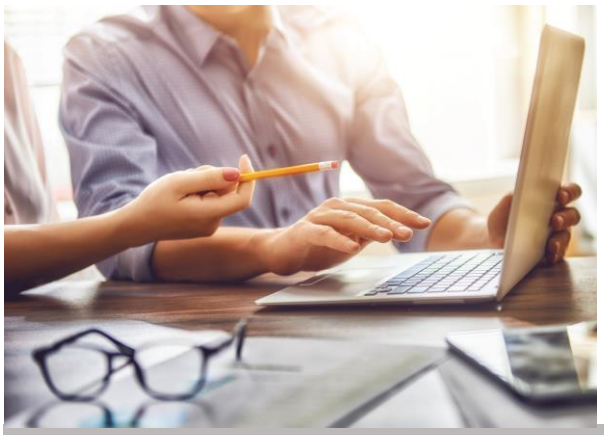

invesco

INVESCO EDUCATION SERIES

INVESTING IN A LOW INTEREST RATE ENVIRONMENT

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June 2021

"The only investor that shouldn't diversify are those who are right 100% of the time"

John Templeton

INTRODUCTION

As the dust begins to settle from a tumultuous 2020, investors must take stock from some of the major lessons learned over the year. Perhaps the biggest lesson was for investors to maintain a long-term focus and to not let short term market movements unduly effect their decision making. In the first quarter of 2020 where nearly all asset classes collapsed in value, bonds proved to be more resilient with safe-haven bonds appreciating in value. An unfortunate side effect of this resilience was for bond yields to sink to all-time lows once again. As the recovery started to take hold, bond yields picked up from their historic lows although remaining at supressed levels. For example, the yield on the 10-year German government bond was -0.2% in April 2021. If you bought €100 of this bond in September and held this bond to maturity, you would have €98 after 10 years and essentially guarantee a loss of capital.

Before Covid hit, market sentiment started to shift with many holding the view that a low interest rate environment could be here to stay. In response to the Covid emergency central banks across the world "acted big" by announcing quantitative easing measures at an unprecedented level. With these support measures, central banks essentially purchase bonds no matter the price helping to support a low yield environment.

In light of the shifting market environment, we undertook a project to re-examine the investment options in the bond space and assess how pension investors should position themselves in a low interest rate environment. At Invesco, we have always believed in the power of long term investment principles such as diversification and avoiding speculation. Bonds have always played an important role in a multi-asset portfolio as they offer real diversification benefits as they typically offer downside protection when other growth asset classes sell-off. Benjamin Graham, nicknamed the "the father of value investing", suggested that an investor should try and keep a minimum of 25% in bonds at all times.

Whilst there is no doubt that lower yields reduce the appeal in bonds, the investment case for their inclusion in a balanced portfolio still remains present. Perhaps the strongest investment case for bonds is the lack of any viable alternatives. Now, more than ever, we feel diversification is key – both at an asset class level but also within the bond universe. In this note, we will provide some background on the low interest rate environment and explain how the various fixed income assets can help investors achieve their goals in these challenging market conditions. The low interest rate environment has caused some investors to look outside the traditional fixed income asset classes and we will briefly discuss options in this area.

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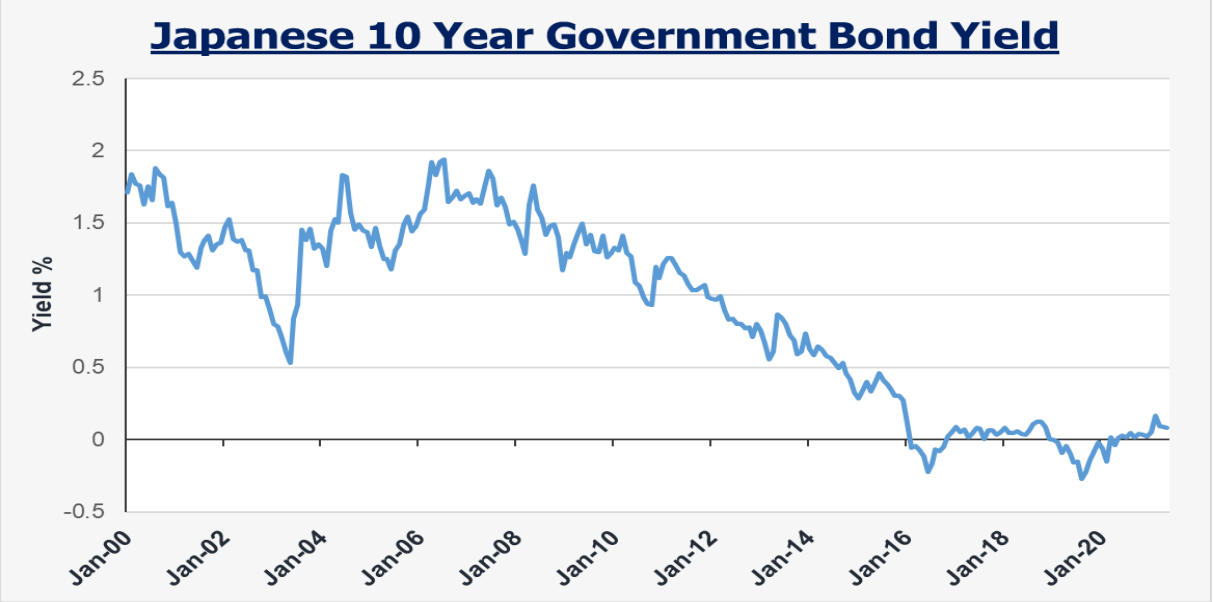
BACKGROUND ON THE LOW INTEREST RATE ENVIRONMENT

