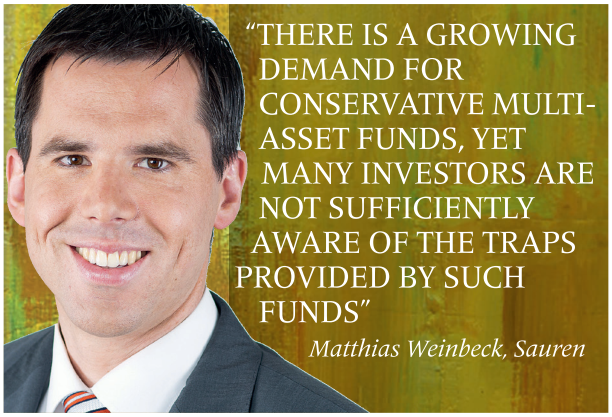
10.2% Fall in Hungary agricultural producer prices in March

Sauren Report on the interest rate trap: Responding to new realities

A report published by German fund manager Sauren Fonds Service, argues that the "interest rate trap" will deliver lower yields. Report contributor Matthias Weinbeck, a fund analyst for Sauren, highlights key strategies for investors facing this challenge. Mona Dohle reports

The high yield party is over- this is the key message of the latest Sauren report. While markets have been anticipating a change in interest rates for months, the report takes an unusual stance by arguing that yields will be low regardless of whether interests rates will increase or not.

"We noticed in conversations with our distribution partners across Germany that there is a growing demand for conservative multi-asset funds, yet many investors are not sufficiently aware of the traps provided by such funds since they often invest a substantial portion of their portfolios in the credit markets" highlights Weinbeck.



THE END OF EASY MONEY

According to Sauren, low interest rates have created a climate in which profits were not based on the abilities of individual fund managers, but on returns from relatively high interest coupons and long term bonds.

This is reflected for example in the German government bond index REX. Between 1981 and 2014, it has seen a 781.3% growth, reflecting 6.9 % annual yield, according to the Sauren report. It currently sits at around 5.6%. Consequently, investors are increasingly looking for other sources of revenue.

One alternative could be illiquid assets such as long term government bonds, which offer higher returns than short term investments. However, the report points out that long term government bonds are vulnerable to interest rate increases, since even a 1% interest rate increase can lead to a 3% loss for a three year bond.

This is reflected in the yield on conservative multi-asset funds, which have shown solid returns in recent years, due to the favourable interest rate environment. However, even if long-term interest rates remain unchanged, the predicted yield remains now at a mere 1.42%.

Another option to increase returns is long-term bonds. German government bonds with a 10 year duration offer 1.624% higher return than 3.5 years bonds. Yet a 1% increase in interest rates could lead to losses of more than 9% for 10 year government bonds.

Alternatively, investors are increasingly looking towards corporate bonds, which offer generally higher returns. Yet, while corporate bonds provide a slightly higher yield compared to government bonds, investors have to be aware that the risk premium may increase.

THE NEW ENVIRONMENT

What could successful portfolio construction in a low interest environment look like? According to Sauren, active management will be essential. "In the past, investors have booked solid returns with a simple portfolio construction of 80% bonds and 20% equities, the key question is now: "How to generate returns going forward?" says Weinbeck.

"We have increasingly considered which assets remain interesting. For our fund of funds, we are more and more looking towards absolute return strategies because they can provide returns even in a rising interest rates environment."

"We have had absolute return funds as part of our portfolio since the late 1990s, but are now increasingly looking to extend their share of the overall portfolio" Weinbeck stresses.

"Towards the end of 2012, absolute return funds had a 13% allocation within our defensive multi asset portfolio, at the end of 2013, this has increased to above 20%" At the same time, we have reduced the ratio of strategies that have a higher sensitivity on interest rate movements from 26% to 20%" he stresses.

Nevertheless, within a fund of funds, absolute return should be balanced against other elements in order to form a stabilising factor, he argues. "We currently believe that a 20-30% share of absolute return strategies would constitute a healthy balance." ■