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JANUARY 2020

THOUGHT LEADERSHIP: THE LAND OF LOW YIELDS

THE LAND OF LOW YIELDS

Monetary policy in its current form has less firepower than ever before. Despite a decade of extremely accommodative monetary policy, global economic growth and inflation since the Global Financial Crisis (GFC) have been relatively subdued. During this time, cash rates have been at all-time lows and central bank balance sheets have multiplied.

Despite its best efforts to normalise monetary policy from 2015 to 2018 through interest rate hikes and balance sheet reduction, the US Federal Reserve (the Fed) cut its federal funds rate by 75 basis points in 2019 and intervened in short-term money markets (and thus, increased the size of its balance sheet). The European Central Bank (ECB) restarted its asset purchase programme in November, while the Bank of Japan has continued to purchase large volumes of Japanese assets.

Domestically, the Reserve Bank of Australia (RBA) is following the same trend, by lowering the cash rate by 0.75% in 2019 to 0.75%, an all-time low. These rate cuts by the RBA followed a three-year period in which the RBA remained firmly on hold.

The doubling down approach of central banks in their policy responses to low inflation and low growth signals that low yields are here to stay. While highly unlikely, the current political landscape makes the probability of central banks adopting even more extreme policy approaches (i.e. modern monetary theory) non-zero. Under such an approach, yields will remain lower for even longer, and in many cases, become and stay negative. Already, a third of all global bonds are negative yielding.

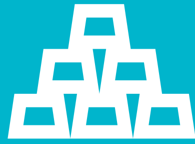
The continuation (and amplification) of the ultra-low yielding environment is having profound investment implications, particularly for investors' defensive assets portfolio. The volume of negative yielding debt increases the risk that investors will earn negative returns, especially negative real returns when factoring in inflation, on investments that previously provided low, but positive, returns. While negative yielding bonds do not actually have negative coupon payments, the income received from holding such bonds is dramatically reduced, which is particularly impactful for investors who rely on the income from bonds for their spending needs. Finally, the march down of yields has called the portfolio

diversification argument into question as bond prices have increased alongside share prices during many market environments over the past decade.

As such, configuring a defensive assets portfolio that provides a reasonable level of portfolio protection, while also meeting return expectations, has become increasingly challenging.

In this month's article, we discuss the challenges for defensive asset portfolios in the persistent low-yielding environment. We start by discussing the driving factors of the low yields, including central bank policy and structural factors. We delve into the role that traditional fixed interest has historically played in portfolios before addressing questions surrounding what an investor will need to consider in this low-yielding environment. These questions include:

- What is the intended role of an investor's defensive assets portfolio?
- What is fixed interest's ability to provide a defensive positioning when rates are starting at such low levels?
- What asset classes should an investor consider in the configuration of its defensive assets portfolio in order to attain a reasonable level of portfolio protection, diversification and income?
- What role do non-traditional/alternative defensive assets play in a defensive assets portfolio in this market environment?

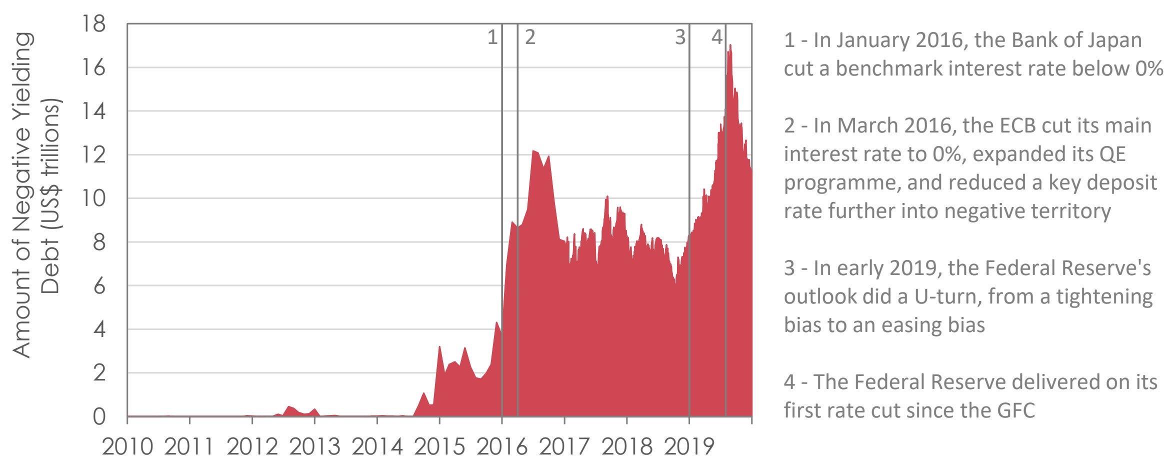


THE RISE OF NEGATIVE-YIELDING DEBT

As at the end of December 2019, the value of global bonds with negative yields stood at US$11.3 trillion, down from its all-time high of US$17 trillion in August 2019. This equated to approximately a third of all outstanding debt globally. The rise in negative-yielding debt is shown in Chart 1 below. We also highlight some of the most pivotal central bank decisions over the past few years, which have contributed to the rise in negative yielding debt.

