D DELEGATE

HEARD FROM CLIENTS

Negative Yielding Bonds and How You Can Avoid Them

What are negative yielding bonds? Who in their right mind would invest in something that promises to return less money than it cost? Do I have these in MY portfolio? Negative yielding bonds are more common than you may think, and investors should always be aware of what's in their portfolios. We often hear questions from clients about these investments, and in this commentary we describe the basics of negative yielding bonds and how you can avoid them.

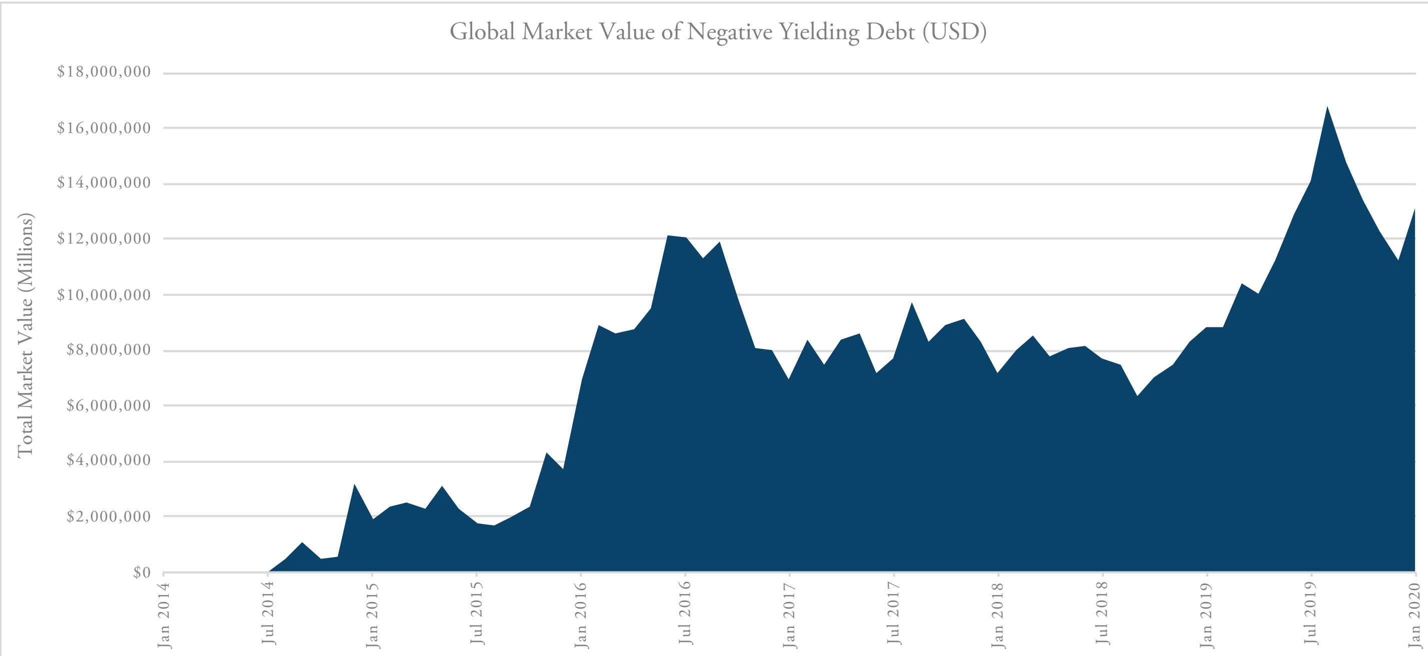
A decade ago, it was hard to imagine a world where over 20% of the global government bond market would trade at a negative yield. When negative yielding bonds first appeared, investors and economists tended to point to idiosyncratic events (e.g., the 1997 Asian Financial Crisis and the 2008 financial crises,) as a rational explanation for this anomaly. Today, economic and fiscal policy makers are increasingly pointing to long-term structural explanations for the need for and existence of negative interest rates. Below are several questions from our clients pertaining to this topic, and a summary of the insight we can offer.
What is a negative yielding bond?

