Cuffelinks
Connecting investors with ideas

Edition 168, 12 August 2016

This Week's Top Articles

Five ways for investors to find true value

Craig Baker

Fees are firmly in focus and quite rightly so. Regulators, the media and asset owners are more fee-aware than ever. But in their desire to compare headline fees across products, investors risk missing the bigger picture. A single-minded focus on headline fees comes at the expense of finding true value for money as well as measuring and managing hidden costs that impact fund performance.

The investment universe is heterogeneous and no two products are exactly the same. All investments need to be assessed and considered independently. Investors need to ask themselves five key questions to establish if they are getting value for money:

1. How large are fees as a proportion of added value?
2. How accessible is the asset class?
3. How much is the manager doing for the fee?
4. What is in the small print?
5. How do I understand and measure the hidden costs?

1. Fees as a proportion of added value

Fees should be proportionate to the amount of active risk taken, i.e. the extent a manager's portfolio deviates from that of its respective benchmark. Assuming the manager has skill, greater active risk gives greater active return (sometimes called 'alpha') above a passive portfolio following the same benchmark. Therefore, asset owners are able to invest less capital to achieve a given level of alpha since the manager is making more active decisions. This should be compensated with a higher fee, all else being equal. Conversely, closet index trackers delivering a low level of alpha should be paid close to passive fees.

Many active managers add value through their largest overweight (highest conviction) positions, only for this to be eroded by a large tail of smaller holdings they have little or no conviction in. The large number of smaller holdings keep the manager's tracking error down, but at the expense of offsetting the alpha. By focusing an equity mandate on, say, 10-20 stocks, investors get a concentrated portfolio of best ideas. It is then possible to build a diverse, highly-active portfolio of concentrated managers which has similar systematic and sector risk exposures as the benchmark.

2. Hard to access assets

Manager fees should be higher when the cost of doing business is greater. A good example of this is direct lending, where the manager organises and contracts on each deal rather than simply buying pre-packaged units from an exchange. Typically, strategies such as direct lending have no low-cost or passive alternatives and are often hard to transact, so investors should expect to yield an illiquidity premium.

3. How much is the manager doing?

Managers can add value over and above active risk through more 'management' of a fund, such as stewardship, activism through private equity and varying gross and net exposures.

Stewardship can add significant value: a CEO’s remuneration package, for example, can be larger than the fee paid to the asset manager, yet few managers vote against CEO pay.

Then there is private equity: firms operating private equity strategies contend with M&A costs, debt fees, placement fees, as well as board and consultancy fees. These can be a significant part of the private equity manager’s fee, yet these costs are also paid in public equity mandates where they are hidden in the companies’ profit and loss accounts.

Investors might also pay for products that provide more exposure to alpha or higher gross exposure.

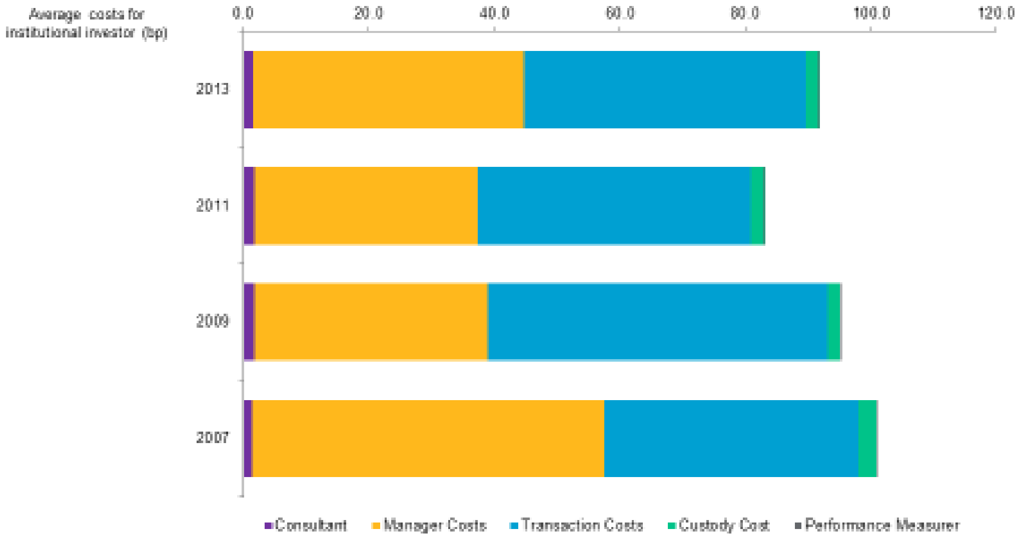
4. Check the small print

The way managers calculate and accrue fees can also make a big difference. Even if the headline fees are the same, a performance fee with a high watermark and hurdle will align managers and investors much better than those without either of these mechanisms.

5. Measuring and managing hidden costs

The chart below shows the total costs paid by the average institutional investor globally over time. While manager fees now represent less than half the total costs paid by institutional investors, they are still sizeable and can be reduced further. Note that transactions costs are often higher than management costs, yet there is far more focus on the latter.

Estimate of average costs for institutional investors, basis points per annum



One way to reduce expenses is simply transact less often, such as by creating mandates that embrace long-termism. Following work done by our Thinking Ahead Group in 2003 and 2004, a number of our clients invested in long-term equity mandates. These long-term mandates have been a success from a performance perspective, with our model portfolio returning CPI+4.9% pa, or Index+2.1% pa, over the 11-year period to end-2015.

Another way of reducing transaction costs is to ensure best execution, a potential issue for alternative beta funds managed by investment banks, for example.