The burgeoning volume of debt that is negative-yielding (meaning that if a negative-yielding bond is held to maturity, the investor will make a nominal loss) reflects the march down in cash rates and government bond yields over the past decade.

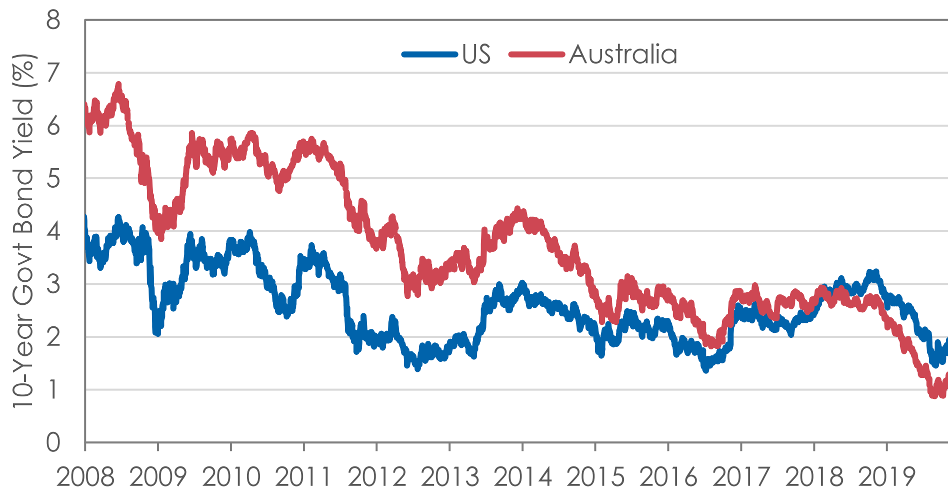
Chart 1: Volume of Negative Yielding Debt, 2010 - 2019



Source: Bloomberg, Whitehelm Advisers

Chart 2 shows the 10-year Australian and US government bond yields. While Australian and US government bond yields have remained positive, they spent much of 2019 below 2%, with the Australian yield breaching the 1% mark in the latter half of the year.

Chart 2: Australian and US 10-Year Government Bond Yields, 2008 - 2019

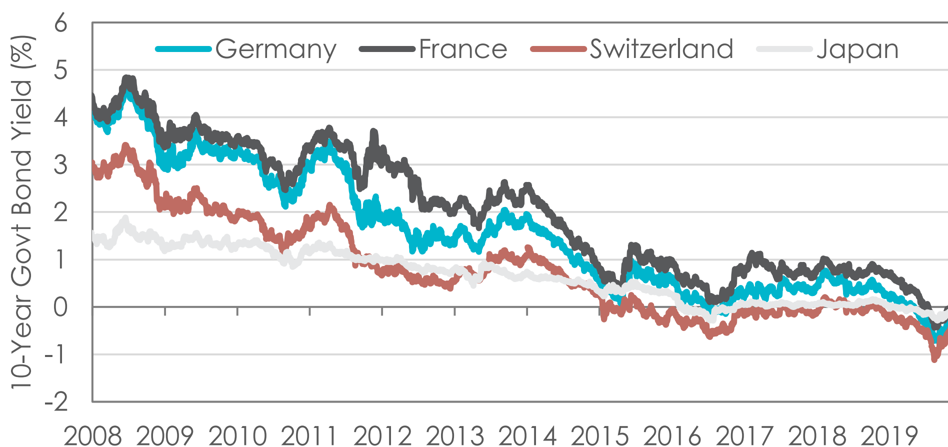


Source: Bloomberg, Whitehelm Advisers

Chart 3 below shows the equivalent yields for select European countries and Japan. Bond yields in many European countries have been negative for some time, moving lower following both the GFC and the European debt crisis, and have remained low (and negative) since.

Japanese bond yields have been very low for some time, reflecting the extraordinarily accommodative monetary policy the Bank of Japan has implemented over the past few decades.

Chart 3: European and Japanese 10-Year Government Bond Yields, 2008 - 2019



Source: Bloomberg, Whitehelm Advisers

YIELDS LOOK SET TO STAY LOW

Central banks tried to support their economies following the GFC through dramatic interest rate cuts and expansive unconventional policy approaches, intended to stimulate the economy by encouraging borrowing and spending and discouraging saving. More recently, a globally synchronised economic slowdown, paired with several simmering downside risks, including the US/China trade conflict, Brexit and other geopolitical tensions, have pushed bond yields lower. The demand for 'defensive' assets, such as government bonds has pushed prices up and yields down. Furthermore, the hunt for yield of any kind, has caused credit spreads to tighten, meaning that yields are now low across the board.