The era of low interest rates was primarily driven by accommodative central bank policy which started following the global financial crisis in 2008. As all of the major economies in the world went into recession, central banks responded with an unprecedented monetary policy called Quantitative Easing (QE). QE relates to the practice of central banks using newly created bank reserves to increase the money supply. Whilst these measures have been partially successful as it has pulled most major economies out of recession, central banks have fallen short of achieving their core objectives. Both inflation and growth in most global economies remained sluggish for the noughties. This new economic era has been given the nickname "Japanification" as Japan was the first major economy to experience the malaise of low growth and low inflation around 20 years ago.

As economies grinded to a halt due to Covid, central banks have responded by announcing yet bigger packages of QE. The Chair of the US Federal Reserve, Jay Powell, has sought to calm markets by committing to keep interest rates low until the end of 2023 at the earliest with the ECB announcing a similarly accommodative position. Investors are now paying close attention to inflation levels as only a persistent overshoot in inflation levels will likely see interest rates rising in the US and in the Eurozone. There is no guarantee that interest rates will increase back to their average levels. We believe investors should design their investment strategy with an allowance for the possibility that we have entered a "new normal" where interest rates remain lower for longer.

A CAUTIONARY TALE WHY INVESTMENT MATTERS, NOT SPECULATION

Since the turn of the century, many investment managers have hung themselves on the same trade - that Japanese bond yields would rise back to comparable levels with the rest of the western world. This type of speculative investment has been punished time and again as Japanese yields have continued to reach new lows as illustrated in the below chart. This loss making trade became so common that it acquired a nickname – the widow maker.



At Invesco, we do not believe in speculative investments whereby you aim to make money by guessing the direction of interest rates movements or other factors. Rather, we believe in investing over the long-term based on solid investment principles that can help investors achieve their investment goal – be they growth focused or more downside protection based.

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GOVERNMENT BONDS

Investors hold government bonds as they are traditionally seen as a safe haven for their money. Whilst current sovereign bond yields may not be particularly impressive, they remain attractive to many investors as they will at least get nearly all of their money back on maturity (if the bonds are held to maturity). Government bonds remain an attractive asset to hold in the event of a recession as traditionally they have appreciated in value when equities fall.

A decade ago, many investors felt that the lower bound of yields on Eurozone government bonds was 0%, however, recent market conditions have shown this is not the case. Fears of the next recession have pushed some Eurozone Government bond yields into negative territory. Some market observers feel that yields could as low as -1% or even lower. Some investment experts have expressed the view that the lower bound is close to -1% as interest rates lower than this could give rise to some investors hoarding physical money.

The yield on a popular basket of Eurozone Government Bonds produced by Merrill Lynch was 0.08% in August (Merrill Lynch Euro Government Bond Index). Whilst purchasing bonds at these low yields would be greeted with chagrin by some, the cold reality is that there are no easy options. Investors who hold cash are penalized by a negative yield of -0.50%.

Inflation linked bonds have performed well over the last year as inflation expectations climbed off their all-time lows due to stimulus measures and vaccine developments. Based on market data, investors are expecting inflation to average 1.6% over the next 20 years. The ECB has an inflation target of 2.0% and if it achieves this target in practice, investors in inflation linked bonds would stand to benefit. Many pension investors will be seeking to protect the purchasing power of their pension and we believe investment in this area is a prudent strategy.

