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INVESTMENT SERVICES

Hymans Robertson Investment Services (HRIS)

What now for low-risk portfolios?

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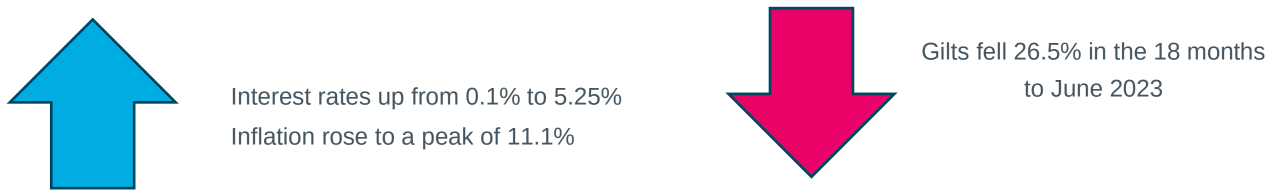
- The past 18 months has been challenging for investors in 'lower-risk' portfolios across the industry. Such investors typically had larger proportions allocated to bonds and have therefore been impacted by the notable sell-off we have seen in the bond market following higher inflation and increasing interest rates.
- Looking-forward, bonds are now more attractively valued than at any point in the last 15 years. Short-dated bonds were yielding over 5% this July.
- We believe bonds should form a cornerstone element of a lower risk portfolio. The current high level of yields gives us the opportunity to generate reasonable returns while at the same time managing the downside risks associated with other more growth-based asset classes.

The market's fall…

There's no doubt the past 18 months has been challenging for bond holders. Spiralling inflation meant developed nations' central banks embarked on the most aggressive programme of interest rate hikes in decades – the Bank of England raised interest rates from 0.1% to 5.25%, with more expected to come. The sharp increase in interest rates led to a commensurate increase in bond yields, which hurt bond prices. This generated losses for investors in 'low-risk' portfolios which typically invest in low-volatility asset classes like bonds. However, the increase in bond yields last year was so substantial that bonds fell further than equities, contrary to the capital preservation property that bond investors desire. This meant, paradoxically, higher-risk portfolios held up better than lower-risk ones. The IA Mixed Investment 0-35% Shares Sector, a benchmark constructed from lower-risk funds, fell by 9.6% in the 18 months to June 2023 compared to an 8.0% drop for the higher risk 40-85% Sector.

Figure 1: Gilts fell as interest rates and inflation rose



HRIS view

At Hymans, we believe low-risk investors should hold a variety of well-diversified assets and shouldn't rely on just a handful of investments, even if the investments are deemed to be 'low-risk' in isolation. As the last 18 months have shown, all market-related investments can sustain losses when held in a concentrated manner. We invest in a variety of different types of bonds that diversifies the types of risk the portfolio is exposed to. In addition, we had a long-term view that, despite years of falling bond yields, interest rate risk should be carefully managed within low-risk portfolios. As a result, our lower risk portfolios have been able to provide better capital preservation and outperform their benchmarks over the past 18 months.

… and now the recovery?

We are aware the losses experienced over the past 18 months might have led some low-risk investors to lose faith in investing, especially when cash rates are at a higher level than we have seen for many years. Nevertheless, we believe bonds should form a cornerstone allocation to a lower-risk portfolio. We set out the reasons for this view below which you may wish to you use with your clients:

Quality bonds can offer protection

- Bond prices tend to be like a rubber band, as long as they don't snap (by defaulting), they should bounce back. A bond will eventually mature at the par price even if it falls in value, below par, in the preceding years.

Bond yields are high, offering return potential

Bond yields are now high compared to recent history (the 2-year UK government bond, or gilt, yield hit 5.4% in July). As a result, expected returns on bonds are as high as they have been at any point in the last 15 years.

Bonds can give investors a degree of certainty

- By buying bonds you can effectively lock in a higher rate of return. You might be able to get a similar return on cash currently, but if the Bank of England starts cutting rates in 12-18 months, then the returns available on cash will fall. By that point bonds would have already increased in value.

Bonds can help complement equity holdings

- Bonds can sometimes help to offset losses from riskier parts of your portfolio during a market selloff and can reduce overall volatility in the context of a wider portfolio of riskier assets.

Bond markets can offer global investment opportunities

- Bond markets cover a variety of countries (including emerging markets), companies, credit qualities and maturities. Portfolios can gain exposure to a variety of different markets, increasing diversification and relying less on certain economic conditions to succeed.

Although bonds, such as gilts, do look attractive at this time, we also acknowledge that there may be some headwinds for the asset class. For example, the Bank of England has changed from being the largest buyer of gilts to a seller, as quantitative easing turns to quantitative tightening, which may put pressure on gilt prices in the short-term. Nevertheless, although the transition to a higher interest rate environment may have been a painful one, the forward-looking prospects look bright. Risks remain, as they always do with investing, but so do exciting opportunities for investors to generate substantial returns, as long as they remain invested.

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