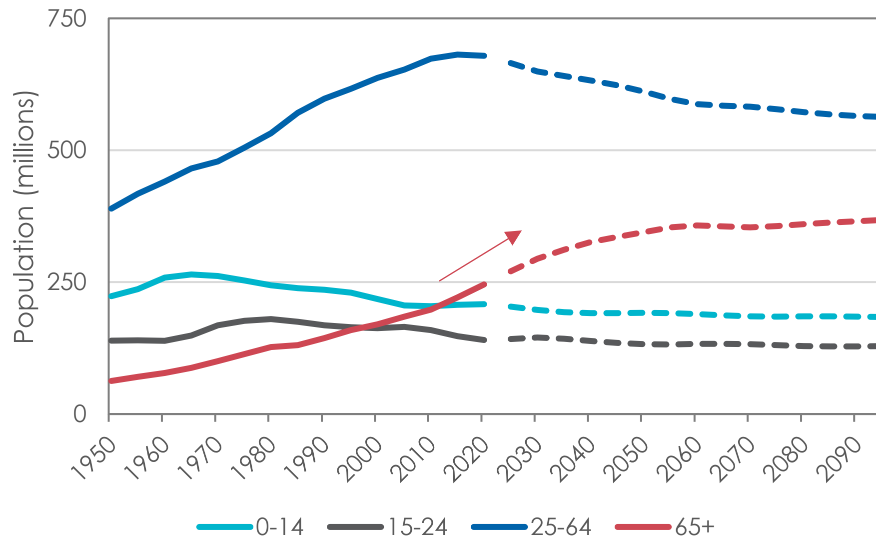
Despite bond yields being at or below their perceived lower bound, we expect that bond yields are going to stay low, and potentially move lower, based on certain structural factors, the global debt load and monetary policy.

Structural Barriers in Economic Growth and Inflation

Changing demographics and the role that technology plays in the economy are considered to be two of the main factors keeping growth and inflation below long-term historical averages. An ageing global population is widely believed to have negative implications for economic growth, both due to a surge of retirees leaving the workforce as well as the strain on public finances that will be inevitable in supporting an ageing population. The working-age proportion of the population will be forced to shoulder higher taxes to support the growing non-working age portion of the population. Higher taxes create headwinds for spending levels, and in turn, economic growth and inflation.

Actual and projected changes by broad population group for developed nations are shown in Chart 4 overleaf.

Chart 4: Population by Broad Age Group, More Developed Regions, Actual & Projected, 1950 - 2090



Source: United Nations: World Population Prospects 2019

Additionally, technological development, implemented effectively, can help companies operate more efficiently. As a result, they have lower production costs and cost savings which are often passed on to consumers through lower prices. The lower prices are generally concentrated in goods and industries that can capitalise on technological improvements. However, as technological advancements become more widespread, inflation is structurally lower. As such, central banks would be expected to keep interest rates low to try to stimulate inflation.

High Debt Levels

According to the Institute of International Finance, debt held by governments, businesses and households has increased by almost 50% since the GFC. Typically, high levels of indebtedness lead to lower levels of credit creation, which then curbs spending and investment. Not only do high debt levels limit the likelihood of strong economic growth, it also discourages central banks from raising interest rates too high and too fast because of the impact that would have on debt servicing costs and future spending. As such, we expect that the high debt levels will corner central banks into maintaining interest rates lower for longer.

Central Bank Policy

Most developed market central banks have reasonably similar mandates, in that they have relatively well-defined inflation rate objectives. The main tool that central banks have to achieve these stated goals is the cash rate, which can often be considered a blunt instrument at best. This explains why the Fed, the ECB and the Bank of Japan adopted such sweeping quantitative easing programmes (QE) over the past decade. What was formerly unconventional is now well and truly mainstream, and central banks are continuing to research and consider new initiatives.

The nature of central bank mandates, the rigidity of their inflation targets and the form of QE they adopted have shown to have the perverse outcome of pushing interest rates structurally lower.

This is not a novel problem, rather it is one that has been discussed at great lengths by central banks, economists and politicians alike. The Fed conducted a review of its monetary policy toolkit in 2019, including a review of whether it should target an average inflation rate of 2%, meaning that it could let inflation undershoot its 2% target for a longer period of time as long as when inflation is above its 2% target, the Fed will not try to rein inflation in. If the Fed were to adopt this approach, we would not expect the interest rate trajectory to change materially in the short term.

In a recent article, we discussed an even more radical form of monetary policy being Modern Monetary Theory (MMT). While MMT continues to be a generally leftfield idea, it has gained traction recently, in large part because left-wing political candidates in the US and the UK have touted it as a way to pay for very expensive campaign platforms. Essentially, MMT is predicated on the idea that governments can never default on debt denominated in their local currency, because they can always print more money to service that debt. Most proponents of MMT argue that interest rates should be held at 0% - anything higher than 0% makes little sense when governments are not on the hook to pay back their debts in any case.

Whatever form monetary policy takes over the coming years, we expect that cash rates will be at or close-to all-time lows. This is our central case view, but note that there are other scenarios that could play out that could see inflation re-emerge (and push interest rates higher). For example, a loss in central bank credibility, potentially caused by the adoption of leftfield policy ideas, MMT being an extreme example, could see inflation rise out of control very quickly. While low inflation and low interest rates pose challenges for defensive assets, so too would high inflation and high interest rates.