CORPORATE BONDS

Whilst popular balanced investment strategies of the past involved a simple allocation to local equities and government bonds, investors today now seek more diversification. Now, corporate bonds have become a more established component of many portfolios. Indeed, as yields moved lower on government bonds, switching from government bonds to corporate bonds became a popular trade.

Corporate bonds offer an enhanced yield over government bonds. This premium means that investors can still earn a positive return of 0.34% as measured by the Merrill Lynch Large Cap Corporate Bond Index in April 2021. Coupled with this enhanced yield, it also offers some diversification away from equities because corporate bonds also tend to exhibit similar features as governments bonds. However, corporate bonds are more susceptible to the economic cycle than government bonds. If corporate profitability deteriorates, this could result in losses. Investors may wish to review the credit quality of their holdings and concentrate on investment grade bonds where there may be an opportunity for capital appreciation. “Investment grade” is used to describe bonds with a high credit rating - typically BBB or higher.

Companies have taken advantage of the low interest rate environment with $5.4 trillion in corporate bonds issued over 2020. This was the most ever – both in terms of the dollar value and the sheer number of deals.

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HIGH YIELD BONDS

The term “high yield bonds” is typically used to describe non-investment grade corporate bonds (i.e. corporate bonds with a lower credit rating than BBB). Yields are now at historic lows for high yield bonds – the yield on Merrill Lynch high yield bond index is 3.49%. The problem faced by investors searching for yield in the post-crisis world is evident as less than 3% of the global bond market now yields more than 5% - the lowest on record.

High yield bonds offer diversification away from typical government bonds. The risk level for high yield bonds is in between government bonds and equities. In the low interest rate environment, the hunt for yield has pushed many investors into high yield bonds. The risks in this area are lower while the cost of capital remains cheap. The asset class has seen inflows with investors speculating that interest rates will remain lower for longer (and hence the risks of holding these assets remain lower).

Historically, high yield bonds as an asset class have delivered strong returns. For example, the MSCI World Index produced a return of 13.5% in the 12 years preceding April 2021 compared to the Barclays US corporate High Yield 2% Issuer Capped Bond Index which posted 8.2% over the same period with 44% less volatility. Another attractive feature of high yield bonds is their performance profile in a rising rate environment (where historically in periods of rising rates high-yield bonds have performed well relative to other assets). This provides diversification within the bond portfolio as government bonds would typically underperform in a rising rate environment.

The investment case for high yield corporate bonds has weakened due to the low interest rate environment pushing investors to purchase covenant light (contracts with weak investor protection) corporate bonds. The amount of debt with minimal or no covenants is concerning. High yield corporate bonds without covenants or with covenants that would disadvantage the rights of investors are very risky at the late stages of an economic cycle. If a recession occurs, these bonds are not likely to offer the type of downside protection typically desired for fixed income investments.

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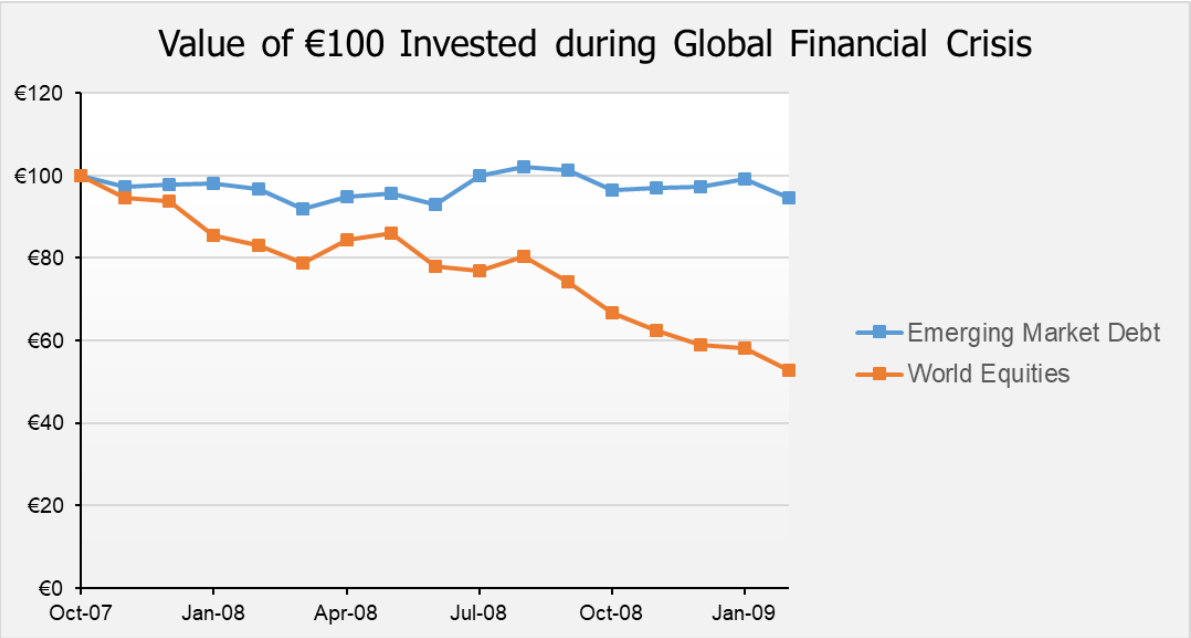
EMERGING MARKET DEBT (EM Debt)