Administration fees, trading costs and expenses

There is also a huge number of hidden costs which are easy to ignore but which can have a material impact on the portfolio. They fall under the broad umbrella headings of 'administration costs' (such as custody and auditing), 'trading costs' (such as dealing commissions and foreign exchange transactions) and 'expenses', which can be just about anything.

Administration costs are the only ones that tend to be included in a given total expense ratio. It is likely, over time, that trading costs will start to be included in total cost comparisons, with an unbundling of execution and research costs driven by regulation.

Foreign exchange is another cost that few investors focus on. Many active managers have poor forex processes, with the design and execution left to back office teams which may not fully understand the 'all in' cost of the strategy.

Finally, there are expenses on items such as Bloomberg terminals, travel costs and indemnity insurance, which we believe should be part of the management fee.

Conclusion: ask questions and seek transparency

In an age where everything and everyone is under greater scrutiny, high costs are naturally raising questions about how much value the industry creates. Investors need to ask the right questions that lead to where the real costs lie and how they can then be addressed.

One way to manage cost issues is via managed accounts, or a managed-account platform, where investors pay the manager a management fee and the managed account provider controls the remaining costs – from prime brokers, to forex, to custody. This has the added benefit of full transparency for each underlying position.

Craig Baker is Global Chief Investment Officer at Willis Towers Watson. This article is general information and does not consider the investment needs of any individual.

Three risk measures provide a fuller LIC picture

Nathan Umapathy

Historical returns can be a good guide when evaluating the merits of a Listed Investment Company (LIC). However, investment performance represents only one side of the risk-reward equation. Investors also need to factor in the risk metrics when assessing a LIC, such as the following three:

- Beta
- Standard deviation
- Sharpe Ratio

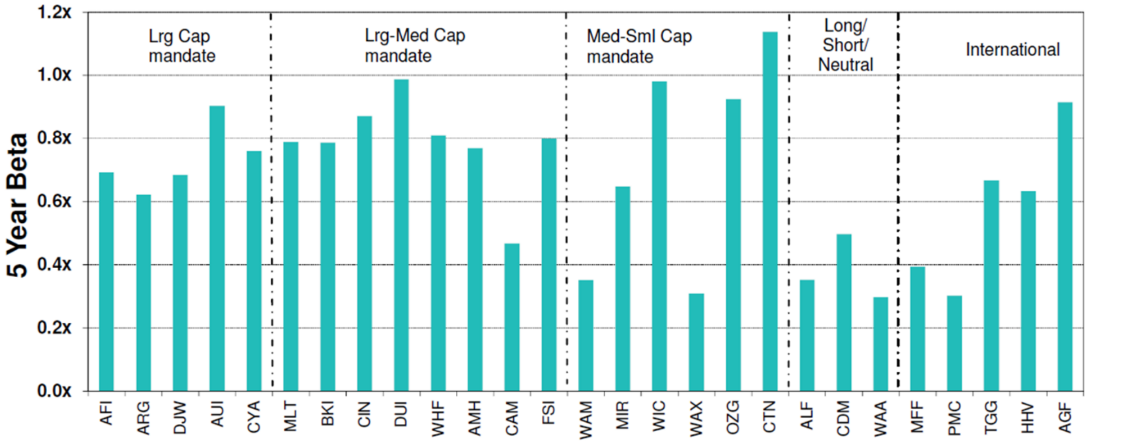
Beta

Beta measures the magnitude of a LIC's movement relative to its benchmark. A beta measurement of 1 conveys that the LIC is moving in line with its benchmark. A beta of less than 1 indicates it is less volatile than its benchmark, and a beta of more than 1 suggests that the LIC is more volatile than the benchmark.

For example, if a LIC has a beta of 1.1 in relation to the S&P/ASX All Ordinaries, then the LIC historically has been 10% more volatile than the index. Therefore, if the S&P/ASX All Ordinaries has gained 10%, with everything else being equal, the LIC would be expected to have gained 11% (10% x 1.1). The reverse is true if the index has fallen.

In Chart 1, we calculate some LIC's five-year share price beta. Overall, it suggests that the share price movement of the LIC is lower than the market. This also suggests that the inherent active nature of a LIC would be a good addition to an investment portfolio to smooth out long-term volatility.

Chart 1: Five Year Share Price Beta



SOURCE: BELL POTTER & BLOOMBERG

Other observations from the graph:

- LICs within the Large Capitalisation and the Large to Medium Capitalisation mandate have a beta largely between 0.6x-0.9x compared with the market. This suggests that, with the right LIC, an investor could achieve the same performance as the market with less risk.
- All the Wilson Asset Management LICs (ASX: WAM, WAX and WAA) have a beta of less than 0.5x due to their historically high portfolio weighting in cash.
- Australian Leaders Fund (ASX: ALF) and Cadence Capital (ASX:CDM) have low betas due to their ability to short investments in comparison to their benchmark.

