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BY HILDA OCHOA-BRILLENBOURG

Monetary Policy Trumps All

Some words of caution.

The financial crisis of 2007–09 presented challenges to investors, but it was the official response to that crisis that has truly turned the world upside down. As a result, fiduciaries responsible for guiding the investment decisions of pensions, endowments, and other long-horizon institutional funds cannot rely simply on long-term capital market return patterns to form judgments on expected returns, relative asset valuations, and asset allocation.

In particular, investors can no longer trust the signals provided by the fundamental cornerstones of financial markets, by which the relative valuations of other assets are judged: the risk-free rate and Treasury yields. The signals emanating from these key indicators have been severely distorted all along the maturity spectrum by the Federal Reserve Board's extraordinary intervention. Fed policy has pushed nominal and real interest rates to record lows in a bid to provide the requisite life support to a faltering economy. Furthermore, the Fed expects that it will need to maintain rates at these exceptionally low levels through 2014.

Faced with this prospect, investors need to rethink capital market expectations informed by

long-run historical experience. Yields on ten-year Treasury notes are currently negative in real terms, and real short-term interest rates are likely to remain in negative territory through 2014. Yields held at these levels call into question the role of Treasuries in an institutional portfolio and overstate the relative attractiveness of other assets.

As a result, long-term investors need to reconsider the usefulness and appropriateness of government bonds in their portfolios. A case can be made that such instruments should be reduced to the minimum required to provide adequate liquidity to meet rebalancing needs and flows out of the portfolio, and to hedge the risk of disinflation and depression. Warren Buffet put it bluntly: government bonds should carry warning labels.

Treasuries are likely to deliver less than a 1 percent real return pre-tax over the next ten years, unless the U.S. economy falls into a deflationary environment in the meantime, precisely the scenario that Fed policy is trying to avoid. Our estimates of the most probable pre-tax real returns for a constant maturity ten-year Treasury note over the next ten years range from ten to 100

Hilda Ochoa-Brillenburg is Founding Partner, President, and Chief Executive Officer of Strategic Investment Group.

basis points, depending on how quickly real yields return to long-term equilibrium levels of 230 basis points.

Table 1 shows what the realized real return on a constant maturity ten-year Treasury note would be over the next ten and fifteen years if real yields reverted to their historical norm over a period of one to ten years.

As shown, the faster the Fed disengages from a policy of negative real yields, allowing yields to revert to more typical levels, the higher the expected return on bonds. For example, if the reversion to a real yield of 230 basis points occurs in one year, the annualized expected real return of a constant maturity ten-year Treasury note over the next ten years would be 110 basis points. If, in contrast, it takes ten years, the annualized real return would be ten

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basis points. Over the last eighty-plus years, the real return has been 2 percent to 3 percent.

Bond returns over the next ten years are thus very likely to fall well short of historical experience. Asset allocation policies based on return expectations informed by historical experience are also likely to fall short of their

Table 1 Real Returns of a Constant Maturity Ten-Year Treasury Note Reverting to Normal Yield		
Time to Equilibrium (years)	Estimated Real Return	
	Ten-Year Investment Period	Fifteen-Year Investment Period
1	1.1%	2.0%
3	1.0%	1.9%
5	0.7%	1.8%
7	0.5%	1.6%
10	0.1%	1.4%

Investors and Savers Beware

The Fed chairman insists that an accommodative Fed policy does not come out of the hide of taxpayers. It is hard to see how that statement squares with the facts. An accommodative negative real rate policy may be a necessary evil to avoid worse outcomes for the U.S. economy, but the cost to investors and savers is all too real.

—H. Ochoa-Brilllenbourg



Ben Bernanke

return objectives. On this basis, there is a strong argument that government bonds should only be held to meet threshold liquidity and portfolio rebalancing needs. As never before, they have now become a wasting asset.

Given this, expectations for bond volatility as informed by historical experience may also be misleading. Allocations to government bonds on the basis of their historical characteristics need to be reexamined and new allocations developed on the basis of a more realistic assessment of expected returns for bonds as well as for other asset classes. Table 2 lays out our expectations for asset class returns over the next ten years.

The impact of lower expected real returns for government bonds on a total institutional portfolio could be significant. That said, liquidity and rebalancing needs in unleveraged portfolios create a natural floor for the

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Table 2 Estimated Real Returns	
Asset Class	Estimated Real Return
U.S. Equity	6.8%
Non-U.S. Equity	6.9%
EM Equity	8.3%
Private Equity	8.5%
Directional Hedge Funds	4.2%
Market-Neutral Hedge Funds	1.4%
Real Estate	2.8%
TIPS	0.2%
Commodities	5.0%
U.S. Fixed Income	0.4%
High Yield	3.0%
Non-U.S. Fixed Income	0.3%

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allocation to Treasury holdings, which varies with the circumstances of the institution and the allocation to other illiquid or volatile assets in the portfolio. A 10–15 percent allocation to government bonds is a reasonably comfortable floor for many institutions with unlevered globally diversified portfolios and a 20–40 percent allocation to less liquid assets such as hedge funds, private equity, and real estate. At that level, assuming the real returns implied by our expectations above, currently depressed real bond yields would reduce total portfolio returns by approximately thirty basis points annualized over the next ten years. Institutions with higher allocations to government bonds would see their

Table 3 Reduction in Estimated Return of Broadly Diversified Portfolios Resulting From Low Treasury Yields

Portfolio Bond Allocation	Impact on Total Portfolio Estimated Return
20%	-0.3%
30%	-0.4%
40%	-0.6%
50%	-0.7%

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returns reduced more significantly, as Table 3 illustrates.

Those institutions counting on historical returns to pay for long-term obligations should seriously review their assumptions and constraints to make sure that they are not blindsided by the current realities of a market distorted by an uncommonly accommodative Fed policy. More precisely, a 30–70 basis point reduction in annual expected returns over a ten-year period in an environment of, say, 8 percent average nominal returns means a terminal wealth that is five to thirteen percentage points lower than would have been otherwise realized. It also means that such institutions would have roughly 5–10 percent less available to spend pre-tax on a yearly basis to meet spending and other budgetary needs.

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