Lower for Longer: Adapt Your Asset Allocation

UBS ETF Market Matters

- The Brexit referendum outcome may increase the likelihood of the «lower for longer» scenario, i.e. a low interest rate environment for an extended period of time.
- Yields on government, corporate and other debt are at historical lows. More than ten trillion dollars of sovereign debt offers negative yield.
- In the "lower for longer" scenario, investors are likely to benefit from a multi-asset allocation approach while searching for yield beyond traditional benchmarks. We show that alternatives and smart beta strategies could add value.
- When expected asset returns are in the low single digit range, currency hedging becomes an indispensable tool to reduce unwarranted volatility.

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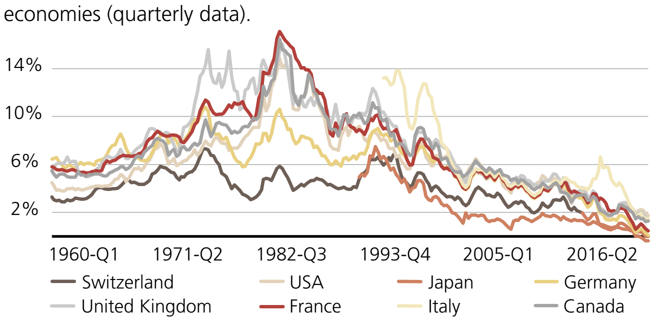
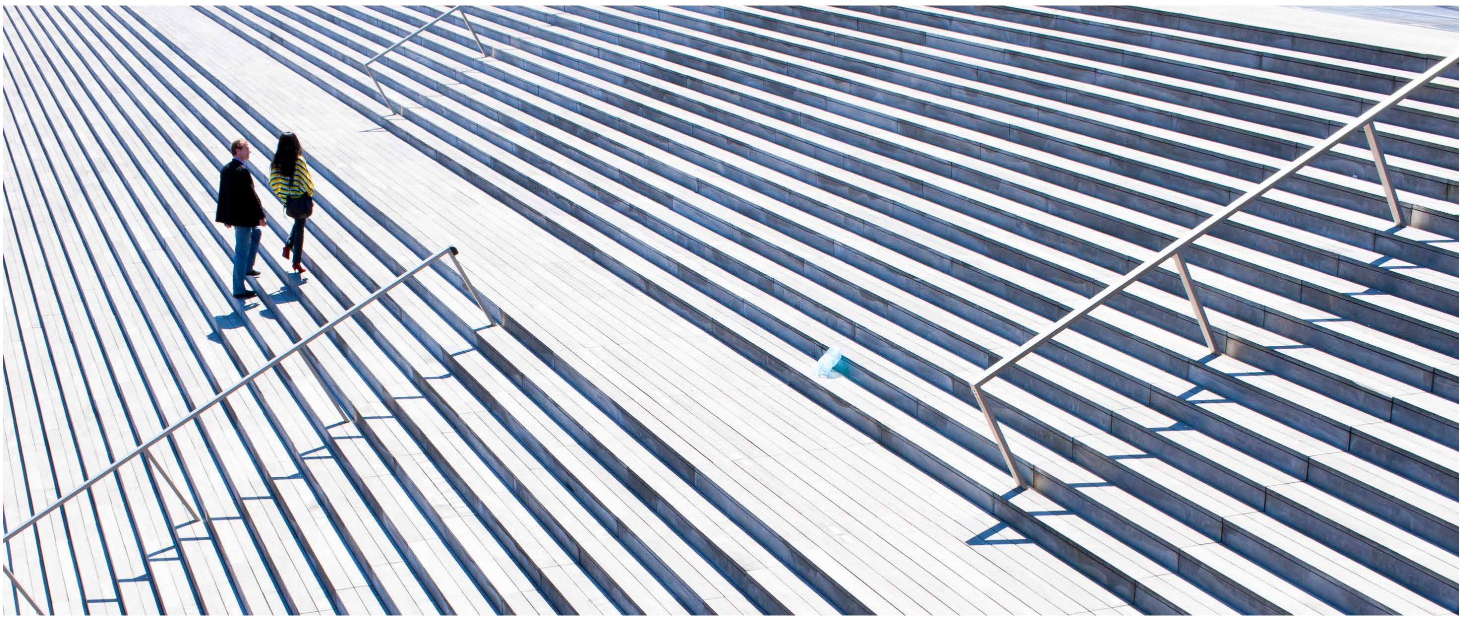
Yields at all-time lows

