A low yield environment: challenges for bond investors

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A BNY MELLON COMPANY[SM]

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Why did you invest in bonds?

Bond investment provided…

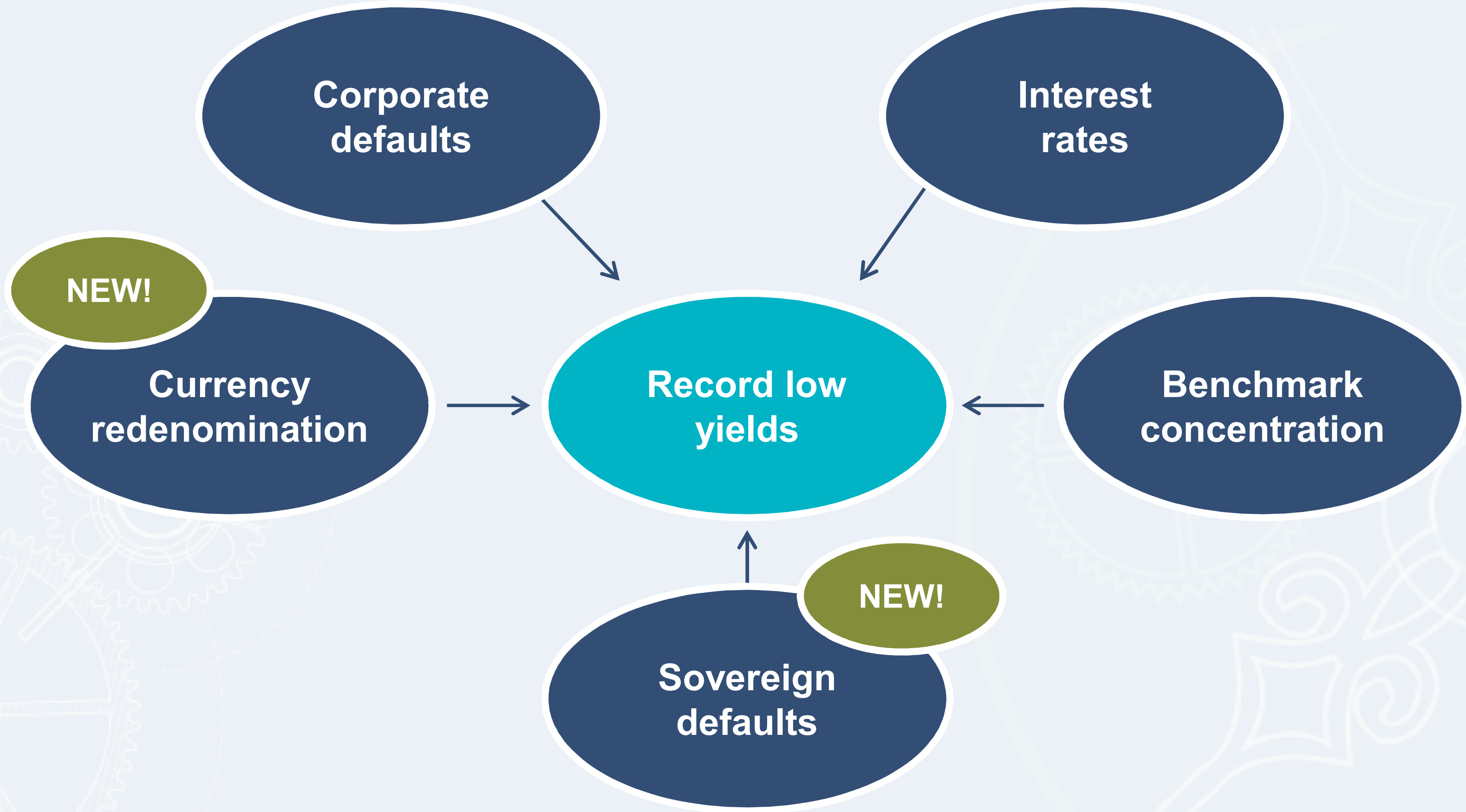
- Consistent income, lower volatility than equities
- A close linkage to annuity rates

…a natural choice for maturing pension schemes

- Primarily government and corporate bonds
- Typically using market indices as a benchmark
- Reducing liability risk and delivering return