To simplify, a negative yielding bond is a loan where the lender expects to recoup less than the amount lent, inclusive of interest and principal. For example, an investor lends $100 and the borrower promises to repay $99 at a later date. This defies the traditional understanding of the time-value of money, natural economic credit creation, and, from our prospective, sounds like an irrational strategy and one we do not consider a prudent investment.

For a specific example, in July 2019, Germany issued a sovereign bond with the following characteristics:

+ Maturity: 10 years (8/15/2029)
+ Coupon: 0.0%, annually
+ Issue Price: 102.64
+ Yield at issue: -0.26%
+ Par: 100

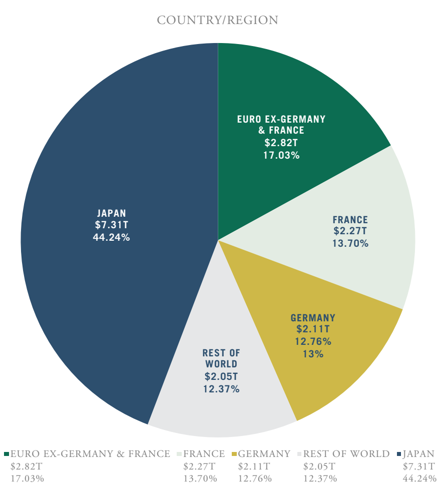
Investors who bought this bond at issuance at a price of €102.64 should expect to receive €100 in proceeds in year 10. This return results in an annualized total yield of -0.26%. Sounds absurd, right? Maybe so, but this scenario has become commonplace as we enter the new decade. And this wasn't the only instance of a central bank issuing negative-yielding bonds in the last twelve months. Today the balance of outstanding bonds with negative yields is approximately $13 trillion, which sounds even more absurd[1].

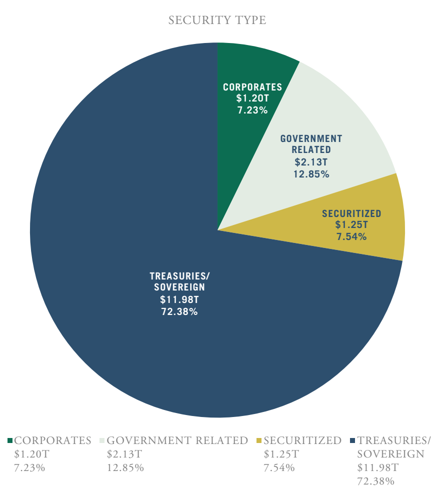


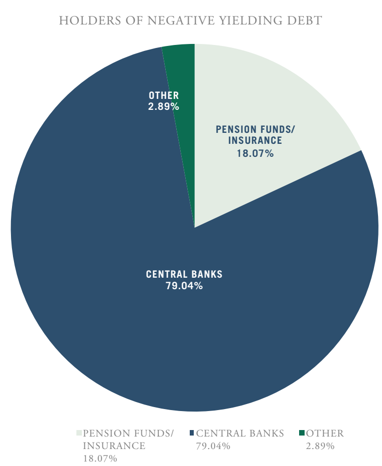
Source: Bloomberg.

WHO IS BUYING THESE BONDS, AND WHY?

Negative yielding bonds have been issued primarily in Japan and Europe. Bonds originated there account for ~87% of negative yielding issuances globally. The types of securities with negative yields are dominated by sovereign bonds (~72%), but even more surprising is the fact that there is over $1 trillion of corporate credit and $1 trillion in securitized products with negative yields. The holders of these bonds are concentrated in central banks and other regulated entities (which often receive favorable regulatory treatment for holding these assets)[2].







Source: DoubleLine.

[1]Source: Bloomberg.
[2]Source: Doubleline. As of August 26th 2019

WHY WOULD AN INVESTOR FOCUSED ON TOTAL RETURN BUY THESE BONDS?