The past two decades have seen an extraordinary decline in interest rates across major advanced economies. More recently, the financial crisis and the European sovereign crisis have prompted central banks to undertake far-reaching quantitative easing (QE) policies that have brought down yields to new historical lows. Figure 1 illustrates this trend, which is widespread, and not specific to a particular country. Moreover, yields on 10-year government bonds of Switzerland, Japan, and Germany have recently turned negative. The Brexit vote has put renewed downward pressure on rates with major central banks indicating a readiness to ease monetary policies further if needed.

Figure 1: 10-year government bond yields for a selection of advanced economies (quarterly data).

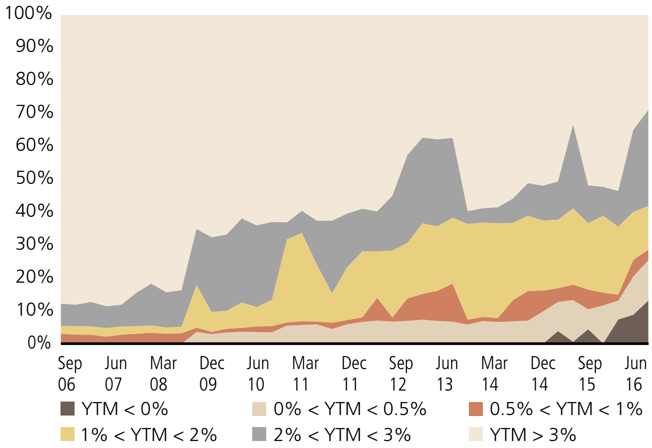


Source: OECD, UBS Asset Management, data as of June 30, 2016



Progressive expansion of QE programs has resulted in substantial reductions of bond yields across the entire term structure and credit curve.[1] Figure 2 illustrates the compression of bond yields captured in the Barclays Global Aggregate universe. Over the past 10 years, the market-valued share of bonds with yields above 3% p.a. has declined from more than 85% to less than 30%. In contrast, bonds yielding less than 0.5% p.a. had only become visible in 2008, but have now exceeded 25% of the market. Strikingly, bonds with negative yields have reached a 10% share as of the end of Q2 2016. According to Fitch Ratings, global sovereign debt with sub-zero yields surpassed USD 10 trillion in June of this year. Such a low interest rate environment has created a clear motivation for investors to hunt for yield.

Figure 2: Market value of bonds within different yield-to-maturity buckets based on Barclays Global Aggregate universe.



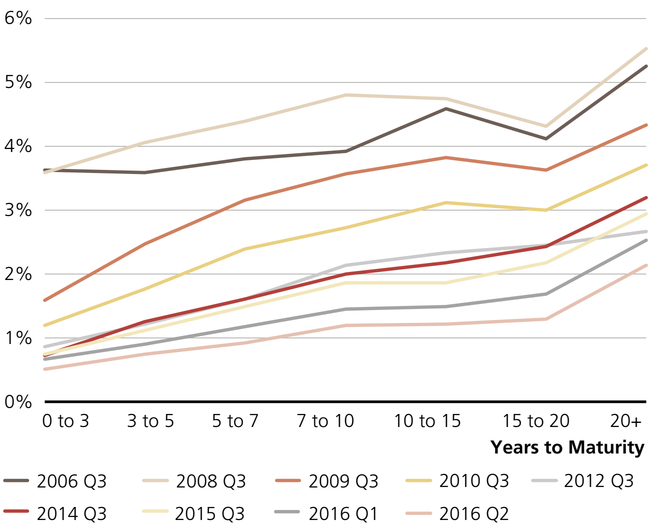
Source: Barclays Point, UBS Asset Management, data as of June 30, 2016

Lower for Longer, the New Normal?