In the past, risk and return were more balanced

What changed? Risk up, returns down…



Interest rate risk is now asymmetric

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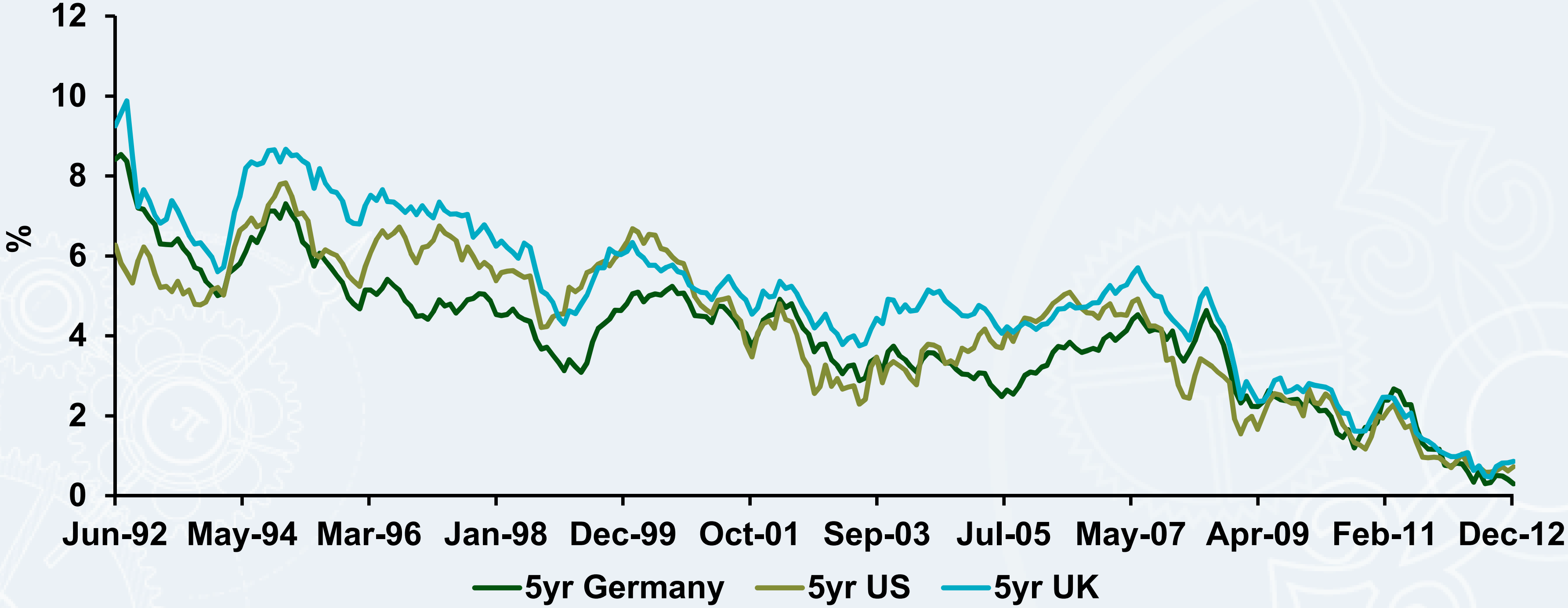
Yields on "safe haven" debt are near zero…

