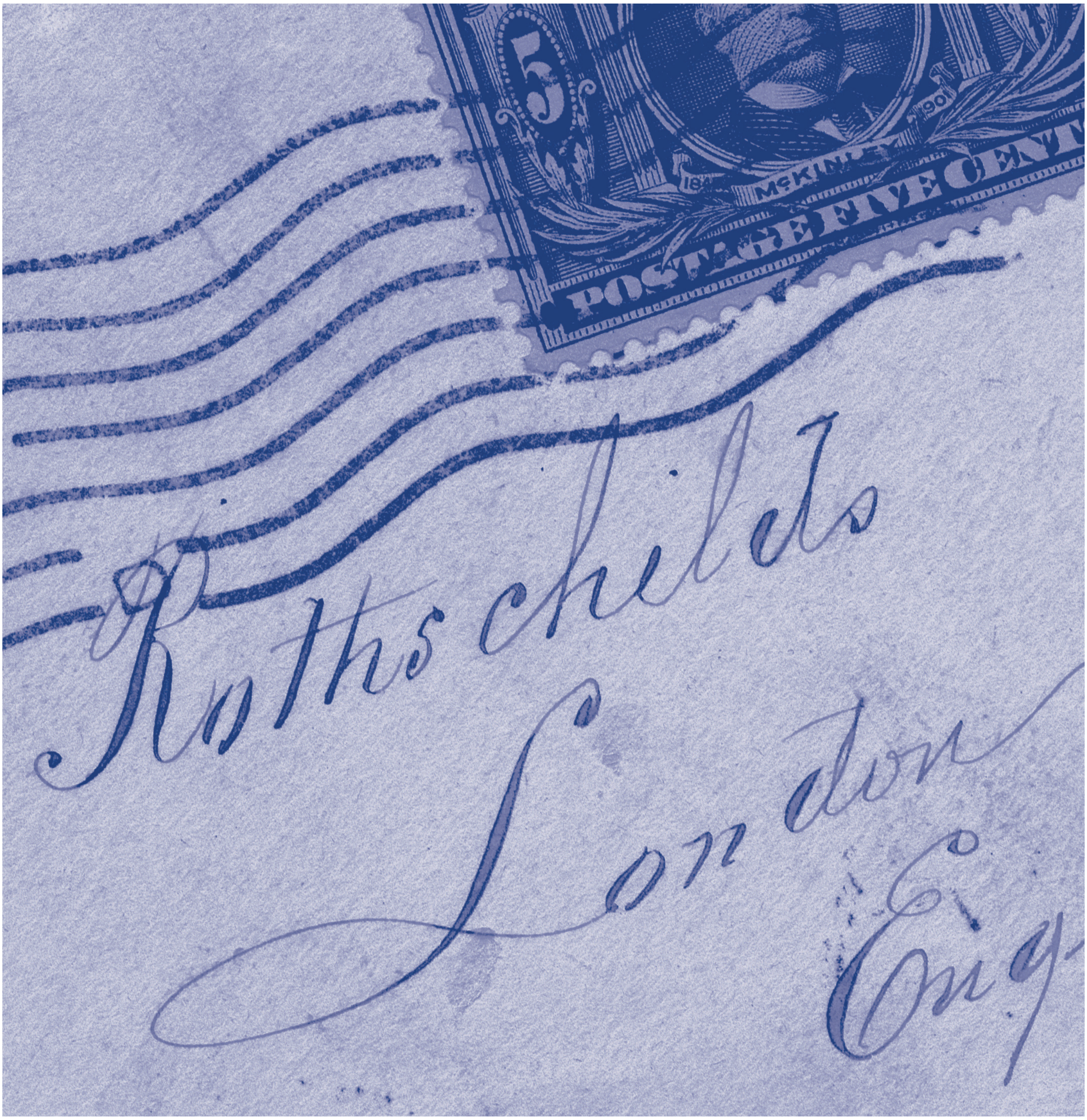
The perils of income at any cost

Quarterly Letter

Issue 16 | October 2017



Rothschild
Private Wealth

Cover image:
Envelope from a Presidential 'Thank you' sent to Nathaniel 1st Lord Rothschild (1840–1915), Senior Partner N M Rothschild & Sons, from President Theodore Roosevelt (1858–1919) in 1904.
Courtesy of The Rothschild Archive

Rothschild Wealth Management
New Court
St. Swithin's Lane
London
EC4N 8AL
+44 20 7280 5000
rothschild.com

Publication date: October 2017.
Values: all data as at 30th September 2017.

Foreword

"Let us rather be satisfied with a little less, dear brothers, if we can thereby remain in the saddle."
Salomon von Rothschild (to his brothers), July 1831

Rather like Salomon von Rothschild we also believe there are great advantages to staying in the saddle – but not necessarily in the hunt.