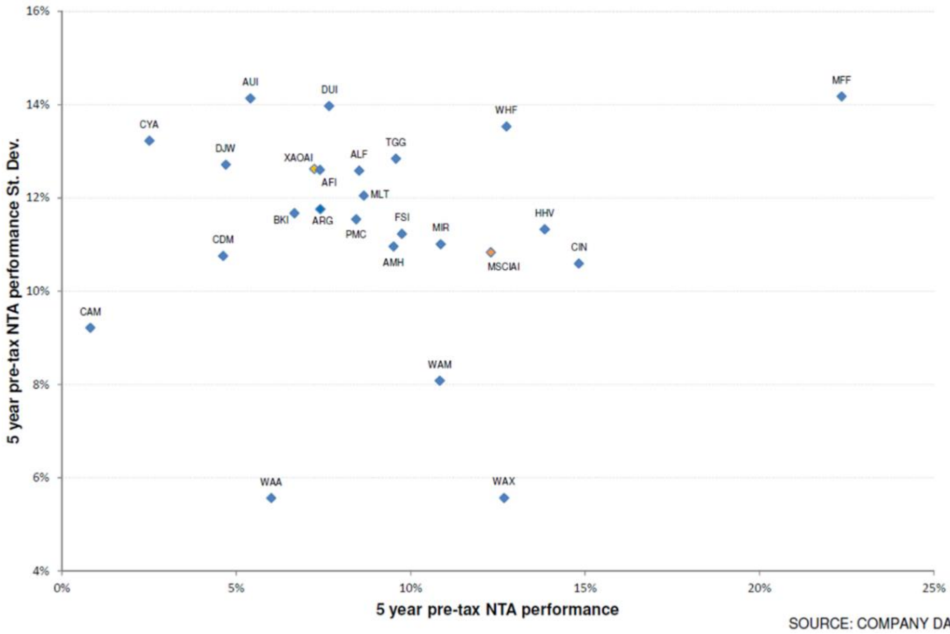
Standard deviation

Standard deviation is a statistical measurement of historical volatility and is the most common definition of risk. It measures a LIC's dispersion of investment return from its historical average. A larger standard deviation indicates higher volatility.

We use the pre-tax net tangible assets (NTA) as our data point to assess the standard deviation. The pre-tax NTA represents a better measure of a LIC's investment performance.

Chart 2 reflects the pre-tax NTA performance of LICs over the past five years. This is reflected by its position along the horizontal, with LICs further to the right achieving higher returns. The graph also highlights the standard deviation of the LIC's pre-tax NTA performance. This is reflected by each LIC's positon along the vertical axis, with more volatile LICs positioned higher on the graph.

Chart 2: Pre-Tax NTA Performance Standard Deviation vs Pre-Tax NTA Performance



SOURCE: COMPANY DATA, IRESS & BELL POTTER

Other observations from the graph:

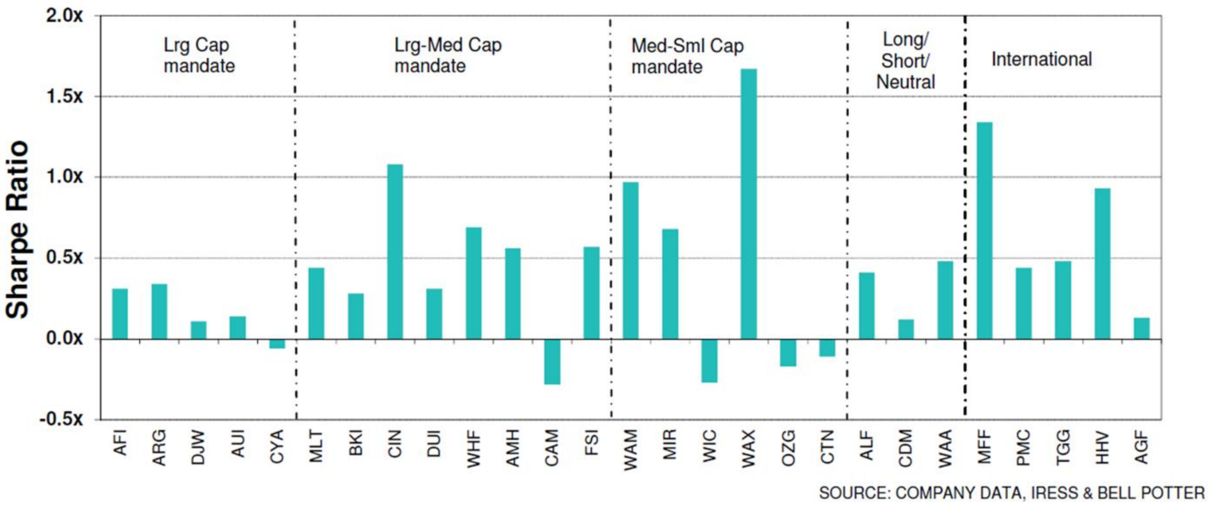
- Century Australia Investments (ASX:CYA) and Australian United Investment (ASX:AUI) have domestic investment mandates but slightly higher risk profiles than the S&P/ASX All Ordinaries Accumulation Index (XAOAI).
- Diversified United Investments (ASX: DUI) also has a higher risk profile due to its holding International exchange traded funds (ETFs) in its underlying portfolio.
- The majority of LICs have a lower standard deviation than the S&P/ASX All Ordinaries Accumulation Index, of 12.6%. And nearly half of these LICs outperformed this index.
- Wilson Asset Management LICs (ASX: WAM, WAX & WAA) attributes its low standard deviation to holding a significant amount of cash.
- Magellan Flagship Fund (ASX: MFF) has been the best performing International LIC on a risk-adjusted perspective.

Sharpe Ratio

The Sharpe Ratio reflects the ratio of all excess returns over the risk-free rate divided by the standard deviation. The higher the Sharpe Ratio, the better the LIC's performance in proportion to the risk it's taken. A LIC with a negative Sharpe Ratio would suggest that a risk-free asset (example, government bond) would be a better investment.

Chart 3 below shows the Sharpe Ratio of some LIC's investment performance over the past five years.

Chart 3: Five Year Pre-Tax NTA Sharpe Ratio



Key notes from the graph above are:

- Large market cap LICs and large-to-medium cap LICs have an average Sharpe Ratio of 0.36x, which is also the ratio for the S&P/ASX All Ordinaries Accumulation Index.
- International-focussed LICs have outperformed risk-free assets over the past five years.

Conclusion

The return is only one side of the investment equation. Investors also must be aware of the risk they are assuming to achieve those returns before they can make an informed judgement when comparing LICs.

