Searching for YIELD

With short-term interest rates still low by historical standards and 10-year Treasury yields trending near 4.4%, investors continue to search for better investment returns in alternative asset classes. In this environment, new security types and products in the fixed income, hedge fund and commodity asset classes have gained appeal among many wealthy investors.

Illustration by Bruno Budrovic/images.com

Bonds have been called "An Investor's Best Friend" because they help to preserve wealth and can provide a stream of income. Unfortunately, we seem to be stuck in a period where the "income stream" part of this investment adage does not apply.

To explain the phenomenon, it is important to describe why the current bond market is atypical. First, commodity prices have hit new highs this year, led by substantial increases in the price of copper and crude oil. Typically, rising commodity prices cause a sharp upsurge in costs for companies and are a harbinger of escalating inflation. As inflation begins to climb, bond yields also typically go up. In 2004 and through the first half of 2005, inflation remained tame because most corporations chose not to pass along higher costs to consumers by raising prices and, instead, absorbed rising input costs or cut other expenses.

So far in 2005, yields on long-term U.S. Treasuries have not risen as quickly or by as much as history would lead us to expect, even though measured inflation has remained relatively low and contained, and the Federal Reserve continues to raise short-term interest rates. For example, 10- and 30-year U.S. Treasury prices rallied in 2004 and remain well-bid in 2005 — keeping yields relatively low — despite the Fed's rate hikes, steady domestic growth, surging commodity and energy prices, and declining unemployment.

This unusual market behavior has pushed many investors to search for higher returns among less traditional investments, such as non-U.S. bonds, hedge funds and commodities, all of which enjoyed favorable returns in 2004. More recently, concerns about the risk of higher inflation have fueled investors' interest in Treasury inflation-protected securities (TIPS).

The Yield Quandary

The question for investors in 2005 is whether the move to seek out higher yields in alternative asset classes is played out. In addition, with the Fed funds rate in April at 2.75% after seven successive 0.25% hikes, yields on short-term Treasuries have hit multi-year highs, making them increasingly enticing to investors. Because yields on these shorter Treasuries now compare more favorably to riskier investment options, Peter Flood, director of fixed income strategy at Northern Trust, notes that investors are asking themselves, "Am I still willing to take on a lot of risk to receive a 6% to 7% return on high-yield bonds when I can earn close to 3.5% on a two-year Treasury?"

As a result, the first half of 2005 is shaping up as a period in which investors are re-evaluating the outlook for inflation and pondering whether asset returns may revert to more normal levels.

With those thoughts in mind, here is a look at some investment choices with possible higher returns.

International Bonds

One area investors may still be considering is non-U.S. debt, in the form of both European sovereign bonds and emerging market issuers. In the second half of 2004, global bond yields declined in many world markets. As a result, international income funds rose 10.5% last year, according to mutual-fund tracker Lipper Inc., while the 10-year Treasury note returned 4.9%.

U.S. residents who purchased non-U.S. bonds benefited from a currency effect — their holdings in foreign-denominated securities appreciated against the slumping U.S. dollar — in addition to the local market performance.

Among other factors, because of the United States' twin deficits (a trade deficit with its global trading partners and a domestic budget deficit), the dollar fell moderately last year — by 4% to 8% — against other major currencies. At the start of 2005, many investment advisors recommended international bonds to their clients amid a consensus forecast for additional dollar weakness and the fact that, due to tepid growth in their economies, interest rates in Europe and Japan were unlikely to match any upticks in U.S. rates.

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Still, for Flood, few of the alternative fixed income asset classes look attractive right now, especially since, according to Lipper, international income funds fell 2.4% in the first quarter of 2005. "Because the Federal Reserve kept the funds rate at record low levels for such an extended period of time, which prompted an extended scramble for higher-yielding investments, all the alternative options have been picked over," Flood says. The situation may change in the future, Flood adds, depending on how much more the Fed tightens rates. "But, for now, there is no beacon of value or opportunity that stands out on the investment horizon." Still, international bonds and emerging market debt could attract additional funds because both are supported by fundamentals in their respective markets and could potentially "provide decent returns aided by a positive currency effect if the dollar continues to weaken," Flood says.

However, Flood cautions, "Moving into these asset categories includes the risk of currency fluctuation as a primary component of your investment, in addition to the risks associated with the asset itself."