THE ROLE BONDS (TRADITIONALLY) PLAY

Investors have traditionally included bonds in their portfolios because they can be a source of low-risk income, provide a multi-asset portfolio diversification and act as a portfolio hedge. We elaborate on these reasons, and discuss why the rationale for allocating to traditional fixed interest investments, such as cash and government bonds, is being challenged in this low-yielding environment.

Low Risk Income

High quality debt (i.e. government bonds, or highly rated investment grade bonds) has historically provided investors with a source of income in the form of the coupon, which is paid at regular intervals. The cash flows associated with high quality debt should be known and predictable. While equity can also provide income in the form of dividends, historically, dividend payments are less certain, and at times, smaller than bond coupon payments (this is not the case currently with interest rates as low as they are).

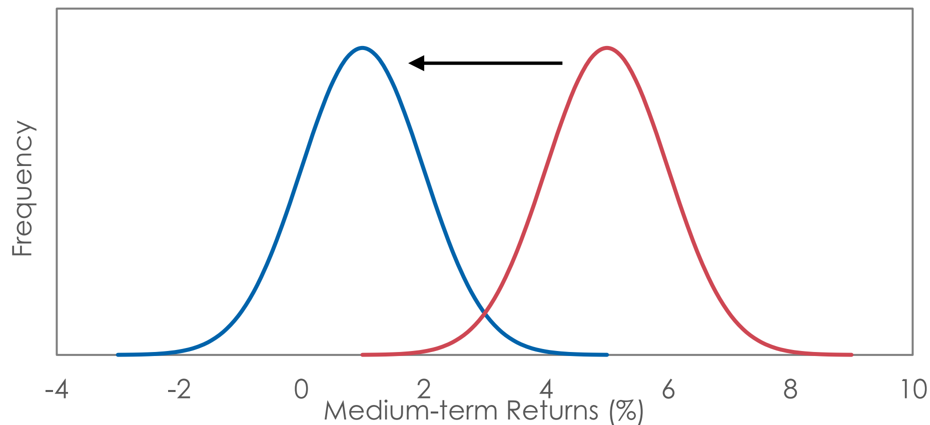
As a result, bond returns have historically been regarded as more stable than most other asset classes, given the certainty of the nominal return if the bond is held to maturity (aside from the case of default). This is now called into question as the starting yield to maturities are plummeting to uncharted lows.

While current coupons on longer-dated bonds may still be high relative to interest rates, as new debt is issued, coupon rates will decrease towards current bond yields.

A bond's income drives its total return, and if the bond is held until maturity, it is the only return component if the issuer has not defaulted. As interest rates decrease, bonds will see lower future returns. Even if a bond's expected return is positive over the medium term, if its yield is only marginally positive, there is a lower income buffer to absorb any changes in its capital value (that arise from even a small rise in interest rates).

Essentially, the return distribution of holding a bond shifts to the left as shown in Chart 5 overleaf, which means that with yields at such low levels, outcomes with negative returns are expected to occur much more frequently.

Chart 5: Illustrative Shift in Return Distribution with Lower Starting Yields



Source: Whitehelm Advisers

While in some cases, bonds will still be able to produce attractive returns, it will require interest rates to push through new record lower bounds, which will pull forward returns through capital appreciation. Depending on central banks' intentions of pushing interest rates lower and through the 0% bound, this is possible. However most central banks, notably the Fed, do not currently appear to have an appetite to push interest rates well into negative territory.

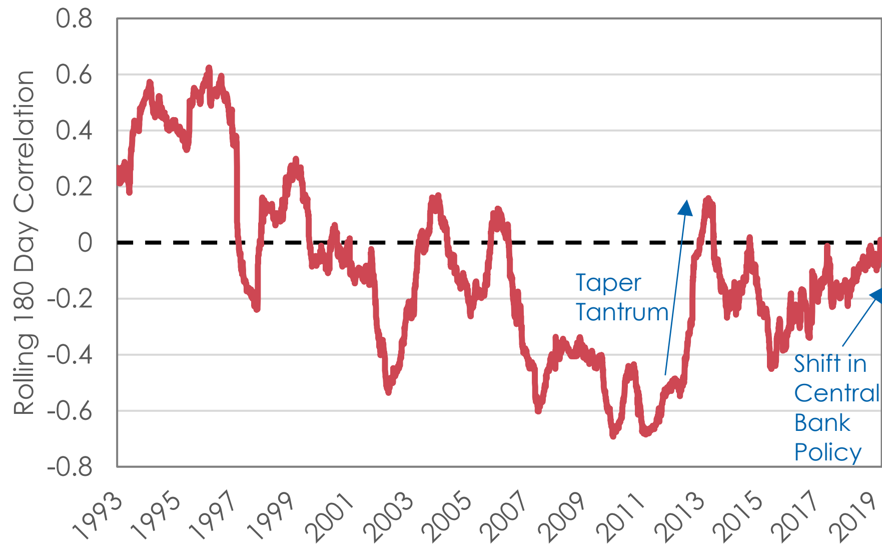
Diversification

Investors have historically allocated a portion of their portfolio to high-quality bonds because of the assumption that they diversify equity risk. In the absence of central bank intervention, an economic slowdown or some other form of financial market stress usually leads to poor equity market performance because of anticipated lower company profits.

