FINANCIAL POST

Thursday, June 7th, 2012

The journey to inconceivable yields

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Daniel Ochoa de Olza/AP Photo

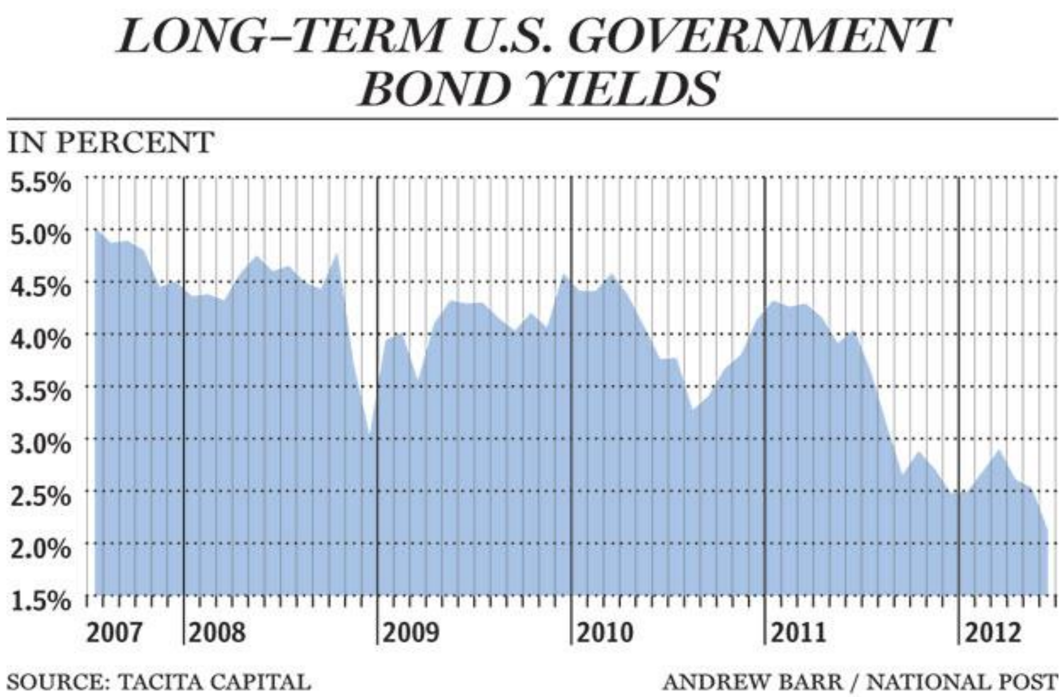
Billionaire Brokers check prices at the Madrid stock exchange. News that depositors are fleeing Spanish banks alarmed the market.

The yields of government bonds of "safe" countries have plumbed new lows as investors engaged in another round of panicky bond buying. News that depositors are fleeing not only Greek but now Spanish banks alarmed the market. However, it was signs of a broadening economic slowdown in the U.S. and China that really triggered a flight to quality.

Despite the U.S.'s fiscal challenges, Treasuries are at yields not seen since the Second World War — a 20-year Treasury is yielding just over 2% per annum. Ten-year bond yields in Germany, France and Austria have all hit record lows. In the U.K., 10year gilts dropped to 1.43%, the lowest level in over 300 years. If you had forecast these rates five years ago, people would have thought you were daft.

Fear was so widespread that yields on two-year German bonds actually turned negative — investors were so desperate for a refuge for their money that they paid the German government for the privilege of investing in their bonds. This hearkens back to medieval times when the wealthy paid goldsmiths for safe-keeping of their gold. Thieves were the worry then, a eurozone implosion is the threat today.

In Canada, we aren't paying the government yet to invest in their bonds; but the government isn't paying us much – the yield on a 10-year bond recently touched 1.62%. Then again, with money pouring into Canadian bonds from abroad, it doesn't have to.



The widespread flight to "safe" bonds, regardless of the paltriness of yields, has the hallmarks of what behavioural finance experts call herding — the tendency of individuals to act with the crowd. The impulse to herd is particularly strong in stressful or threatening situations.

Humans aren't alone in exhibiting herding behavior. Many bird, mammal and even fish species herd together when threatened by a predator. In explanation, evolutionary biologist W.D. Hamilton asserted that each member of a fleeing herd tries to push to the center of the group in order to reduce its own danger. What evolves into a frantic horde is actually motivated by the self-interested needs of each member.

Similarly, herding can begin with rational acts by individual investors — in this case, increasing their government bond allocations in uncertain times. As other investors picked up these “buying” signals, they also purchased the same bonds driving prices up and yields down. Massive bond purchases by central banks further depressed yields.

With each flare-up of the sovereign debt crisis, more money has poured into “safe” bonds, with the investors oblivious to ever-decreasing yields. Systematic traders that profit from falling interest rates have jumped in adding to the downward pressure on yields. Many retail investors have hopped on the bandwagon simply because “safe” bonds have generated the best returns recently.

A proverbial feedback loop has been created where every new rush of bond buying that drives up prices and reduces yields validates the actions of the prior bond purchasers. In the space of a few years, yields that would have once been viewed as inconceivably low are now widely accepted as the “new normal.”

Yet, current yields are arguably inadequate compensation for the risks of government bonds. Inflation is running just above 2% per annum; this results in negative real (i.e. inflation-adjusted) returns for short and mid-term bonds. The Bank of Canada’s target for future inflation is 2% so continued inflation is likely. Finally, many investors are unaware that as the interest rates fall, government bonds become more sensitive to changes in rates – this increases their losses in a scenario of rising rates.

None of this is to say investors should not have some allocation to “safe” government bonds in their portfolios. Rates may stay low for years. However, investors must recognize that “herding” has driven the price of safety to extraordinarily levels and consequently, government bond allocations have to be judicious. You don’t want join the lemmings jumping off the cliff.

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