These three metrics do not tell the complete story. However, they should be used together with historical return, and qualitative factors such as investment philosophy, management experience and the cost of running the LIC. Together, these factors will make investors far more informed when determining which LICs to add to their portfolios.

Nathan Umapathy is Research Analyst at [Bell Potter Securities](). This document has been prepared without consideration of any specific client's investment objectives, financial situation or needs and there is no responsibility to inform you of any matter that subsequently may affect any of the information contained in this document.

For the latest Bell Potter Quarterly Report, click here, and for the Weekly NTA update, click here.

Low SMSF returns highlight value of retirement advice

Melanie Dunn

Much has been made of the current low-return environment and its potentially long-lasting consequences. People using retirement projection tools might find their return assumptions are unlikely to materialise.

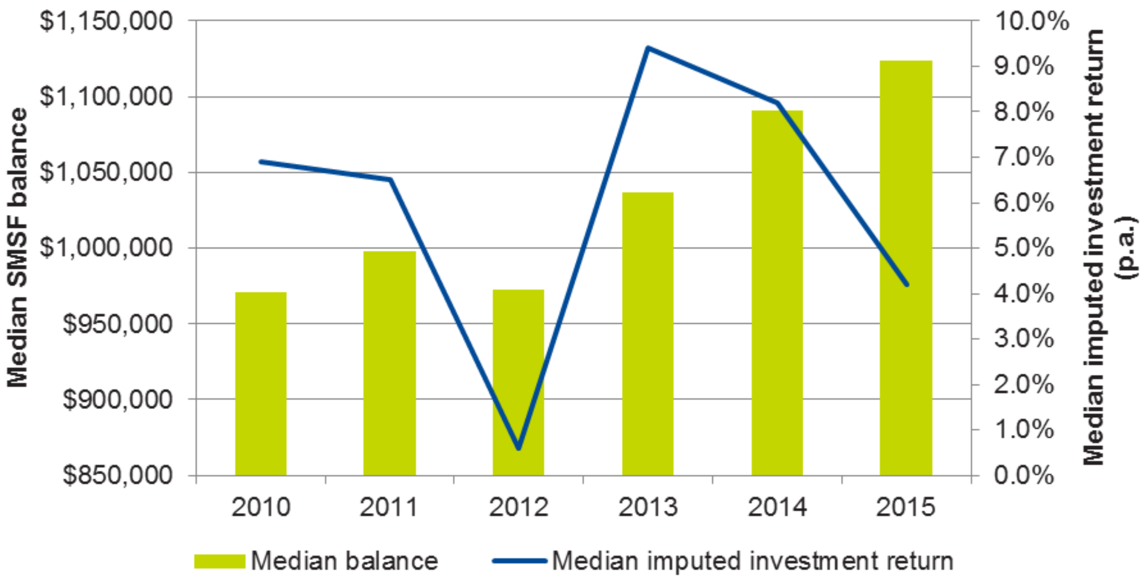
In light of this uncertainty, retirees need to factor risk into their retirement planning, and advisers should make them aware of a range of investment outcomes.

Retirees can then use this information to decide when they can afford to retire, or what level of spending they can sustain over the course of their retirement.

2015 SMSF returns and fund balances

Research conducted by Accurium and the SMSF Association of over 65,000 SMSFs looked at how the retirement adequacy of Australia's SMSF trustees has changed over the 2015 financial year. The study found the median balance for two-member SMSFs increased by 3.0% over the year to $1.1 million, based on a median investment return of 4.2%. This is lower than the average return over the previous five years of 6.2% per annum for the SMSFs in the study.

Chart 1: Median SMSF balances and investment returns as at 30 June



Note: Imputed investment returns are calculated net of administration expenses and gross of income tax. These imputed investment returns should not be used in comparisons with other superannuation sectors.

Fewer SMSFs are large enough for comfortable standard

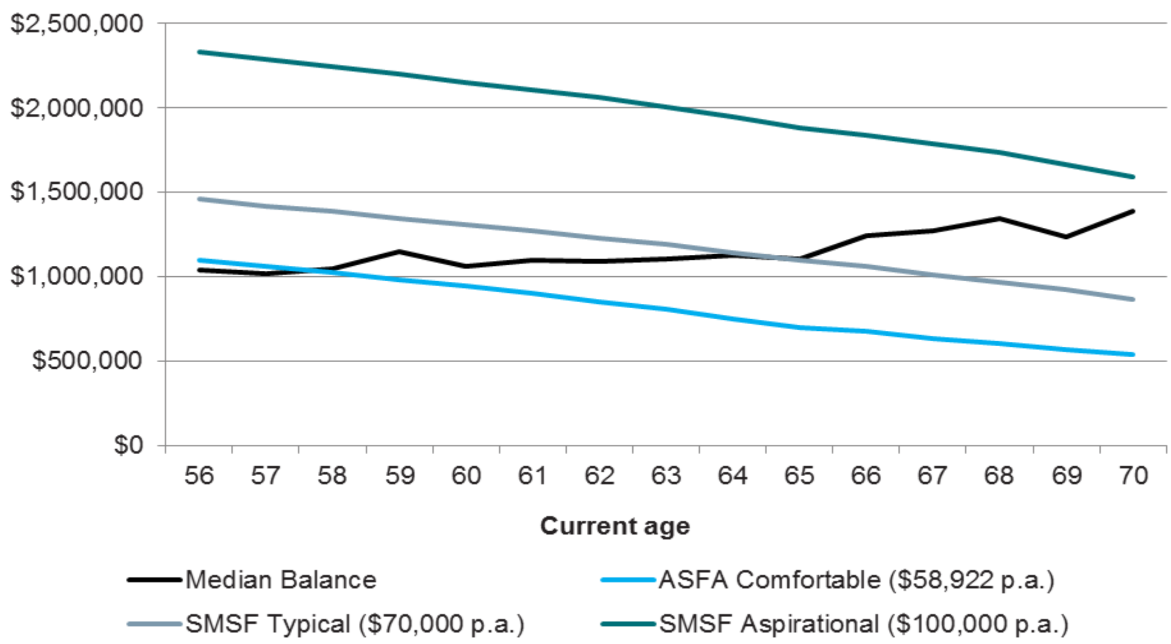
The research used Accurium's health**check** to determine retirement adequacy, a retirement projection model that considers 2,000 economic and demographic scenarios and provides estimates of the savings needed to afford different lifestyles with different levels of confidence.

