Central Bank Policy and Portfolio Construction

By Vincent McCarthy, CFA

"All courses of action are risky, so prudence is not in avoiding danger (it's impossible), but calculating risk and acting decisively"—Niccolò Machiavelli, *The Prince*

Since the global financial crisis began, we have witnessed an unprecedented rise in the influence of the world's major central banks. The explicit goal of their intervention has been to lower borrowing costs and push asset prices higher to create a "wealth effect" that causes asset holders to feel wealthier and motivated to spend more. While the efficacy of central bank policy on the real economy is a much-debated topic, risk assets have responded in an almost Pavlovian way, with each round of monetary stimulus pushing asset prices higher.

But central banks have created a much more challenging environment for investors because the yields on traditional "risk free" assets, used to balance or reduce risk in portfolios, are now at or near record lows. Cash returns are now effectively zero or negative while the real yields on many top-tier government bonds are also negative.

Most notably, portfolio managers face a serious quandary when constructing lower-risk portfolios, which tend to be heavily weighted to risk-free government bonds and cash. Investors with a lower risk tolerance are still seeking to generate a return similar to what they would have historically earned in cash and AAA government bonds with the same level of risk. Unfortunately, in the current low-interest-rate environment, it is simply not possible for investors to achieve a return anywhere near current inflation without taking on extra risk, whether in the form of credit risk, duration risk, leverage, or the inclusion of other asset classes.

In Europe, the German 10-year government bond yield (the benchmark risk-free government bond) is currently trading around 1.34%. Historically, from 1980 until 2013, the German 10-year government bond annual yield averaged 5.7%, reaching a high of 10.8% in September 1981 and a record low of 1.2% in May 2012. Given such circumstances, how should portfolio managers model the risk–return profile of core government bonds? One could argue that, based on mean reversion, these government bonds should now be modeled as lower-return/higher-risk assets relative to any prior period.

The same question could be extended to all asset classes because of the distorting influence of the world's major central banks (i.e., low interest rates and large-scale asset purchases). Although focusing too much on the short term can be a debilitating exercise, should portfolio managers and clients now re-think the long-term expected returns that are built into the portfolio construction process, given that central banks could keep rates low for another 5, 10, or even 20 years, as has been the case in Japan?

The outlook for expected returns in the long term will certainly be tied to economic growth. In the developed world, economic growth remains anemic, forcing the major central banks to pursue more aggressive monetary policies in an attempt to compensate for restrictive fiscal policy and to stimulate economic growth. So far, these policies have boosted asset prices and have had mixed results for economic growth. There is no sign that central banks will diverge from their current path. We have seen already that even the hint of a change in policy can send the markets into a tailspin. We must also consider the diminishing marginal impact of looser monetary policy as a reason why even more monetary stimulus will be deployed to stimulate economic growth.

Mervyn King, outgoing governor of the Bank of England, recently likened monetary policy to "running up an ever-steeper hill." He explained, "Monetary policy works, at least in part, by providing incentives to households and businesses to bring forward spending from the future to the present. But that reduces spending plans tomorrow. And when tomorrow arrives, an even larger stimulus is required to bring forward yet more spending from the future. As time passes, larger and larger doses of stimulus are required."

Don't forget that the Bank of England has been one of the most aggressive central banks with regard to monetary easing. Since the financial crisis began, the Bank of England has cut its benchmark interest rate to 0.5% and expanded its balance sheet by a factor of 5. Expressed as a percentage of GDP, the increase is greater than corresponding increases in the U.S., Japan, or the eurozone. Yet the U.K. economy remains mired in stagflation. Economic output is still below the level of five years ago while inflation and unemployment remain too high. Nevertheless, the Bank of England and other central banks remain committed to these policies, even if the marginal benefit for the real economy is questionable. Therefore, I expect more, not less, monetary stimulus.