The lower inflation that usually comes with lower economic growth can make the stable income from bonds increasingly attractive in this scenario. Furthermore, when equities fall, bond yields usually fall, which results in higher bond prices that help offset equity losses during periods of economic stress. This negative correlation between equities and bonds is predicated on the assumption that bonds are inherently defensive, and act as a portfolio diversifier.

However, the correlation between bond prices and equity prices is not always negative, which means that an investor's defensive portfolio may not always provide the desired level of diversification. Chart 6 overleaf shows the correlation between Australian bond and equity market indices over the past 25 years. There have been some notable examples of the correlation between the two indices becoming less positive, including the taper tantrum of 2013, when markets reacted to an expected end to QE. A second example is that experienced in the past year and a half, as central bank policies have flipped from a tightening stance to a more accommodative stance at the start of 2019. The accommodative at all costs position adopted by central banks has supported and will continue to support both equity and fixed interest markets.

Chart 6: Australian Bond vs Equity Correlation, 1993 - 2019



Source: Bloomberg, Whitehelm Advisers

Capital Preservation

One of the main differences between a bond and a stock is that the principal value of a bond is returned to the investor in full at the bond's maturity date. Investors who are concerned about capital preservation have a preference for holding high quality bonds over stocks for this reason.

However, in a world of negative yields, investors endure a heavy cost, and are effectively paying away their capital for the perceived safety of these investments.

The challenge is also one of sequencing. Investors that have been aggressively positioned have benefited from asset price rises, and now have more 'ability' to take defensive positions. Those investors that have been conservative (i.e. primarily concerned about capital preservation), especially those in cash, are now in a really bad position. Their capital has remained the same size, and its income generating power is decimated. Investors that are concerned about both capital preservation and having spending power are essentially being forced to take risk at some point, or they will face longevity risk (the risk of outliving savings).

CONSIDERATIONS FOR DEFENSIVE ASSETS PORTFOLIO

With the ballooning volume of negative-yielding debt, added to that the volume of debt that has yields just hovering above 0%, investors with a defensive mindset are finding themselves in a particularly difficult spot. The role of bonds as a portfolio diversifier has diminished. While the income that they provide continues to be 'stable', it may be negligible or negative. For those looking for capital preservation, traditional fixed interest is not even able to provide that when starting yields are negative.

Maintaining a defensive assets portfolio of cash and government bonds will mean accepting lower returns. But for investors who have specified risk and return tolerances and objectives, the traditional allocation to cash and government bonds may make such objectives unattainable. Investors are going to be required to take a closer look at how they can construct their defensive exposure, so that it will do what its name suggests – be defensive – while still having the potential to provide some real returns.

For investors who are willing to take a riskier stance, there are a lot of options they can consider, including emerging market and high yield debt. This is the path that Japanese investors have taken in the wake of negative yields in the Asian nation – searching for yield by investing in increasingly risky asset classes including high yield and emerging market debt, as well as equities. However, for investors who do not have the appetite to add risk to their portfolios, the options may be quite limited. That said, we consider that there are several opportunities for investors in less traditional fixed interest asset classes, the merits and drawbacks of which we discuss in the sections below.

Term Premium

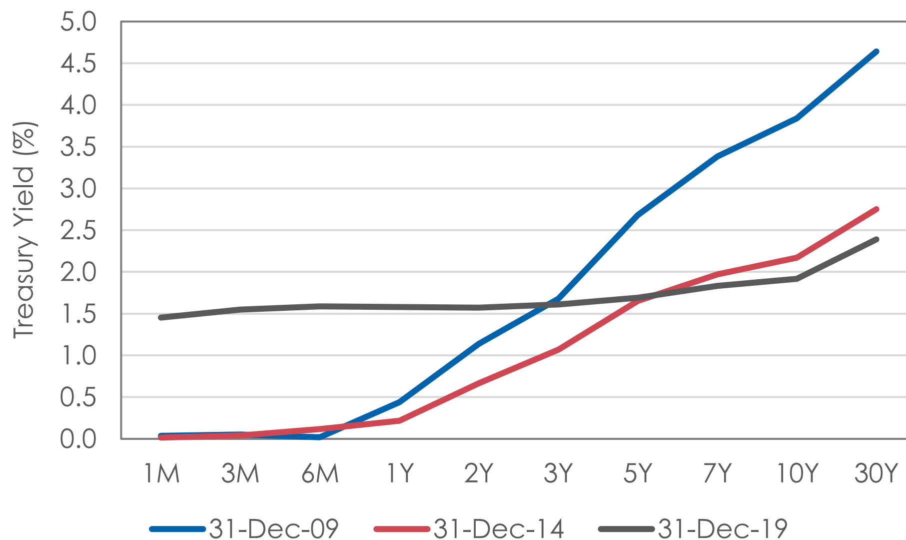
In an environment that looks set to see a continuation of low and negative yields, investors may be enticed to lengthen the duration of their portfolios. However, yield curves are currently very flat which means that investors are compensated with only a minimal term premium for holding riskier, longer-dated bonds.