The research found that a 65-year-old couple will need $702,000 in savings to be confident of affording the ASFA Comfortable Retirement Standard, which is currently $58,922 per annum for 65-year-old couples. This is at the 80% confidence level, meaning retirees still have a one in five chance of outliving their savings. It also assumes an asset mix consistent with the ATO average for SMSFs in pension phase. Age pension entitlements, tax and superannuation settings are allowed for.

The results are testament to the success of the SMSFs in the sample, given about 70% of the couples in the research have enough in their funds to afford this lifestyle. However, that comes with an important caveat. Lower-than-average returns in 2015, together with a weaker economic outlook, mean fewer SMSF couples are in this fortunate position compared with a year ago, where 75% were on track for a comfortable retirement.

Lower expected returns are also affecting those aspiring to a higher standard of retirement living. For example, the study found a 65-year-old SMSF couple will need $1,886,000 in savings to be reasonably confident of having an income of $100,000 p.a, as shown in Chart 2. The proportion of 65-year-old SMSF couples with sufficient assets in their SMSFs to support this lifestyle has fallen from 34% to 29% over the past year. (Spending levels are assumed to keep pace with inflation, and allow for changing circumstances as retirees age. Specifically, spending is assumed to reduce by 10% once retirees reach age 85 and to drop by 30% once one spouse passes away).

Chart 2: Savings needed for different spending levels with 80% confidence vs. median SMSF balance



SMSF retirees can also achieve higher retirement living standards with savings outside of superannuation. However, the study highlights the need for trustees either in or preparing for retirement to review their plans.

The research also analysed the sustainability of individual SMSF households' retirement plans based on their desired spending levels and their savings, both inside and outside their SMSF. Of the 1,500 households in the study, three in five could be reasonably confident that their savings would last as long as they do.

Our study also found a clear correlation between wealth and sustainability. It might seem intuitive that those with more wealth are more likely to sustain their desired retirement spending levels. However, the study revealed that SMSF retirees do not automatically increase their spending in line with greater wealth.

Value of retirement risk advice

SMSF trustees and their advisers need to assess their plans before and during retirement, depending on how much trustees need to spend per annum, how to meet essential expenditure and how to adjust asset allocations as a response to lower-yielding markets.

To do this effectively, advisers, or those going it alone, need the right projection tools that don't just use average returns and lifespans, such as Accurium's retirement health**check,** to consider a range of outcomes. To access Accurium's research paper *SMSF Retirement Insights: Are trustees prepared for retirement?*, prepared in conjunction with the SMSF Association, click here.

Melanie Dunn is SMSF Technical Services Manager at Accurium. This article is information only and illustrates the value of providing retirement risk advice to SMSF trustees and is not intended to be financial product advice, legal advice or tax advice, and should not be relied upon as such. Advisers and SMSF trustees may need to seek appropriate professional advice.

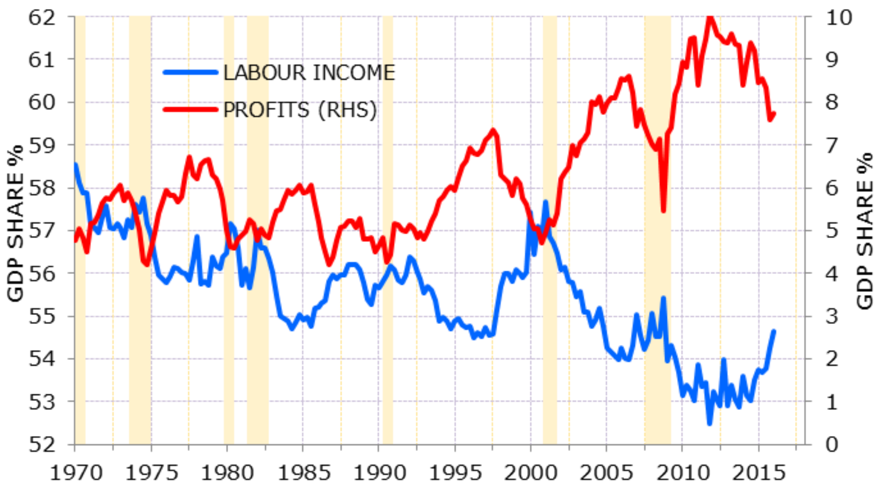
Income inequality and a crumbling model for capitalism

Justin Braitling

Economic rationalism – that is, a belief in free markets, deregulation, and globalisation – has been a hallmark of progressive governments in the West since the demise of socialism. While these policies have sustained productivity and growth, the spoils have not been evenly shared as living standards in low and middle income households have stagnated in many developed countries. The median income for an American male is unchanged in real teams over four decades. The promise of open markets and capitalism has sadly failed the middle class and their dissident voice is becoming louder.

You can see a clear divergence emerging in the share of incremental growth going to labour versus capital by way of profit share in the graph below.

