The myth of return-free risk

Where should bond investors go to find returns when interest rates are so low? “Bonds are return-free risk,” said the head of the Norwegian Oil Fund. He might have been referring to German sovereign bonds. At the time of writing a German ten-year bond has a yield of 1.5 percent. You can buy the bond, hold it until maturity and then state that, nominally speaking, you have not lost money. But if Germany issues an 8-year bond with a 3.5 percent yield in a couple of years, you will have lost money in the sense that you have missed out on a better alternative. In a bond fund, higher market interest rates immediately translate into a lower price on the bonds issued. Hence when the risk is low, the risk is on the downside.

Or is it? 1.5 percent is not the floor for long-term German interest rates. The Japanese state pays only 0.6 percent on ten-year bonds, and in Switzerland the corresponding rate is 0.9 percent. If the German interest rate were to fall from 1.5 percent to 0.7 percent within 2 years, you would receive a capital gain of 7 percent. Unlikely? Perhaps, but it is within the realm of plausible outcomes.

So what is the main difference between Germany on the one hand and Japan and Switzerland on the other? In Germany inflation is expected to be just below 2 percent for the next 10 years. In Japan and Switzerland, which have had deflation, inflation expectations are considerably lower. What, then, must happen for German long-term interest rates to fall to the level of Japan or Switzerland? Inflation expectations in Germany would need to sink to the same depths as in Japan and Switzerland.

Could it happen? Yes; at the time of writing inflation in the Eurozone is 0.5 percent. That is one quarter of the inflation target of the European Central Bank. And the trend appears to be downwards. This might change, but there is no knowing whether or when this might happen. So far Continental Europeans still believe that the European Central Bank will deliver on the 2 percent inflation target.

But what is central bank president Mario Draghi to do? The policy rate is already zero. He could introduce negative policy rates – but it wouldn’t take much interest negativity before people would choose safes and mattresses over bank deposits. He could buy bonds. That may have an effect on the economy, but it hardly has any effect on inflation. The US and UK central bank has bought bonds en masse – and inflation has fallen.

Hence, we cannot exclude the possibility that the Eurozone’s inflation will fall further and end in deflation, as was the case in Japan and Switzerland. Yes, inflation is slightly positive in these countries for the time being, but things could turn fast, as they have done several times in Japan. If inflation expectations also fall, what would stand in the way of a drop in German interest rates? A solid economic upturn.

Long-term interest rates are the sum of the real interest rate and expected inflation. Typically the real interest rate rises when there is an upturn in the economy. There are therefore forces that each pull in opposite directions with respect to nominal interest rates: An upturn may pull the long-term interest rates up, and a continuous drop in inflation may push the long-term interest rates down.

I believe that these two factors will balance each other out. Ergo I believe that the long-term German interest rate will remain somewhat stable for the next few quarters. Implications? An upturn in the Eurozone will result in less difference between the various government rates; the spreads are coming in.

With stable German interest rates, we believe that there is money to be earned by being invested in the so-called peripheral countries of the Eurozone. SKAGEN’s bond funds have made profit here over the past six months, and we believe there is more to be gained in the next few quarters.

The same balancing of forces probably also applies in the US. The real economy is pushing the interest rate up while monetary policy is pushing it down. This also creates opportunities. Particularly in countries that have issued dollar-denominated bonds. A lower spread relative to Treasury bonds can be expected where there is high growth and healthy government finances.

Local currency bonds too will get a boost if the long US interest rates remain as they are. This is contingent on local inflation and local inflation expectations not taking off. But, with a few exceptions, there has been remarkable convergence over the past few years. Low inflation is no longer a mature markets phenomenon. Inflation is low and stable in many of the emerging markets. It is not the case that high growth causes high inflation.

Take China, for example. With annual growth around ten percent for several decades, China has not had any serious inflation problem. In fact, China has had periods of deflation. What then of the general rule that the higher the relative living standards, the higher the relative price level?

When inflation is low and stable, this effect comes via a strengthening of the local currency. Countries which grow faster than developed economies over time typically get an increasingly stronger currency. Not continuously, but rather in fits and starts. But continuous enough to make their fixed income securities attractive beyond the mere yield.

– Torgeir Høien
Portfolio manager

SKAGEN Tellus

- SKAGEN Tellus generates profit via three channels: interest coupons, bond price appreciation and currency gains.
- Our investment in Brazil is a good illustration of all three income flows and was the fourth largest contributor last quarter.
- We earned most in the Eurozone last quarter, particularly in the peripheral countries.

PERFORMANCE IN EUR	1Q 2014*	2013
SKAGEN Tellus	4.0%	-4.1%
JPM Broad GBI Unhedged	2.7%	-8.2%

* As of 31 March 2014

Portfolio Managers

Torgeir Høien and Jane Tvedt

Source: Bloomberg

Our investment in Brazil is a good illustration of all three of our income flows. Unlike the market, which viewed anything from emerging markets as an abomination last year, we believed that there was money to be made in Brazil. And we were proved right. Our Brazilian investment was the fourth largest contributor last quarter.

Up where we belong

SKAGEN Tellus had a strong first quarter, with a return of 4.0 percent measured in euro – 1.3 percentage points ahead of the benchmark index.

SKAGEN Tellus is a unique actively managed bond fund, which invests in government bonds from around the world searching for capital gains. We have a broad mandate and enter markets where we believe bonds are undervalued. An undervalued bond is one whose yield is, in our opinion, too high. We also seek to gain on currency exposure when we buy bonds in local currency.

Since we launched the fund in 2006 we have had an average annual return of 5.4 percent. Our objective is to beat the benchmark index, which measures what one would typically achieve in the global bond market, by 1.5 percentage points. So far we have achieved an annual excess return of 1.8 percentage points. And we have achieved this with lower volatility than the market. That is, we have delivered our unit holders superior risk adjusted returns.

SKAGEN Tellus generates profit via three channels: interest coupons, bond price appreciation and currency gains. The fund achieves bond price gains when interest rates fall and we are left with bonds which give higher interest coupons than the market rates. And we achieve currency gains when bonds in local currency increase in value because the currency that the bond is denominated in rises.

Our investment in Brazil is a good illustration of all three income flows. Last year we bought a long-term Brazilian bond in local currency. Unlike the market, which at the time viewed anything from emerging markets as an abomination, we believed that there was money to be made in Brazil. And we were proved right. Our Brazilian investment, which constitutes 4.8 percent of the fund, was the fourth largest contributor in the quarter. The contribution came primarily from bond price gains and interest coupons, but there was also a positive contribution from a stronger Brazilian currency. We believe there is more to be gained in Brazil.

Where we earned the most in the first quarter, however, was in the Eurozone. Last year we entered a number of the peripheral countries. Interest rates were high there at the time as many investors feared defaults. What prompted us to invest was the prospect of a turnaround in the business cycle, which has occurred. In our view there is much more to be gained here too.

Fiscal moderation is certainly important for keeping a lid on interest rates, but what is most important for bringing down interest rates is economic growth. Because this causes the tax base to grow at the same as unemployment and social benefit expenses fall. Countries can grow themselves out of a financial crisis; it is rare that they can save themselves out of one. Greece is an exception – but Athens's financial excesses were extreme.