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Bankers all agree: interest rate risk is on the rise

The best options according to asset managers Government bond performances no longer sustainable

by Andrea Gennai

For months the markets have been reciting the same refrain: beware of rising yields because bonds, especially long-term ones, can lead to capital losses. Take the fate of the ten-year German Bund, now yielding 0.48% after falling below zero: this recovery is still an anomaly and is failing to keep pace with inflation. Up to now, the phenomenon of rising yields has been fairly contained, at least as investors see it, and this has persuaded many clients to postpone making a decision. Above all in the private sector, where bonds are a key component of investment strategy, the experts are all issuing the same warning: time for a portfolio review is running out. Investors should be opting to reduce the bond component, or at least change its weight to include stocks other than government bonds.

"A paradigm shift is under way," points out Sandro Daga, head of private banking at Deutsche Bank. "Interest rates have hit bottom and consequently the risks for bonds are greater than in the past. We advise our clients to be cautious with fixed-income securities, especially on the long maturities; but since this asset class is a 'must-have', the best way is to focus on managed funds rather than individual stocks. Actively and professionally managed funds can help to guard against interest rate risk, credit risk, and exchange rate risk, in the interests of healthy diversification."

Deutsche Bank is now taking the route of advanced advisory services, assisting clients with objective valuations and relying on strategic portfolios and diversified and less correlated investment products and strategies.

It's not easy to explain to a typical Italian client the transformation that the markets are undergoing. In the last decade the situation has been changed by the massive intervention of the central banks and continuously falling yields have made fixed-income a very attractive asset class.

"We believe," says Carlo Manzato, head of Advisory & Sales Italia at Credit Suisse, "that we've seen the end of a decade of falling rates. And this calls for a complete change of strategy vis-à-vis our Italian clients, who are very attached to the bond market. Investors with 70% in fixed income, who are still making a good return, have to realise that from now on they'll need to move at least part of their portfolio into riskier assets. This message hasn't entirely got through to Italian investors yet. When dealing with wealth management, we can act directly; the problem arises with advisory services because we see that clients are reluctant." Credit Suisse proposes many different types of diversification according to client profile, ranging from high-dividend or more defensive stocks to currency diversification, with an eye on lower correlation. The company is not against trying something new. "Another option for knowledgeable investors," says Manzato, "is capital guaranteed or partially guaranteed certificates. We use them as hedges, in other words we move clients out of long positions and bring them back in with a protected investment."

In a phase like the present one, it is absolutely crucial not to forget liquidity, so that investors can grasp opportunities as they arise. "It's very difficult to recommend fixed-income products at the moment," explains Massimiliano Cagliero, CEO of Banor SIM, "because they produce such poor returns. Such an investment is actually too risky on longer maturities when interest rates are picking up. The advice we give many clients at this stage is to keep to cash and invest the rest of their portfolio in high-dividend shares, for instance. Tactical liquidity is important in this phase because even bonds are producing virtually no return. The advantage of cash, moreover, is that it reduces the portfolio's overall volatility." There are other options that can achieve the same result. "Also important, we believe, for clients who can handle it," says Cagliero, "is to include derivatives in a portfolio with a view to reducing volatility, and not for speculation. For example, buying a stock such as Eni and building a strategy around it by selling calls or puts."

Under pressure

0.5%

yield on ten-year Bunds

After a long period at below zero, the yield on German ten-year government bonds has begun to rise. The rate is still exceptionally low for a ten-year maturity, but it is a sign that we are on the way to monetary policy normalisation. Interest rates will stay where they are for some time to come, but the market is betting that the ECB will soon give concrete indications that it is reducing purchases under the quantitative easing launched more than two years ago. Other central banks too (starting with the FED and the Bank of England) are moving in the direction of greater restriction.