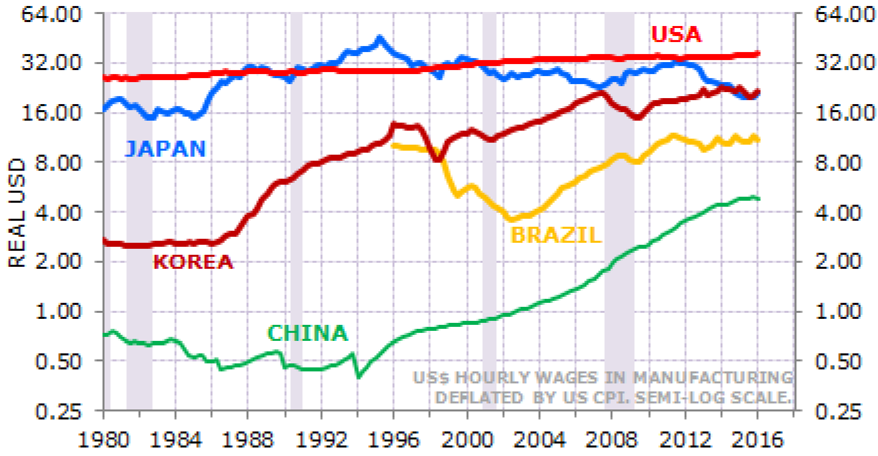
US labour income and profit share



Source: Minack Advisors

Owners of capital, aka the wealthy, have benefited tremendously from soaring returns on capital. Real wages on the other hand have lagged well behind productivity improvements. The impact of globalisation on low-skilled jobs has been an important contributor here. As capital has shifted to lower labour-cost destinations, the owners of capital have benefited from the immediate uplift in productivity, while the workers that have been displaced have seen living standards fall. The graph below illustrates the 10-fold increase in real wages in China versus stagnation in the US and Japan.

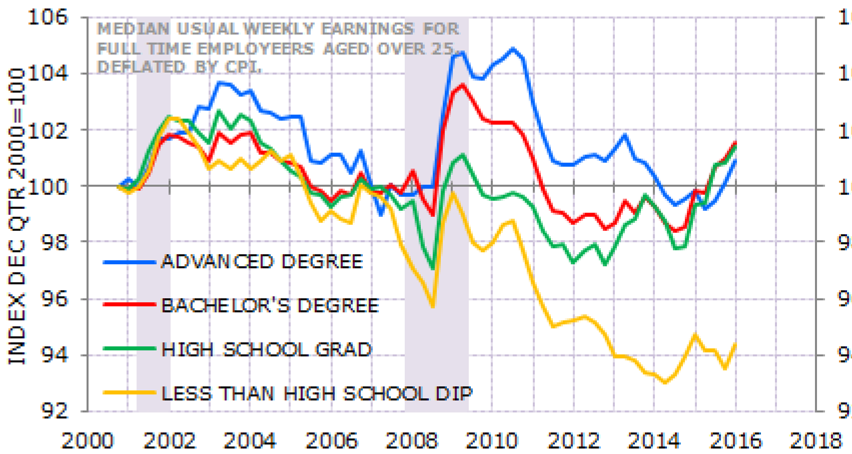
Manufacturing hourly pay in real US$ terms



Source: Minack Advisors

Migration and open borders, another feature of globalisation and political union, has intensified this threat to job security. In the graph below, you can see how immigration has put downward pressure on the real wages of unskilled workers in the US. Austerity policies in the aftermath of the financial crisis have further stressed households dependent on social services. To them it seems unfair that the banks get bailed out yet they pay the cost through austerity.

US weekly median pay by education level



Source: Minack Advisors

Falling interest rates, another feature of the 'great moderation' of the past 20 years, have only exacerbated this trend toward inequality. Those who own most of the assets have benefitted as asset values have been bolstered by lower interest rates. The asset poor have missed out, while real wages have fallen.

Financial markets and politicians missing the signals

The disenfranchised are rejecting these liberal beliefs, giving rise to the nationalist and extremist views that are gaining popularity in many western countries. The unexpected Brexit result in the UK, the ascendancy of Donald Trump in the US, and the rebuke to the LNP in the Australian election are all manifestations of this. The political class appear detached from the shift in public opinion. Financial markets, where the true acolytes of the neoliberal church reside, are even further removed. A consequence is the ongoing failure of markets to recognise the importance of this protest vote and the potential impact on favourable policies that have been tremendously beneficial to investors.

The shift in political mood and the prospect of a reversal in these market-friendly policies are a negative for the market outlook. The political establishment also seems a long way from recognising the problem. Consider the retribution to Brexit voters the European Commission is calling for, clearly far from a workable solution.

Make no mistake; this is a very loud voice, a voice that will become louder until we see a reversal in the divergent trends in the above graph. In the meantime, the political risks will grow, unsettling financial markets.

Shifting demographics, weak productivity and deleveraging are all features of slowing global growth. The precipitous fall in bond yields in recent weeks reflects this outlook, with many bonds now trading below the zero bound. Australia's 10-year government bond rate has slipped to 1.8%, fractionally above the cash rate. With the yield structure so flat and no carry or compensation for duration, it is hard to see any scenario where bonds can deliver anything but horrible returns in the medium term. Investors have been left with few choices, explaining the resilience of shares in the face of disturbing developments both politically and economically.

We feel more confident than ever in the merits of hedging strategies like those employed by Watermark. Bond yields are telling us the outlook for growth is as weak as it has been in a generation. There is no carry; a passive, buy and hold strategy will deliver low returns at best. Only an active strategy that can deliver enhanced returns through security selection stands a chance of delivering acceptable returns in this climate.

Justin Braitling is Chief Investment Officer at Watermark Funds Management. This article is for educational purposes only and does not consider the circumstances of any investor.

SMSF asset allocation moving in unexpected ways

Graham Hand

There has always been considerable misinformation surrounding the asset allocation of SMSFs. The main reason is the inadequate categorisation and long-time lags in the 'official' Australian Taxation Office (ATO) statistics. Cuffelinks has discussed this directly with the ATO, as reported in previous articles here and here.

