European Bonds: Realigning Your Investment Strategy to Offset Negative Interest Rates

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In the space of a few years, the European bond market has transformed radically. Investor confidence and requirements have changed in response to longer duration, historically weak yields and the emergence of sovereign risk.

Low yields for longer is now a harsh reality. Traditional fixed income allocations, with their heavy tilt towards domestic government bonds, no longer seem to be the most appropriate strategy for achieving long-term investment goals. Adopting alternative solutions could help to better align investment goals with the new market environment.

The last few years have reminded us of the importance of sovereign risk. As the experience of Greece has demonstrated, the concept of a risk-free return on developed countries' sovereign debt remains relative.

It is very likely that investors will distance themselves from government bonds in favour of alternative investments as part of a more elaborate approach to offset medium-term risks.

For some investors, extending the maturity profile could be a suitable strategy aimed at harvesting the term premium. In the Euro Treasury market, the Barclays over 10-year segment offered a yield of 1.30% at end-February 2016, providing investors with an alternative to short-term negative interest rates at shorter maturities but also increasing interest rate sensitivity risk with a duration of 13.9 for this universe. One approach could involve allocating part of the portfolio to over 10-year Treasuries and at the same time halving their allocation to eurozone government bonds with over 1-year maturities.

The overall duration of their eurozone bond allocation would be largely unchanged but the yield contribution would increase by 0.22%, based on data as of 29 February 2016. This would free up cash for investment in other fixed-income strategies without the same level of duration exposure or reliance, or interest rate risk.

Going deeper down the credit spectrum is another option. The euro corporate segment has been demonstrating trends very similar to its sovereign counterpart: worsening credit quality, lengthening duration and decreasing yield to maturity. This is a viable option only if the primary goals are to avoid negative interest rates and remain invested in euro-denominated assets.

International bond exposure is a solution worth considering. Depending on risk appetite, investors could consider diversifying their portfolios away from region-specific risk to US government and treasury bonds, US high yield bonds, emerging market debt in local currency and convertible bonds.

Diversifying into international fixed income assets inevitably carries some foreign exchange risk and it makes sense for most investors to hedge that currency risk. Currency hedged ETFs can be an effective tool to manage this risk.

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In an environment of extremely low interest rates, global convertible bonds are a viable option for investors reaching for higher yields with downside protection. Particularly since exposure can now be found through more efficient routes, such as ETF.

Some investors use allocation to convertible bonds as a way of increasing returns in their fixed income portfolio, whereas others use the allocation to reduce draw-down risk and volatility in their equity allocation. Some investors consider it to be a hybrid solution and manage it out of their multi-asset or alternative allocations. This varied approach to the asset class illustrates the diversification benefits that convertible bonds can add.

Low yields in the years ahead is the harsh reality for eurozone investors. Going longer along the curve, going deeper into credit or diversifying internationally should be considered as viable options to offset the unfavourable outlook on the European bond market.

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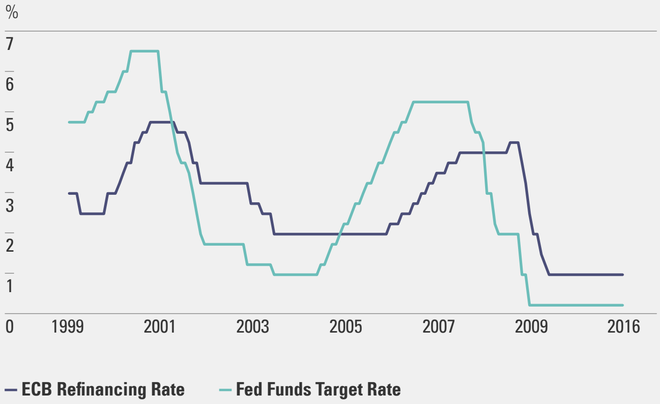
Figure 1: US and Eurozone Interest Rates



Source: Bloomberg, 31 December 2015.

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