The U.S. Federal Reserve has committed to keep rates near zero until unemployment falls to at least 6.5% and until the recovery is self-sustaining. The European Central Bank has pledged to maintain an easy monetary policy "as long as needed." Given the structural weakness in the eurozone economies, this

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"Asset Allocation in a Distorted Interest Rate Environment," *CFA Institute Conference Proceedings Quarterly* (March 2013) [www.cfapubs.org]

"Regime Change: Implications of Macro Shifts on Asset Class and Portfolio Performance," CFA Institute webcast (September 2012) [www.cfawebcasts.org]

process could take many years. Previous attempts by the Federal Reserve to wean the U.S. economy off quantitative easing have failed. Meanwhile, the new governor of the Bank of Japan, Haruhiko Kuroda, is fully supportive of Prime Minister Shinzo Abe's crusade to rid the country of deflation and is expected to pursue much more aggressive monetary policy. The incoming governor of the Bank of England, Mark Carney, is likely to increase the size of the bank's asset purchase program but also could take the radical step from inflation targeting to GDP targeting.

Pinpointing the turning point in monetary policy comes down to how long it will take to work off the excesses and imbalances accumulated in previous decades, and such an outcome appears to be some time away. The aggressive action of the world's major central banks will provide a cap in any rise in yields and could even push yields lower, but over the next 10 years, investors probably will not be able to achieve the historical returns they came to expect over the previous 10 years. Likewise, it is difficult to envisage cash returns at pre-crisis levels any time soon.

Moreover, central banks could be setting the stage for an even bigger financial crisis than in 2008, with no clear indication of how they will exit the financial assets accumulated on their respective balance sheets. For example, within the Federal Reserve, opinions are mixed as to how the U.S. economy will evolve and hence *when* and *how* the Fed should exit its asset purchase program. According to Charles Plosser, president of the Philadelphia Federal Reserve, "If we get it wrong, the damage might be significant … we run the risk of very high inflation or disruption to financial markets." In other words, when the proverbial drug is taken away, there will be one serious comedown. I believe central banks will continue to tolerate the potential long-term side effects in their attempts to stimulate a sustainable recovery in the real economy.

With so much uncertainty in the world, proper diversification of portfolios is more important than ever. With respect to the types of portfolios that traditionally were considered lower risk (cash and government bonds), investors need to be willing to accept lower returns than were achieved historically. To have any prospect of achieving the desired return, portfolio managers and advisers need to educate their clients about adding additional asset classes that may help them achieve their return objectives.

To avoid disappointment, significant due diligence and client education are required before following the lead of the world's major central banks and moving up the risk curve. The worst thing to do is to chase higher-return assets without educating clients about the types of risks involved.

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LETTERS

FRESH THINKING IN THE INDUSTRY

With interest, I read the interview with Rob Arnott about the equity risk premium ["An Opening of Minds," March/April]. In particular, the notion of replacing "risk free" asset with a "risk minimizing" asset is an appealing concept. Ditto for efficient frontiers that define risk as asset–liability mismatch. It's amazing that such a sensible approach has not caught on. Maybe it needs some good illustration and a marketing strategy!

In recent months, I have seen other pieces that also challenge the old paradigms (e.g., the efficient market hypothesis versus an adaptive-market hypothesis). Though probably triggered by painful market experiences over the past 10–15 years (as Arnott points out), it is nonetheless inspiring to see some fresh thinking in the industry.

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THE XX FACTOR

Perhaps the most disheartening aspect of the article "Boardroom Diversity in the EU" by Claire Fargeot (EMEA Voice, November/December 2012) was the fact that it was penned by a female. It was a striking blow to women fighting for equality. Yes, we have to fight because more often than not we are not given the recognition that we deserve. I too am against quotas when the free market is functioning, but since women started on the road to job equality in the 1960s, progress has been painfully slow. One cannot honestly say that of all the potential board member candidates, only 13.7% are women at least as qualified as men. Furthermore, at the current 1.5% growth rate, to reach female representation of 40% would take 72 years! Besides, a simple look at the general population shows that number should be closer to 50%. Even in the male-dominated finance world, about 20% of CFA charterholders are women. Female charterholders would make excellent board members based on their rigorous analytical training and high ethical standards. All too often I've seen intelligent women passed over due to the old boys' club that still exists or because women do not brag about their accomplishments. The men's "accomplishments" can be so risky that they threaten the company's viability. Whom would you rather have as a board member—thoughtful, disciplined Shelia Bair [current chair of the Systemic Risk Council and former chair of the U.S. FDIC] or all-or-nothing Jerome Kerviel [convicted on charges stemming from the 2008 rogue trading scandal at Société Générale]? Studies have shown that companies with female board members are more successful, particularly in the long term. One upside of the current situation is that I can profit from the ebbs and flows of the market that stem from egotistical male-dominated decisions.

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