The term emerging market debt is used to describe holdings of a basket of bonds from emerging market countries like Mexico or Brazil. This is a fixed income area that is gaining more popularity. Whilst it used to be an asset class held by more niche investors, many now feel a small allocation to emerging market government debt will help improve the risk adjusted returns of a balanced portfolio.

Perhaps the strongest investment case for holding in this area is the attractive yields that are still available with the yield on a popular basket of local currency emerging market government bonds at 4.7% in April 2021 (based on the JP Morgan GBI Emerging Market Global Composite Index). Coupled with this, emerging market debt offers diversification benefits as emerging market economies can be at different stages of the economic cycle compared to the developed world. For example, local currency emerging market debt stood up remarkably well whilst most risk assets sold off during the global financial crisis as illustrated in the below chart (based on EM Debt index outlined above and MSCI World index for World Equities).



In the past, investors disliked the political risks in this area as these bonds can experience adverse performance if a financially irresponsible government is formed in an emerging market country. It is worth noting that emerging market debt did not provide the same level of protection during the Covid-19 sell-off with it falling -16.7% in the 19-day period where global equities sold off -26.1% peak to trough (measured based on daily returns).

Whilst we believe the investment case in this area is strong, we feel it is more appropriate to be held within a balanced portfolio for long term investors as emerging market debt could experience a large sell-off during a global recession as it is more sensitive to market sentiment. Overall, we feel a small allocation can improve the risk adjusted returns of a balanced portfolio.

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OTHER OPTIONS IN A LOW INTEREST ENVIRONMENT

Unprecedented negative interest rates have pushed some investors to move part of their money away from traditional fixed income assets into the following areas:

- **Cash**

Cash has become one of the most popular alternatives to the fixed income assets we have discussed in this paper. Whilst the yield of -0.5% is lower than all of the fixed income alternatives, investors are attracted by its capital preservation characteristics. While other fixed income assets will typically experience losses on paper if interest rates increase, this is not the case for cash. Investors would be holding "dry powder" that could be used in the event that yields return to normal levels. We feel this strategy is only appropriate for active investors who will redeploy their cash when better opportunities arise. For more passive investors, there is a risk they maintain their cash holdings for too long and could experience a "cash drag" – a term used to describe the lower returns earned on cash over the longer term relative to other asset classes.

- **Gold**

The investment case for gold is that it will be less affected by the potential inflationary impact of quantitative easing as a precious metal. Gold has delivered a return of -7.3% over the 1-year period to 30th April 2021. This is disappointing performance against a backdrop of rising inflation expectations and unprecedented levels of quantitative easing. This illustrates how gold provides an imperfect hedge against inflation. This option has gained limited traction in the pension investment world. Over the longer term, the investment case for holding gold is weakened by the fact it does not produce any income unlike other asset classes like bonds, equities and property. There are also difficulties in gaining access to this asset class.

- **Illiquid Assets**

An eagerness to post enhanced returns could push investors into less liquid areas – for example alternative credit like a book of mortgage debt. This approach comes with additional risk which should be carefully considered with your investment consultant.

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CONCLUSION

In this market environment, choosing the right fixed income investments to generate returns may be more challenging. As we have entered an unprecedented period of low interest rates, it now seems more important than ever for investors to evaluate the investment opportunities available and choose the investments that best suit their needs.

It's always important to consider asset classes in context, rather than in isolation. On their own, bonds may appear less appealing today if an investor's goal is simply to maximize returns from that part of a multi-asset portfolio in the short-term. However, for long-term investors, they should never forget that bonds are still the asset class that puts the balance in a balanced portfolio.

While we are unlikely to see fixed income deliver the same level of returns as it has done over the last 30 years, the asset class will remain as a fundamental part of a well-diversified portfolio.

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