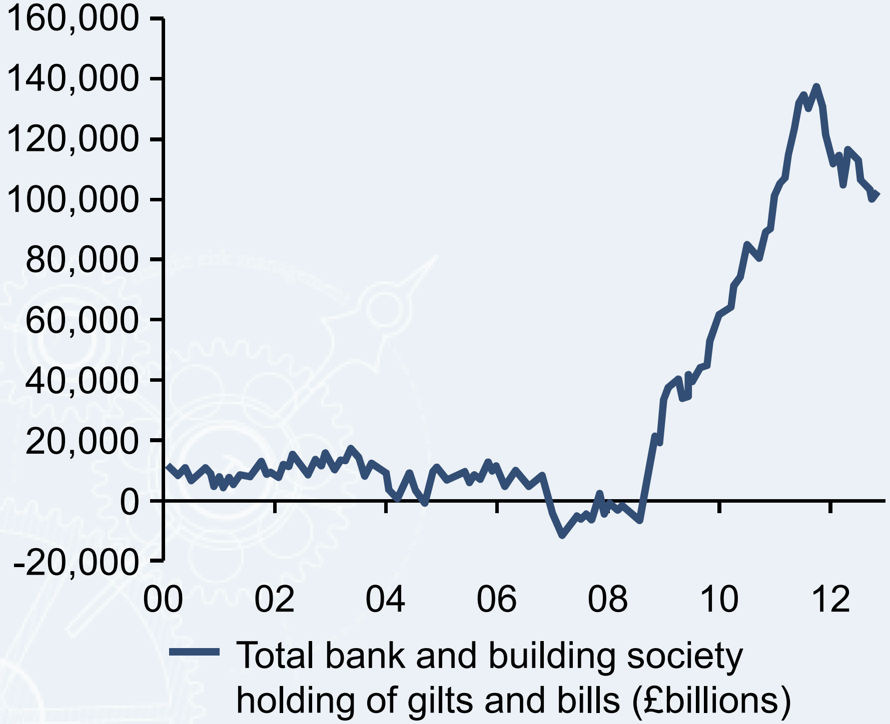


Government bonds: plenty of risk, little reward

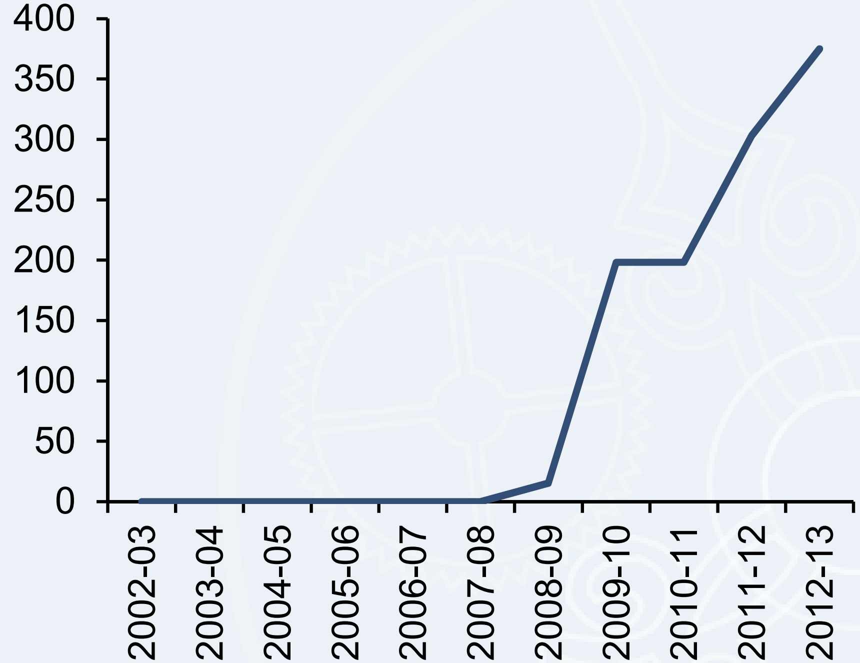
Source: Bloomberg as at 31 December 2012.

New buyers have helped this…

Regulatory ie banks



QE buying of gilts (£bn)



Regulation and QE create price insensitive owners of government debt

Source: Bank of England as at 9 January 2013.

Corporate bond benchmarks are also exposed…

What do you lose if yields return to 2008 levels?

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Europe
-10%

…and it's 25% Spain and Italy

Global
-12%

…over 32% financials

UK
-15%

…over 23% supranationals (EIB, KFW etc)

Market indices are not a great starting point…

Traditional economic analysis not the driver today…

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Before 2008: Cyclical

- Growth
- Inflation
- Interest rates
- Supply and demand

For now: Non-cyclical

- Zero interest rates
- QE measures
- Asymmetry of interest rate risk
- The search for yield

Risk and return: the future is different

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Traditional approaches have served you well…

- 151%return from gilts since 1997
- 36% in the last five years
- Corporate bonds performed better still – due to higher yields

But this simply can't be repeated

- Interest rates cannot realistically fall further
- QE represents an overhang of bonds to be sold in the future
- Inflation remains a potential long-term threat
- Sovereign default risk cannot be ignored

Source: Merrill Lynch Index G0I0 as at 30 August 2013.