The main shortcoming is that the category 'Overseas shares' only includes direct share investments, and excludes the billions invested through listed and unlisted trusts and other managed investments. When I confronted the ATO on SMSF asset allocation, their response was: *"It's fair to say a substantial amount is in international equities, much larger than the number quoted under the 'Overseas shares' category."*

According to the official statistic, less than 1% of SMSF assets resides in 'Overseas shares'. Considering that SMSFs hold one-third of our $2 trillion in superannuation assets, this inaccuracy is a major shortcoming. In fact, people marketing global funds often take advantage of this low number, imploring trustees to correct their ridiculous asset allocation mistake and invest in their global fund. The truth is, trustees are already using hundreds of other available global channels.

A more accurate SMSF allocation number

SuperConcepts has released its 2016 Financial Year Analysis based on the actual investments of about 3,300 SMSFs administered by its subsidiary Multiport. Due to its relationship with AMP, this group has more financial adviser input than the average SMSF, giving a greater allocation to managed funds and global equities, but it is instructive of SMSF trends nonetheless.

Asset allocation of sample SMSFs as at 30 June 2016

Sector	30 June 2015 (%)	30 Sept 2015 (%)	31 Dec 2015 (%)	31 March 2016 (%)	30 June 2016 (%)
Cash and short term deposits	17.0	18.7	18	18.4	18
Fixed Interest	12.9	12	12.3	12.3	12.2
Australian Shares	37.1	36.4	35.4	35.8	34.5
International Shares	14.1	12	12.9	12.6	13.1
Property	18.3	20.4	20.8	20.4	21.7
Other (Hedge funds, agricultural funds, private geared & ungeared trusts and collectables)	0.6	0.5	0.6	0.5	0.5
Total	**100**	**100**	**100**	**100**	**100**

Source: SuperConcepts Pty Ltd

The interesting and sometimes unexpected changes in the last year include:

- A fall in equity investments, with domestic down from 37.1% to 34.5%, and international down from 14.1% to 13.1%, refuting the claims about the TINA (There Is No Alternative to equities) mentality in the sector. SuperConcepts attributes this fall to trustees reducing their exposure during periods of higher volatility, and less appeal of the local large cap stocks. Among the most commonly held investments, two pooled structures, Magellan and Platinum, are favourites with this group for global exposure.

  Over the course of 2015/2016, the amount held in the top 10 listed securities fell from 16.5% of all investments to 14%. The Top 10 shares by market cap still represent about 38% of Australian equities held by SMSFs, but the reduction recognises that investors are more concerned about the capital growth of the banks, BHP, Newcrest, and Telstra. Increasingly, SMSFs are looking for opportunities outside of the large caps.

- Cash holdings have increased from 17% to 18% despite low interest rates. Within this segment, term deposits rose more strongly than at-call cash, which took a hit in the last quarter in the face of falling cash rates. It's surprising to see more in this segment.

	30 June 2015 (%)	30 Sept 2015 (%)	31 Dec 2015 (%)	31 March 2016 (%)	30 June 2016 (%)
Cash	12.3	13.1	12.6	13.1	12.5
Term Deposits < 1 year	4.7	5.6	5.4	5.3	5.5
Total %	**17**	**18.7**	**18**	**18.4**	**18**

Source: SuperConcepts Pty Ltd

- Property has been the big winner, up from 18.3% to 21.7%, including both listed and unlisted segments. Direct property (often business premises held by the SMSF and rented to one of the trustees, rather than residential property) rose steadily, but the major increase came in the 'other' category of syndicates and unlisted trusts. With listed A-REITS trading at a hefty premium to NTA, unlisted trusts have benefitted from the search for yield at better prices. Managed funds struggle to gain widespread support.

	30 June 2015 (%)	30 Sept 2015 (%	31 Dec 2015 (%)	31 March 2016 (%)	30 June 2016 (%)
Direct Property	14.6	16.5	16.5	16	15.7
Listed Property	1.7	1.7	1.9	2.2	2.1
Managed Funds	1.3	1.2	1.2	1.3	1.3
Other (Syndicates, Unlisted Trusts etc)	0.7	1	1.2	0.9	2.7
Total %	**18.3**	**20.4**	**20.8**	**20.4**	**21.7**

Source: SuperConcepts Pty Ltd

- Fixed interest allocations fell overall, but hybrids and direct holdings rose. Managed funds in this segment comprise only 4.4% of assets, losing out badly to cash.

(The full report also looks at market movements versus funds flow and makes the same conclusions regarding increases in cash and property and reductions in fixed interest and equities).

Trustees take cash flow decisions in the final quarter

Both inflows and outflows from SMSFs are always at their highest in the June quarter as trustees take action before the end of the financial year. However, with uncertainty surrounding the May 2016 budget, average inflows to SMSFs in the June 2016 quarter of $10,700 were the lowest since 2012. June withdrawals are also heavy, at $17,800, as trustees ensure they meet minimum pension requirements. Withdrawals are always heavier than contributions in any quarter, showing how much the continuing growth of SMSF balances relies on market performance.

Check from another source

We checked these numbers against the Vanguard/Investment Trends March 2016 SMSF Investor Report, based on a survey of 3,531 SMSF trustees. Its major findings are consistent in direction and include:

- Direct shares (outside of managed funds and ETFs): 38% of total SMSF assets in 2016, down from 41% in 2015
- Cash and other cash products: 25%, up slightly from 24% in 2015
- ETFs: now at 3%, up from 2% in 2015
- Managed funds: 10%, up from 9%
- Direct property (residential & commercial): 11%, up from 10%
- Other investments: 13%, steady

Investment Trends believes the allocation to direct shares (outside of managed funds and ETFs) has declined over the past three years as a result of market performance and poor investor sentiment towards individual shares.

