

Investment
update

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**Stewart Cowley, Head
of Fixed Income and
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Stewart joined OMAM in June 2009 from Newton Investment Management where he held a similar role and managed the Newton International Bond Fund and BNY Mellon Global Bond Funds, both rated AAA by Standard & Poor's. He has more than 20 years' experience of global fixed income markets, having begun his career in 1987 as a broker before subsequently switching to fund management.

Duration low to slightly negative

The God Policy

Arithmetic is resisting quantitative easing. As yields approach 2.5% - 3%, risk overtakes reward and any positive effects fade away

The researchers at the Large Hadron Collider in Switzerland think they may have found the Higgs Boson, the so-called "God Particle" that binds the standard model of atomic interactions together. If they are right it's the greatest intellectual achievement of mankind mainly because it will be one of the few theoretical predictions that then goes on to be observed in practice. Six hours down the road in Frankfurt, there is a group of people trying to find a single policy to bind them all - the European Central Bank that is. It would be no less an intellectual achievement if they did and we could be forgiven for calling it "The God Policy" if they achieved it.

The great thing about physical laws is that they work at all points of space at all times under all conditions. The problem with economic laws is that they apply in some places, at certain times but only under certain conditions. In that sense, economic laws aren't laws at all. They are more like a set of guidelines.

Recently, there have been a number of discussions about Quantitative Easing, about how it might be or might not be working and what its limitations are. This applies equally to the US Federal Reserve, the Bank of England, the European Central Bank and the Bank of Japan. Graham Turner at GFC economics has recently written a tremendous piece on this subject which brings together a number of ideas with which I am sympathetic. Briefly put, the standard model of QE is that central banks buy government bonds from portfolio managers. These same portfolio managers then recycle the money back into risk assets (equities and corporate bonds) which in turn trickles down into the economy boosting money supply and making good the shortfall in growth. This is the so-called "portfolio balance channel" of QE.

John Maynard Keynes in his "General Theory of Employment, Interest and Money" recognized this effect and acknowledged that yields would be driven down by QE but there would be a lower limit to its effectiveness. He concludes that "a long-term interest rate of (say) 2 per cent leaves more to fear than to hope, and offers, at the same time, a running yield which is only sufficient to offset a very small measure of fear". In other words, there may come a numerical value for bond yields at which QE becomes ineffective because everybody will have sold out of long-dated bonds because they are all (capital) risk and no reward. This is interesting because it also introduces a psychological or motivational angle to portfolio managers' actions.

Keynes doesn't put precise numbers on it nor does he consider over what holding period one is talking about or indeed that the duration of a bond changes as yields decline and fall. The duration effect is significant because it increases as yields fall thereby magnifying the capital risks as prices rise.

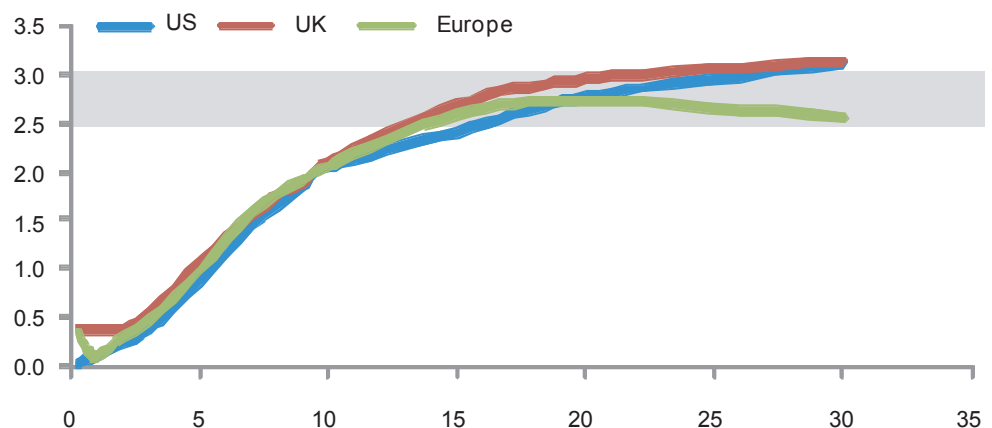
If you ask the question: "What yield rise (price fall) can I tolerate and not experience a capital loss relative to cash on a long-dated bond?" then, even for long holding periods (like one year), and allowing for the coupon accrued during the period, the results are shocking. What you will find is that as yields decline below 3% for all maturities between 10 and 30 years, the rise in yields before an investor experiences a loss relative to cash declines quickly to below 0.2%. Below a 2.5% yield, the rise is a mere 0.1% in most cases. Just think about that for a second - yield increases of over 0.1% to 0.2% during a year will lead to losses relative to cash. We have noted that volatility has increased as yields have declined and, these days, you can observe yield movements of that magnitude in a day. In that case we suggest that the lower boundary for bond yields as a result of QE is 2.5% - 3.0% which is somewhat higher than Keynes suggested and higher than the broad run of yields currently applying to US or UK 10 to 30 year government bonds.

Capital risks are clearly very high in the minds of investors when short-term interest rates are close to zero and long-term bond yields are also at very low levels (as we have now). Also, especially this year, we've observed that the time horizon for fund management has become very short. In addition, the liquidity of the financial system has declined which adds to overall volatility. Taken together, there is virtually no room for error.

The combination of the maths, foreshortened time horizons and the systemic decline in liquidity is a poisonous cocktail. From a portfolio manager's point of view (as Keynes spotted and which can now be shown more accurately), when long-term interest rates fall below 2.5% - 3.0% there is every incentive to sell the bonds to the central banks engaged in QE and hoard the cash. The reason is simple; at low yields, as a portfolio manager, your inclination is to think that the next yield movement at these times is up. Rising yields are as much a threat to corporate bonds and equities and so all asset classes now look risky and so psychologically you are not inclined to buy anything.

The effect is that the transmission of QE through the portfolio channel breaks down and no longer has the desired effect. At this point central banks are simply chucking money at the problem, with no more effect than the transfer of duration risk out of government coffers and into their own vaults. It is this that more than likely accounts for why QE appears to have less and less of an effect as yields reach the 2.5% - 3.0% range, with selling by portfolio managers and buying by central banks reaching a metastable equilibrium. Interestingly, this is where long-term government bond yields are presently stuck (see Figure 1).

Figure 1: Western yield curves



Source: Bloomberg

We should expect that, one day, the vast majority of long-dated debt will be in the hands of central banks. After that, the slightest inclination that yields are set to rise or the buyer of last resort has tired of the process of QE will send yields soaring as no portfolio manager in their right mind will buy that kind of duration at such low yields. The premium for holding long-dated debt should rise, especially if real yields are low (or negative) at the time and inflation is at elevated levels. When this happens (and it may be in the coming year) god help us all.

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