The current and historical yield curve for US Treasuries is shown in Chart 7 below. The yield curve as of 31 December 2019 is clearly dramatically flatter than it was five years ago and 10 years ago. Investing in longer-dated fixed interest also has limited upside given the theoretical lower bound of interest rates (noting of course that there has proven to be some wiggle room around this bound), and the downside could be very large if interest rates were to increase even marginally.

That said, an area for a small amount of potential value add is by considering what can be done with an investor's cash allocation.

With cash rates as low as they are, investors that have cash allocations are earning next to nothing on their deposits. We consider that there is the potential for increased yield by carving out a portion of an investor's traditional allocation to cash and allocating to three and six month term deposits and notice period accounts. Notice period accounts and term deposits with major commercial banks bear low counterparty risk, but offer potential yield upside over cash. The size of the allocation is ultimately dependent on the investor's overall liquidity profile, as both term deposits and notice period accounts result in a fall in liquidity within the defensive assets portfolio.

Chart 7: Treasury Yield Curve, Current and Historical



Source: Bloomberg, Whitehelm Advisers

Securitised Credit

Institutional investors often favour traditional credit markets over securitised credit strategies (also known as asset-backed securities (ABS) or structured credit), however we consider that certain segments of the securitised credit asset class have the potential to be advantageous to investors in this low-yielding environment from both a risk and an income perspective. Securitised credit involves grouping a number of assets together that would individually not be economically viable for institutional investment, and selling all rights to cash flow and the individual security interests, if applicable, from these assets to investors. The assets can include personal or student loans, auto loans and mortgages.

Unfortunately, this asset class is tainted because of the GFC, however the defaults in securitised credit during the GFC were predominantly related to loan underwriting standards in US sub-prime mortgages. Other securitised credit assets performed reasonably well. In any case, a number of regulatory and structural improvements have been made in the market, including increased regulatory oversight of ratings agencies, stronger underwriting standards and improvements in modelling techniques.

There are a variety of types of securitised credit, including ABS, mortgage-backed securities (MBS) and collateralised loan obligations (CLOs), the last of which consists of the rights to cash flow and the security interest in corporate loans, generally those rated B and BB.

There are a variety of other benefits of securitised credit, including:

- they are often floating rate, meaning that investors are provided with credit exposure but without duration;
- senior tranches of securitised credit often have short maturities, which means that the credit spread duration is also relatively low;
- they can be invested in across a range of credit ratings, including AAA;
- they are considered defensive in relation to high yield and most emerging market corporate bonds. While yields on securitised credit are typically lower than those on high yield and emerging market debt, the volatility is typically lower; and
- senior tranches have built-in deleveraging functionality, which means that the securities' credit quality increases towards maturity.

Specific types of highly-rated MBS worth considering are US agency MBS, or those issued by the Federal National Mortgage Association (known as both FNMA and Fannie Mae), Federal Home Loan Mortgage Corporate (known as both FHLMC and Freddie Mac) and the Government National Mortgage Association (known as both GNMA and Ginnie Mae). Ginnie Mae is a US government agency, while Fannie Mae and Freddie Mac are US government-sponsored enterprises.

Ginnie Mae is a guarantor for federally backed loans and MBS, while Fannie Mae and Freddie Mac buy loans from commercial lenders, bundle them together and issue and guarantee the MBS. In other words, when residential homeowners default on their borrower obligations, Fannie Mae and Freddie Mac are responsible for the losses on the loans they guarantee, while Ginnie Mae issuers are responsible for the delinquent debt. As such, agency MBS essentially has credit risk equivalent to that of US Treasuries (negligible).

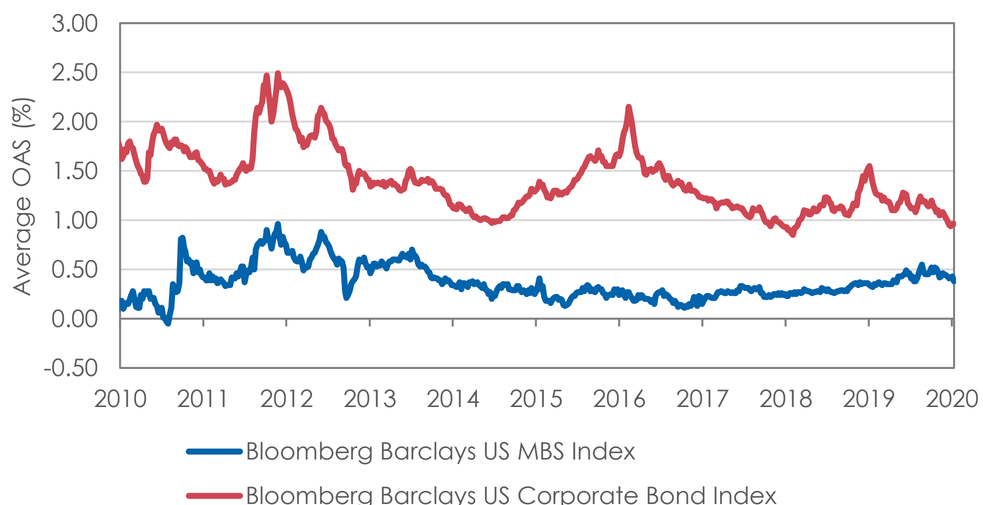
US agency MBS currently look attractive when compared to US investment grade corporate bonds, when we compare both spreads and risk. The difference between investment grade corporate bond spreads and MBS spreads narrowed to the lowest level the difference has been in a decade as of early January 2020, as per Chart 8 below.