The term lower for longer describes the potential scenario of long-term persistence of low interest rates, including the possibility of negative interest rates. While several countries implementing a negative interest rate policy (NIRP) have likely approached a limit to monetary easing[2], investors are asking themselves how long will it take for the rates environment to get back to normal. One way to address this question is to look at the market pricing of long-term debt. Figure 3 shows the term structure of bonds in the Barclays Global Aggregate index. One can see that yields declined substantially across all maturities over the years. A limited flattening of the curve is also observable. As of Q2 2016, bonds with 20+ year maturity have an average yield of 2.15%, while bonds with a maturity of 0 to 3 years offer 0.5%. This difference may suggest that markets do not expect a material increase in nominal interest rate, given that it also incorporates credit risks.

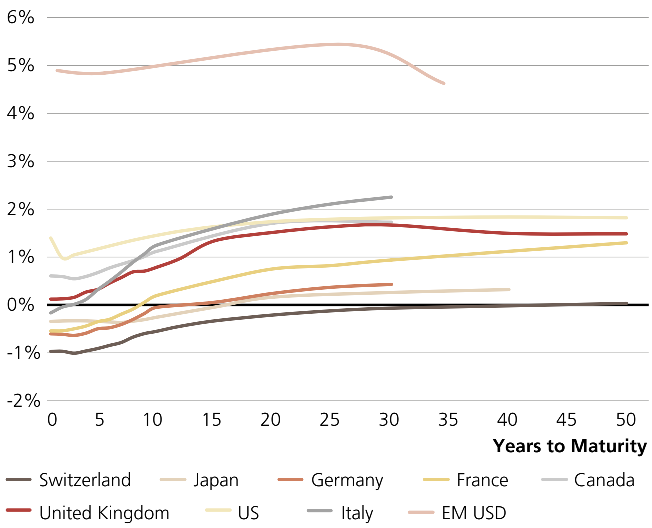
Figure 4 presents yield curves of government bonds. The lowest yields are observed for Switzerland, with its entire term structure below zero except for the 50 year bonds which offer a mere 0.02% per annum. Yields on Japanese and German bonds are sub-zero at maturities of up to 15-20 years and both curves are also relatively flat. US yields range from 1% at the short end of the curve and up to 1.8% at the 30 year maturity. Investors searching for higher yields need to look beyond the core economies and consider taking on more risks. For example, emerging market debt in hard currency (EM USD) offers a yield pick-up along the entire term structure relative to advanced economies (Figure 4).

Figure 3: Yield-to-maturity of bonds within different maturity buckets based on Barclays Global Aggregate universe.



Source: Barclays Point, UBS Asset Management, data as of June 30, 2016

Figure 4: Sovereign bond yield curves.



Source: Bloomberg, UBS Asset Management, data as of June 30, 2016

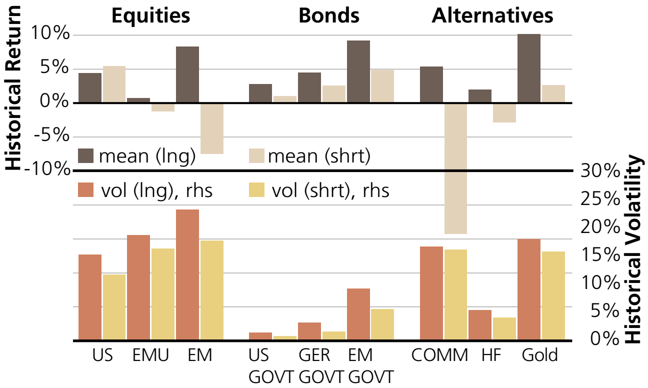
[1] For example, in June 2016 the ECB has started to purchase investment grade corporate debt subject to several eligibility criteria.
[2] NIRP is currently pursued by central banks of Switzerland, Japan, Denmark and Sweden as well as the ECB.

Think about multi asset implementations

The long-term persistence of low interest rates is a substantial challenge for investors trying to achieve their risk-return objectives. Low-single digit expected returns on developed equities and bonds might be potentially boosted via a multi-asset approach, incorporating emerging market risk or investing in non-standard exposures. Comparing risks and returns across the major asset classes over the short and long term in Figure 5, reveals the benefits of a multi-asset implementation. In the longer term (in this case nearly 16 years) most asset classes provided a positive return, while in the short term (3 years) the return differences appear to be more pronounced. A multi-asset portfolio may have additional benefits from a risk-budget viewpoint. For example:

– A 40-40-20 portfolio (with equal geographic regional allocation) has a long term return of 5.58% and volatility of 8.79%
– A 60-20-20 portfolio has a long term return of 5.35% and a volatility of 11.90%
– The highest return from single asset allocation was from gold, a return of 10.14%, but at a rather high volatility of 18.01%