Treasury Inflation-Protected Securities

Recently, rising commodity prices — particularly the skyrocketing price of oil — and larger-than-expected increases in certain narrow price indices have fueled concern that broad-based measures of inflation may spike. This, coupled with the atypical behavior of 10-year Treasury yields and the promise of continued short-term interest rate hikes by the Fed, has many investors taking a fresh look at TIPS.

TIPS can help investors protect themselves from the erosion of value that fixed-income investments typically suffer during inflationary cycles. Unlike regular bonds, TIPS have two parts: a low fixed rate of interest and the underlying principal. If inflation rises over the life of the TIP security, the principal value will increase, giving investors both the fixed coupon rate and additional principal at maturity — providing a real investment return above the rate of inflation.

Hedge Funds

Last year, hedge funds grew in popularity as more pension and endowment funds and high net worth investors allocated money to these investments. Hedge funds attempt to generate steady returns, regardless of the market's direction, by employing a wide range of investment strategies. Because of this, hedge funds can increase a portfolio's overall return

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ASIAN CENTRAL BANKS HELP KEEP U.S. INTEREST RATES LOW

Asia's monetary authorities helped hold U.S. bond yields at low levels in 2004, even as the Federal Reserve raised short-term U.S. rates. The overseas central banks purchased U.S. Treasury notes for most of the year and some, especially the Bank of Japan, also continued to sell their own currencies and purchase U.S. dollars in an effort to forestall a decline in the U.S. dollar. What prompted these actions? A weaker dollar hurts the competitiveness of Asian products in the United States. To minimize this, Asia's central bankers use the proceeds (dollars) from selling their products in the United States to purchase U.S. Treasuries. This recycling of funds into Treasury bonds has helped to lower U.S. interest rates, and, by extension, allowed U.S. consumers to keep financing (and purchasing) Asian-made merchandise.

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and reduce overall risk, particularly the risks of a declining equity market.

This past year, a trend has developed, particularly among institutional investors, of tactically shifting small allocations out of fixed income and into hedge funds, says Lori Runquist, senior vice president and director of alternative investment strategies at Northern Trust.

“Interestingly, hedge funds are viewed at certain times, especially in declining markets, as a defensive alternative to being long equity investments. But, given today’s atypical bond market, some institutional clients are shifting funds from fixed income to hedge funds,” Runquist says. This tactical shift is not recommended for individual investors requiring income from their bond investments. However, it may be a viable strategy for institutional investors that want greater diversification and the potential to lower their portfolio’s overall volatility. A diversified basket of hedge funds has historically helped to lower a portfolio’s volatility, Runquist says.

Where hedge funds are an appropriate investment for a particular investor, investing in a fund of hedge funds can further diversify the holdings within the asset class because a fund-of-funds usually provides the investor with a broad mix of managers and investment strategies. This can create more stable long-term investment returns than placing the entire alternative investment allocation into any one individual hedge fund.

Commodities

Increasing uncertainty about rising inflation and the falling U.S. dollar have renewed some investors’ interest in commodities — including real assets such as gold. Demand for commodities has risen in the past year as prices for raw materials, precious metals and basics such as coffee and cotton have climbed. Because commodities are one of the few asset classes that typically benefit from inflation, they are attractive to investors who fear inflation but want the potential for higher returns than are available from TIPS.

Until recently it has been difficult for investors to diversify portfolios concentrated in financial assets by adding commodities or broad commodity exposure. However, new investment vehicles, such as exchange traded commodity futures indices, can provide a “financial assets only” portfolio with passive exposure to a broad range of commodities. One such commodity index — The Dow Jones AIG Commodity Index — tracks the future price of 20 commodities, including energy, livestock, grains, industrial metals and soft commodities such as cotton, sugar, cocoa and coffee.

Adding broad commodity exposure through an index can be advantageous for two reasons. The various commodities tend not to be highly correlated with each other and index returns may be less volatile than the returns on an individual commodity. Second, the broad commodity exposure can help diversify a portfolio of stocks and bonds, which in turn may possibly lower risk and increase overall return.

Finding New Opportunities

With many fixed-income products offering relatively low returns, some investors are turning to less conventional investment strategies to add yield and diversify risk in their portfolios. Given today’s atypical environment, these options — non-U.S. bonds, TIPS, hedge funds and commodities — may be worth examining. Within the considerations of their unique objectives and risk tolerance, investors may discover new opportunities for achieving their long-term financial goals. ■