While US investment-grade corporate bonds are currently yielding about 60 basis points more than US agency MBS, it is important to understand the difference in risk between the two asset classes. Presently, more than half of the issuers in the investment grade index have the lowest credit rating that allows them to still be classified as investment grade. Agency MBS, on the other hand, share the same high credit rating as the US government.

We consider that US agency MBS could play an interesting role in an investor's defensive assets portfolio as the asset class is expected to deliver higher returns than an allocation to government bonds. While the returns from the asset class would be below that of an allocation to investment grade corporate bonds, the higher credit rating on offer means that it could serve as an important portfolio diversifier. Furthermore, the US agency MBS market is the most liquid aside from the market for US Treasuries.

Mortgage REITs take MBS investing one step further. A mortgage REIT is a company that invests in MBS and pools of mortgages. It uses equity and debt to do so, with the debt generally secured by the mortgage investments themselves. Mortgage REITs are equity investments, but have an annualised yield of generally 5-10%, 90% of which they are required to pay as REITs. A deeper dive into mortgage REITs is beyond the scope of this article.

Chart 8: Investment Grade Corporate and MBS Spreads, 2012 – 2020



Source: Bloomberg, Whitehelm Advisers

Inflation-Linked Bonds

Inflation-linked bonds can offer a defensive investor inflation-specific protection, as they increase in value during inflationary periods. A number of governments around the world, including the United States, the UK and Australia, have issued inflation-linked bonds, with the American version referred to as Treasury Inflation Protected Securities (TIPS). TIPS and equivalents act as a hedge against inflation, and as a result, their returns typically have a low correlation with stocks and other fixed interest assets (that would react negatively to a surge in inflation). As such, they can provide investors inflation protection and diversification. Furthermore, the credit risk associated with TIPS is equivalent to holding a US Treasury, which is very low, as the counterparty is the US Government.

Real Assets

Real assets, including real estate, infrastructure and natural resources, are another asset class that investors are increasingly attracted to in this low-yielding environment. Valuations of core property and infrastructure have been increasing since the GFC, partly because valuation discount rates for these assets have been decreasing with the decline in interest rates.

Real assets, specifically core real estate and infrastructure assets, typically provide:

- diversification within a multi-asset portfolio: unlisted real assets typically have low correlations to other more traditional asset classes, which reduces overall portfolio risk. The factors that drive the prices of real assets are usually different to equity and bond prices;
- a hedge against inflation: the value of real assets, specifically unlisted real estate and infrastructure, tends to increase with inflation;
- a store of value over the long term: they are hard, tangible assets that provide a store of value. Additionally, the value of assets that are in markets with high barriers-to-entry tend to increase over time; and
- reasonably stable and predictable cash flows: most real assets are linked to contractual revenue such as concession agreements and long-term leases, which are more stable and predictable than income streams from other asset classes (dividends from shares, for example).

It is of course worth noting that there are several risks involved in investing in real assets, including duration, financing/leverage risk and illiquidity risk, among others.

There has been a push by global institutional investors into real assets for some time, and this push is only expected to strengthen. This has driven up real asset valuations, which is of benefit to those already invested, but is a barrier to entry for those who have not. Valuations are expected to continue to rise as the global push into real assets by institutional investors continues. This will help with the capital appreciation component of the return on real assets for early movers. However, it does make it challenging for institutional investors, as future investments are unlikely to perform as well as current holdings.

Infrastructure Debt

The section above on real assets focused on the role of real assets in general, but a subclass that is particularly interesting from a defensive assets portfolio perspective is infrastructure debt. Infrastructure assets tend to have capital structures that are majority financed by senior ranking debt and the rest as equity and/or subordinated debt. Infrastructure debt is less risky than infrastructure equity as equity investors are lower on the capital structure and take the first loss in the case of an unanticipated fall in revenue, for example. The stability and low volatility of infrastructure asset cash flows, and debt investors' position in the capital structure, makes infrastructure debt reasonably secure. This is reflected in its very low default and impairment rate over time relative to comparable corporate debt.

Infrastructure debt is a heterogenous asset class, but it can offer higher yields than similarly rated corporate bonds. There are a couple of reasons for this, one being that infrastructure debt is more complex than corporate debt, and has higher barriers to entry. Furthermore, infrastructure debt is more illiquid than corporate bonds, so investors in infrastructure credit earn an illiquidity premium. As such, the appropriateness of an infrastructure credit allocation within a defensive assets portfolio is highly dependent on liquidity needs.

Gold and Other Commodities

A more leftfield idea that has been gaining attention recently is carving out a portion of a defensive assets portfolio for gold, or its equivalents. Historically, gold as an asset class has been overlooked and often questioned by institutional investors for a variety of investment and practical reasons. The most obvious is that gold does not bear any yield, rather the only way to profit by holding gold is if the price increases.