Product opportunities

The SMSF investment patterns suggest there are good opportunities for bond funds and other cash alternatives, ex-20 Australian equity funds and other global equity funds. Property is more popular, but managed funds are smaller than listed property and unlisted trusts and syndicates.

Graham Hand is Editor of Cuffelinks. See the full Investment Patterns Survey here. SuperConcepts is a Cuffelinks sponsor.

Response to Roger Montgomery on bond signals

Warren Bird

In a recent article in Cuffelinks, Roger Montgomery asked the question, “Are bonds failing us as a warning signal?” He argued they are, for two reasons. First, bond yields are “an artifice created by central bank buying” and thus do not reflect economic fundamentals. Second, credit quality is low and yet corporate bond yields are also low, which means the market is signalling incorrectly about risk in the corporate sector.

This article debates both those aspects of Roger’s argument.

Let it be said at the outset, however, that the debate is not about whether bond yields are unusually low. Of that there is absolutely no doubt. Across the credit spectrum – from high quality government bonds through investment grade and high yield corporate bonds – yields are at absolute historically low levels. A large chunk of the world’s government bond market (all in Europe and Japan) is trading at negative nominal yields, and the average yield across the US Treasury market is only 1.1% (which incidentally is not the lowest ever – that mark was posted four years ago when the average US government bond rate was just 0.8%, although at the longer end, 10 year bonds at 1.5% match the low they reached in 2012.).

More to low rates than central bank buying

We need to analyse the drivers of the bond markets more rigorously before we conclude that the only reason for the low yields is central bank buying pushing against fundamentals, which are 'sending the wrong signals'.

Central banks have been buyers – in Europe and Japan this continues, though the Fed stopped a couple of years back - but so have many other bond market participants. At the peak of the Fed's buying, there were plenty of Treasury bonds being supplied, with the US budget deficit running at 10% of GDP. However, the deficit is much lower now, back to around 2.5-3.0% of GDP. Continued buying of US government debt issues has taken the average bond yield on US Treasuries from around 1.5% two years ago to 1.1% now, but this has been demand from the market, not the Fed. There is no longer a 'central bank distortion' in US Treasuries.

It's just as valid to see negative and low bond yields as the result of a poor macroeconomic environment. Rather than monetary policy 'not working', the economic headwinds have been so great that all it's prevented is an even worse outcome for growth and unemployment. A real rate of return on risk free capital (i.e. government funds) in this climate is non-existent. The real yield on 10 year US inflation-linked bonds is just 0.1%.

Low inflation, with widespread forecasts of deflation, therefore argue that current bond yields align with the fundamental drivers of bond markets in a fairly normal sort of way. Far from sending a failed signal or being dysfunctional, the bond market is performing as expected.

Roger's article also suggests that corporate bonds are not expressing risk levels appropriately. However, the spreads over US Treasuries (the credit risk premium) that corporate bonds are paying, across the range from AAA to CCC, are close to long run average levels. Not wildly tight, as would be needed to support a claim that risk isn't being priced properly. Arguably, that was the case before the recession in the US in 2000-01 and before the GFC, which both saw spreads trading at close to 1.5 standard deviations below average. At those times the market wasn't paying credit investors enough for the macro risk that was evolving.

However, in 2016 this is not the case. When US growth is chugging along, not great and struggling to sustain any acceleration, but not slumping in a way that causes huge concerns about corporate defaults, spreads are at around their long run average.

Low corporate rates driven by low government rates

The only reason corporate and high yield bond yields are at absolute low levels is because the underlying government rate is low. The extra yield over that rate to compensate for credit risk is still providing adequate compensation for risk.

Let me give just one ratings band to illustrate. BB-rated bonds in the US are currently trading at an average yield of 5.07%. This is a spread to US Treasury of 3.9%, spot on the long-run average spread to Treasury. They were even tighter in early 2014, at 3% even.

Pre-GFC, BB spreads were below 2%. That level was crazy because the break-even spread for BB is 2.15%. That is, at a spread of 2.15%, BB credits are paying just enough to cover the expected loss from defaults in that part of the market. In the current market, investors are being paid well above the break-even.

The article also says corporate debt issuance has been excessive. Maybe in China, as the chart in the article shows, but not in the US. In the investment grade space, the size of the market has been growing at 9.7% per annum for a couple of decades, the same in the last two and five years. In the high yield space, the market has been growing at a slower pace over recent than its long run expansion. In the lowest-rated credits (BB and CCC), there has been little expansion for the past few years.

Uncommon and common ground

The bond market faces issues, especially for those who trade in it and require lots of liquidity to move large parcels of securities around quickly. But as a fundamental signal of how the fundamentals of the world economy are tracking, it is still providing valuable information. That's a different view to the one that Roger presented.

What I share with Roger is the desire to see a world that provides investors across all asset classes with stronger returns. But I don't blame central banks for the fact that this isn't the case – they are merely players in the same very difficult game as the rest of us.

Response from Roger Montgomery

"I have absolutely no problem with this alternate view. I don’t agree with the general proposition that this is normal and there’s nothing really to see here. Yields on US 10-year treasury bonds are lower today than they were during the Great Depression, indeed they are the lowest they have ever been since the 1700s. I suspect that is not a reflection of the state of the economy and if it is, we are in a whole lot more trouble. Different views are what makes a market and if others want to buy the securities I am selling, I’d be lost without such views."

Warren Bird is Executive Director of Uniting Financial Services, a division of the Uniting Church (NSW & ACT). He has 30 years’ experience in fixed income investing. He also serves as an Independent Member of the GESB Investment Committee.