Figure 5: Performance of major assets classes in the USA, Eurozone and Emerging Markets. *Lng* refers to period since 2000, while *shrt* to the last 3 years (TR net daily data, in local ccy)



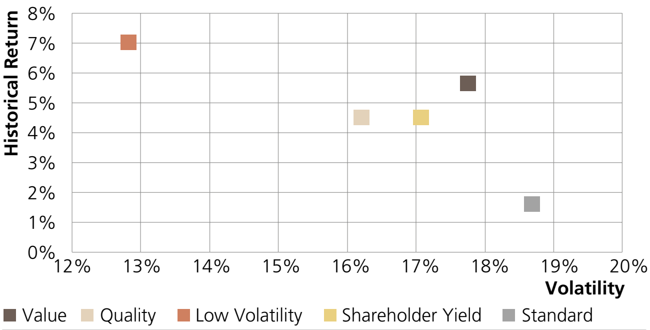
Source: MSCI, Bloomberg, UBS Asset Management, data as of June 30, 2016

These simple examples demonstrate the need to diversify across asset classes. Importantly, such a multi asset allocation is also implementable through efficient solutions such as Exchange Traded Funds. Within the multi asset portfolio framework, it might be worth considering adding indexed exposures which use alternative weightings, that is to say, factor (or alternative beta) investing.

Think beyond traditional benchmarks

Recently developed novel, rules-based indices provide exposure to factor investing. Investors now have transparent passive solutions which offer access to value, quality, low volatility or high dividend stocks. Such factor investing is founded on thorough academic research which identifies characteristics in securities that are likely to outperform the markets in the long-run. Figure 6 shows the example for the Eurozone equity universe, where the performance of several factors is compared to the standard benchmark (MSCI EMU). All four factors have delivered higher returns over the long run. In addition, levels of volatility are relatively low, implying substantial risk-adjusted gains.

Figure 6: Risk-return profile of MSCI EMU factor indices versus the MSCI EMU standard benchmark. (TR net monthly data, Jan '00–Jun '06)

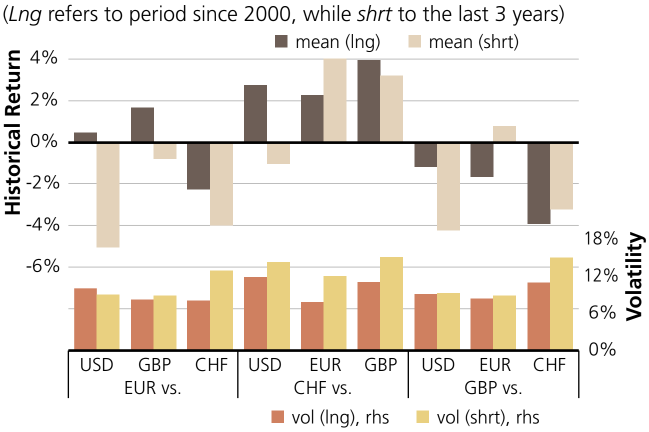


Source: MSCI, Bloomberg, UBS Asset Management, data as of June 30, 2016

Think about currency hedging

When implementing global asset allocation, foreign investments may be affected by currency movements. When the (expected) returns are modest, the impact of the currency returns can be substantial or even dominant, particularly in the «lower for longer» reality. Currency movements are often driven by central bank policies, which might diverge causing substantial currency fluctuations. A prime example of a policy-induced shock was the unpegging of the Swiss franc on January 15th 2015 resulting in a 20% jump of the Swiss currency against the euro. The more recent example includes the strong depreciation of sterling following the UK referendum outcome. The importance of currency hedging is not limited to such idiosyncratic events, since, in the world of single-digit returns, any profits can potentially be quickly eaten up by currency fluctuations. Figure 7 shows the magnitude of returns and volatility for major currency pairs. In some cases, the currency returns as well as volatilities are substantially higher than for major asset classes.

Figure 7: Returns and volatilities of major currencies
(*Lng* refers to period since 2000, while *shrt* to the last 3 years)



Source: MSCI, UBS Asset Management, data as of June 30, 2016
Past performance is not indicative of possible future returns.

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