A few strategies appear to be at work here. Among them include (using the previously described German bond as a reference point):

+ A STORE OF VALUE: When storing cash for safety, an investor believes that all other assets will return less than -0.26% over the next ten years

+ CURRENCY HEDGING: Cross-currency hedging and/or protecting against the possibility that the value of the Euro will depreciate more than -0.26%

+ THE "GREATER FOOL" THEORY: Belief that rates will fall further and there will be buyers when the yield becomes even more negative, generating a positive capital gain for the buyer who purchased the bond at a less negative yield

+ PASSIVE INVESTING: This is truly a pitfall and a key reason why Delegate does not generally recommend passive fixed income investing. When looking more closely at the bondholders, many large, passive, index-driven global bond mutual funds and ETFs buy positions based on the index, which is based on issuance. Negative yielding debt comprises ~20% of the Barclays Global Aggregate Bond Index. Other than the ECB (the largest holder of the German bond referenced above) Vanguard is the largest holder through its mutual funds and ETFs. One Vanguard portfolio, their "Total International Bond Index Fund" holds over 3.6% of the total issuance of that series. For investors who have a global bond allocation, we recommend taking a closer look at the exposure of the vehicles currently utilized to avoid any exposure to negative yielding bonds.

WHAT DOES DELEGATE RECOMMEND TO ITS CLIENTS?

Most simply put – stay away. Here's why:

We know that negative interest rates have not yet been effective in stimulating the economies where they have been tried (i.e., Eurozone and Japan). Members of the EU do not have the sovereign power to print their own money (without ECB oversight) or borrow money issued by their own central banks, so negative policy rates, driven by the European Central Bank ("ECB"), keep the Eurozone glued together, allowing countries to stay solvent. In Japan, the BOJ owns nearly half of Japan's federal debt, but still hasn't seen its inflation rate move up to its 2% target. If the objective of negative interest rates is to stimulate economic growth and inflation, it looks to be a failed experiment at this point.

+ More concerning are the consequences to investors that we don't know, including the potential for significant short-term price volatility.

+ Some big picture questions we are asking ourselves:

+ How will individual countries and the global economy reverse the course of negative interest rates?

+ If a recession occurs during a period of negative interest rates, what policy tools will central banks use to stimulate economic growth? Will these tools be enough?

+ Is there a "reversal rate", a level at which negative rates harm pensioners, insurers, and banks far more than the potential benefits?

+ What happens to the bonds held by the ECB if an EU member country, Italy for example, leaves the Eurozone and begins printing and borrowing money in its own currency?

+ As portfolio managers, we always look at the risk relative to return based on different market scenarios because of the unknowns.

Let's go back to the scenario at the top, and the German 10 Year Bond issued in July 2019. If a speculator purchased $1M at issuance with the yield at -0.26%, and if they hold this position for 10 years, then in August 2029, they would receive $974,000. However, consider what happens in the near term, if rates rise or fall.

	HORIZON 03/03/2020			HORIZON 03/03/2021		
TARGET HORIZON YIELD	TOTAL RETURN %	HOLDING PERIOD RETURN %	NET P&L (EURO)	TOTAL RETURN %	HOLDING PERIOD RETURN %	NET P&L (EURO)
+ 100 bps	-69.77%	-9.04%	-€ 94,311	-7.94%	-8.53%	-€ 88,990
+50 bps	-45.22%	-4.66%	-€ 48,563	-4.28%	-4.60%	-€ 47,950
0 bps	-00.44%	-0.035%	-€ 363	-0.44%	-0.47%	-€ 4,926
-50 bps	81.51%	4.84%	€ 50,435	3.57%	3.85%	€ 40,190
-100 bps	231.90%	9.97%	€ 103,937	7.76%	8.39%	€ 87,510

Source: Bloomberg.

Because of the sensitivity to interest rate fluctuations, this chart demonstrates that losses in the range of ~4% to ~8% are foreseeable. While 50 to 100 bps swings in interest rates do not occur on a daily basis, they can happen quickly. As a reminder, the bond doesn't pay a cash coupon to the holder.

While we don't know if this regime of negative yielding debt will result in an asset bubble that causes a global financial crisis, or the long term effects on savers, the banking system, or inflation, we are confident that the embedded risk profile is unacceptable relative to other financial assets and should not warrant any exposure in a portfolio.