So what now for bond investors?

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Need to rebalance risk and return…

- Starting point is zero interest rate risk ie cash*
- Don't use market-weighted bond indices
- Permit shorting to benefit from falling markets
- Expand beyond traditional bond asset classes

An absolute return bond approach: Cash Plus 4%*

* Cash is defined as 3 month Libor.

Why Cash* Plus 4%?

Long term, it beats bond yields and has outpaced inflation

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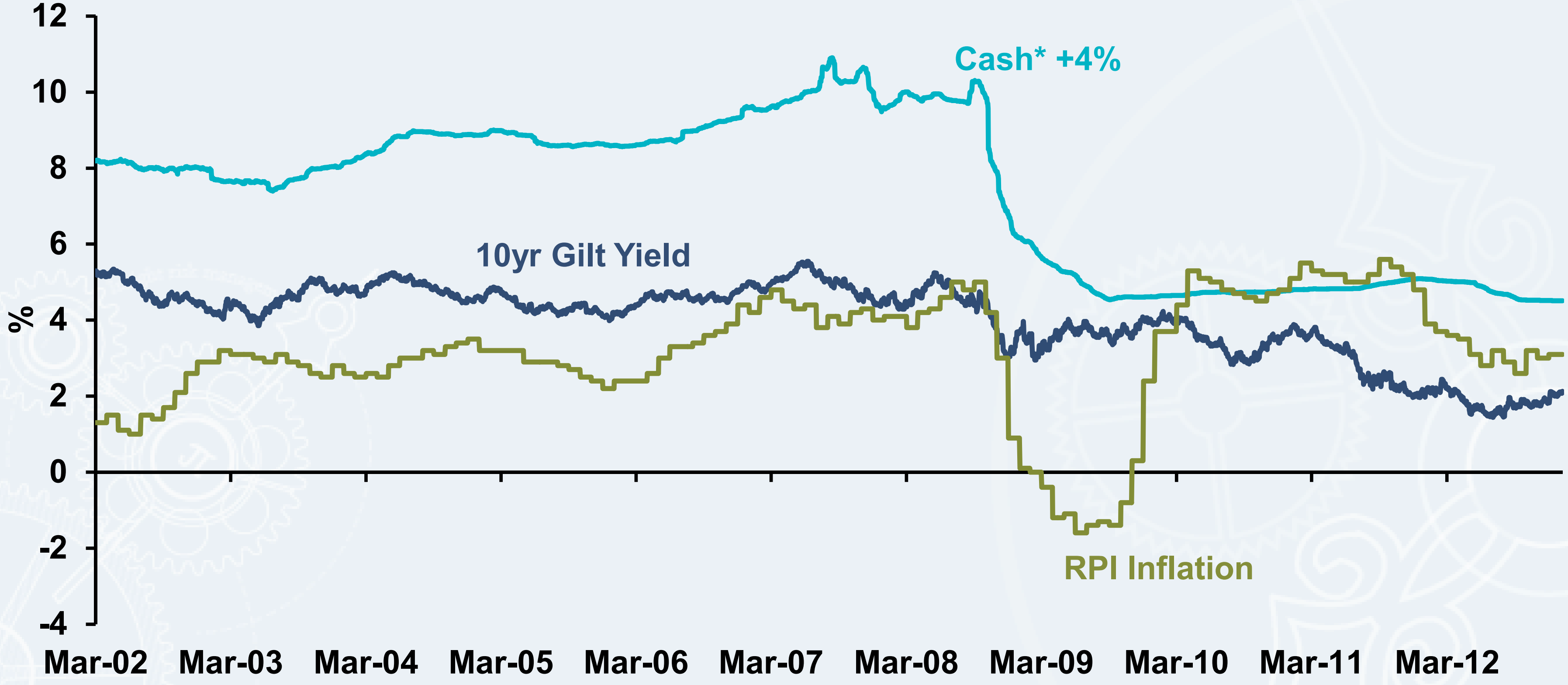
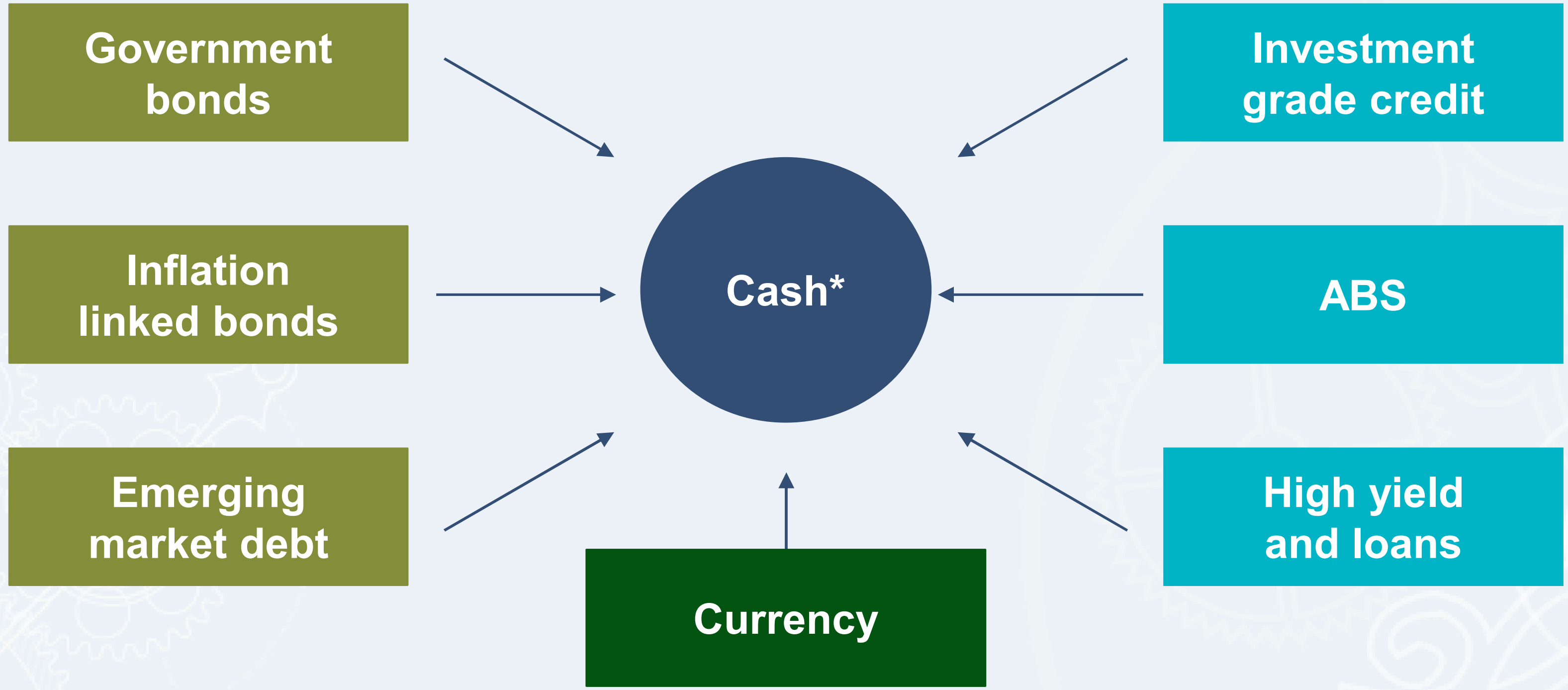


Absolute return bond investment rebalances risk and return

Source: Bloomberg: 10 year generic UK Gilt yield, UK RPI, 3 month Libor plus 4%

* Cash is defined as 3 month Libor.

Absolute return bond investment



A global diversified approach

Source: Insight
* Cash is defined as 3 month Libor.

How do you generate absolute return?

US versus Germany: relative market performance

No net market risk – a safer way to target returns

Source: Bloomberg as at 9 January 2013.Generic 30 year US Treasury yield relative to 30 year Generic German Bund yield.

Summary: today's bond risks need a different solution

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Solutions

- ✓ Absolute return bond investment
- ✓ Cash benchmarked
- ✓ Unconstrained bond asset classes
- ✓ Long and short positions

Risks

- ✘ Asymmetric interest rate risk
- ✘ Concentrated market indices
- ✘ Corporate credit risk
- ✘ Sovereign credit risk

Notes

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