However, in a world where a third of global bonds bear a negative yield, gold may be worth another look. It has a relatively higher yield compared to the government bonds that are negative yielding, and does not bear any counterparty risk. It typically retains its value because of its relative scarcity. The price of gold often increases during periods of financial market or economic stress given its position as a safe haven asset, however the persistence of the low yielding environment has also provided support for the gold price. The relationship between the gold price and the volume of negative yielding debt is shown in Chart 9 below.

Chart 9: Gold Price vs. Negative Yielding Debt, 2015 - 2019

Source: Bloomberg, Whitehelm Advisers

Other commodities also stand to benefit from the negative yielding environment. On one hand, negative interest rates reduce the opportunity cost of holding commodity reserves in the ground, which could reduce the supply, all else equal. On the other, the impact that negative government bond yields, and bond yields in general, has on expected returns across most asset classes, increases the attractiveness of investing in commodities. A potentially reduced supply and an increased demand make commodities a potentially lucrative (but very risky) asset class in this market environment.

While gold and other commodities look attractive on paper, is it practical or suitable for institutional investors to be investing in these volatile assets? In our view, the idea is theoretically appealing in adding yield to a defensive portfolio, but is unlikely to be suitable from the perspective of providing broad portfolio protection. If an investor were to invest in gold, a great deal of caution and a high tolerance for risk would be required.

Insurance-Linked Securities

Insurance-linked securities (ILS) can provide an investor diversification in a completely different manner. ILS are financial instruments that are linked to property losses caused by natural and man-made catastrophes whose values are driven by insurance loss events.

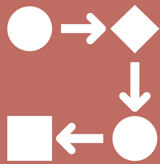
There are several different types of ILS, but the most common is catastrophe bonds (cat bonds). Cat bonds were first introduced in the 1990s, following a series of natural disasters that had significant financial consequences for insurance companies. Cat bonds transfer the risk associated with major catastrophes from the insurance company to the investor.

Cat bonds can appear appealing to investors, through both the yields on offer being higher than those paid by government bonds, but also because of the diversity they can add to a multi-asset portfolio. While appealing from a diversification perspective, cat bonds bring about a 'fat tail' risk, meaning that when losses occur as a result of catastrophe, they will be significant. So, for an investor primarily concerned about getting as much yield as possible out of the defensive assets portfolio, ILS, and cat bonds in particular, may be attractive, however we do not consider they provide enough protection to investors with any amount of focus on downside protection. Finally, given that we are at the height of a natural disaster with the ongoing bushfire crisis, now is probably not the time to get Trustees of superannuation funds comfortable with catastrophe risk.

Summary

In the discussion above, we reviewed several asset classes which institutional investors may consider in their asset allocation positioning for their defensive assets portfolios. We consider that some, including term deposits, securitised credit, real assets and infrastructure debt are the most suitable for additional consideration as forming a component of an investor's defensive assets portfolio. Investors in managed global credit strategies may already have exposure to these asset classes, so assessing the investment constraints and allocations to such investments is a way of potentially increasing exposure to these attractive asset classes.

On the other hand, insurance linked securities and gold and other commodities may look attractive from the perspective of yield relative to negative yielding government bonds, but investing in them would require a significant amount of due diligence to ensure that they are appropriate from a portfolio defensiveness angle.



CONCLUSION

With the start of a new decade, we often stop to consider what the next decade will bring. Over the past few weeks, it has become apparent that the next decade will be interesting from a variety of perspectives. An American election later this year will shape the American political climate but will also have a significant impact on geopolitical tensions. A tit-for-tat show of military force in the Middle East between the United States and Iran could foreshadow an escalation of tensions over the coming decade. The breadth and intensity of the bushfire season in Australia also acts as an omen of what a changing climate actually means.

Ultra-low and, in many cases, negative, interest rates are expected to be even more of a surety over the next few years. At the close of the past decade, central bank policy shifted back towards an accommodative stance. Paired with the structural factors that are keeping inflation and growth down, we expect that interest rates are likely to remain ultra-low for a while yet.

This environment causes the historically attractive characteristics of traditional high quality fixed interest into question. No longer is an allocation to government bonds and cash going to provide the stable income and diversification that it once did.

As discussed in this article, we expect that investors need to consider the implications that the negative yielding environment has on their asset allocation across their entire portfolio, but most specifically on their defensive portfolio. The traditional allocation to cash and government bond yields will still provide the safety that is usually desired in a defensive portfolio, but is unlikely to provide a means for meeting return targets. Asset classes that have been overlooked in the allocation of a defensive assets portfolio are now becoming more appealing, and sought after.

While institutional investors such as Australian superannuation funds may still be a ways off comfortable in having meaningful allocations to asset classes such as gold and other commodities, a divergence from 'traditional' fixed interest is widely anticipated over the next decade. Finding yield, while also providing the portfolio protection, will require creativity and innovation, which could include expanding the investment horizon to some of the asset classes discussed within this article.

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