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Don't leap from the frying pan into the fire

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Investors pell-mell retreat from equity markets can drive them straight into assets that have their own unique risks.

The fear in early August was almost palpable as stock markets plunged. The spectre of financial contagion from Europe, the downgrade of U.S. long-term debt and ever-worsening economic news was just too much for many investors. Anxiety that had never fully dissipated since the 2008/09 market crash reasserted itself with a vengeance, triggering a rush for the exits by many.

Unfortunately, their pell-mell retreat from plummeting equity markets drove many of these investors straight into assets that all have their own unique risks – risks that have been elevated by the U.S. Federal

Reserve's ultra-low interest rate policy. Take cash, for example. Canadian T-Bills are now earning less than 1% as the Bank of Canada's imminent rate hikes have faded. Safe and liquid, T-Bills may be a temporary refuge but you can't fund a retirement on these returns. And worse, the Fed has committed to keep rates low until at least mid-2013. For retirees living on their investments, a lengthy stretch of dismal yields means that excessive cash holdings could result in serious capital erosion.

The flight to safety in combination with Fed policy has driven government bond yields to levels not seen since the 1940s. The Canadian 10-year bond yield hit 2.32% on August 8. Investors fleeing to this safe haven are embracing inflation risk. The Bank of Canada is on record that it targets a 2% annual inflation rate as a guide to its monetary policy while the Fed's most recent estimate of annual inflation in the U.S. over the next decade is 1.83%. Many investors are jumping into an asset that today offers a real annual return potential of less than 1%. And for high net worth investors with bonds outside their registered plans, that is before the bite of taxes.

Worse, interest rate risk accompanies inflation risk. Barring a deflationary collapse, interest rates are almost certain to eventually move up, thereby driving down bond prices. If the Bank of Canada is successful at delivering its target inflation over the coming years – and remember they can print money – yields should increase 1.5% to 2.0% from today's level. For Canadian bonds in general, this will result in price declines approximately of 9% to 12%.

Some investors, dismayed with the government bonds, are hunting for better returns in investment-grade corporate bonds. Not a bad idea, but again this ups the risk ante. Corporate bonds are not immune to interest rate risk. They also possess credit risk as faltering business conditions and even bankruptcy can demolish their value. Case in point: the bonds of bankrupt telecom giant Nortel Networks were once rated investment grade.

I recently heard about an advisor who is moving large chunks of his retired clients' investments into longer-term corporate bonds in a desperate reach for yields of 4% to 5%. I wonder how many of these clients are aware of what rising inflation and interest rates can do to longer-term bonds – long-term corporate bonds suffered real return losses of 1.5% per annum from 1946 to 1979.

The search for return undoubtedly has some investors loading up on high-yield bonds. An 8% yield is mighty enticing in a world of minuscule rates. Yet, high-yield bonds are nearly as risky as equities – they typically suffer double-digit losses in recessions.

Other investors are piling into gold. Are they aware that gold dropped over 60% the last time the bullion bubble burst in 1980?

In a financial world distorted by extreme stock market volatility and exceptionally low interest rates, investors need to avoid leaping from the frying pan into the fire. Excessive interest rate, credit, or commodity risk can be as detrimental to long-term financial success as undue equity risk.

The Roman dramatist, Terence, counselled, “Moderation in all things.” Not bad advice for your portfolio in these distorted markets.

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