 years, another approach is to actively manage their asset allocation. “Alternatives are not a miracle solution to the expensive equity and bond markets, but we are seeing a greater proportion of a typical super fund go into alternatives such as commodities for inflation-hedging characteristics, unlisted property and different forms of credit exposure,” he says.

Beesley says the issue with illiquid assets is the restriction it can create in terms of future asset allocation decisions. “If markets correct, your hands are tied in terms of the power you have to go into those assets and pick up a bargain. That is where it is good to have money in cash, despite the low return.”

Not what you'd expect



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