This is often the case with the pursuit for income. There are some paths we won't follow, because we don't know where they lead, and because the journey may be too bumpy for our liking. Our principal concerns are to stay upright, to look forward with clarity and to keep our balance.

We understand the temptation to take more risk to gain an acceptable income, especially when conventional income returns are very low. But we don't believe in chasing returns at any cost. In the following pages, we'll explain why.

Our objective is always to preserve and grow our clients' wealth by focusing on total returns. We hope you agree that we can achieve this without needlessly testing the resilience of our portfolios.

Helen Watson
CEO, UK Wealth Management

The perils of income at any cost

To receive an income from investments is not a modern invention. The first national bonds can be traced back to 1694 when the Bank of England issued bonds to help fund the country's participation in the Nine Years' War against France.

The characteristics of these bonds, however, were rather different to modern day bonds. They took the form of what was called a 'tontine', where individuals paid into a common pool to receive dividends until their death. The investor's original capital was never returned; when each investor passed away their dividends were shared among the remaining investors. When the number of participants inevitably shrank to zero the Bank claimed what was left.

The desire for income persists today, and so because we think from time to time it is quite revealing to look at what we don't own – and why, this quarterly letter focuses on income-producing investments. (Rest assured, we won't attempt to cover the whole universe of things we don't own – even our most enthusiastic readers might lose interest in a letter discussing 1.5 million listed bonds, 43,000 listed companies and 100,000 mutual funds!)

At Rothschild Private Wealth we take a total return approach when seeking to deliver our clients' investment objectives. This doesn't mean we will make positive returns in each investment period, but instead that our returns are comprised of both income and capital growth. This breadth allows us to favour different types of investment, depending on the market environment and the attractiveness of opportunities. Today the income of our typical portfolio is close to 0.8%, a record low. We feel that many income-producing investments offer unattractive risk/reward characteristics. In this letter we examine specific income investments we prefer to avoid.

How the world has changed after the global financial crisis

On 9th August 2007 the financial world started to change. This date heralded the onset of the global financial crisis (GFC), with two BNP Paribas hedge funds investing in $2.2bn of US mortgage debt being frozen. It was also the first and last day of Mervyn King's – then the Bank of England's governor – holiday.

From there, when it became clear there were trillions of dollars of unreliable investments in the financial system, banks stopped trusting each other and the wheels of commerce started to roll off the tracks.

While it would take another 13 months for the financial crisis to come to a head – with the failure of Lehman Brothers – by then fear had seeped throughout the system. Dominoes tumbled. The Lehman bankruptcy forced western governments to take extraordinary steps to avoid a complete meltdown. Central banks were in panic mode; their concern was to prevent a systemic collapse.

Given this backdrop it is hardly surprising that policy makers resorted to radical, new and untested treatments to keep the patient (the global economy) alive.

Across much of the developed world central banks slashed interest rates to zero (or just above, or below) and introduced 'unconventional policy making', which has had dramatic consequences for many income producing investments.

An inescapable fallout

The most significant unconventional policy making tool the central bankers employed was quantitative easing (QE), where new money is electronically created by central banks (modern money printing), giving them the ammunition to encourage economic growth by buying government bonds or other financial assets. For instance, when the GFC struck, the US Federal Reserve (Fed) purchased mortgage backed securities, bank debt and Treasury notes in the months and years that followed – patterns of asset purchases that were replicated subsequently in the UK, Europe and Japan.

The scale of QE was unprecedented – $4.5 trillion in the US, $0.6 trillion in the UK, $5.1 trillion in Europe, $4.7 trillion in Japan. To put these figures in perspective, Japan's QE programme (which is still growing) equates to more than $37,000 for every man, woman and child – enough to buy a Toyota Prius and still have change.

On 9th August 2007 two BNP Paribas hedge funds investing in $2.2bn of US mortgage debt were frozen, heralding the onset of the global financial crisis.

While debate continues about the success of the various stimulus measures, the fallout from this massive intervention is inescapable: investors have been deprived of much of their traditional sources of income from cash and bonds. For example, UK 10-year gilts paid 5% in September 2007, compared with 1.3% 10 years later, in September 2017.

This income drought has hastened risky, income-seeking behaviour as investors have lowered standards to satisfy their thirst for income. We see evidence of this across the investment universe: within fixed income, equities and 'new asset classes'.

To preserve and grow our clients' wealth we believe it is prudent to stay clear of many of these income sources in the current climate.

To preserve and grow our clients' wealth we believe it is prudent to stay clear of many of these income sources in the current climate. Amid the backdrop of income scarcity, let us explore what the policies ushered in during and after the GFC have meant for investment classes – and why we believe we are right to be cautious.

Has the fixed income market become untethered?

Some argue that elements of the fixed income market have loosened their connection with reality. It's hard to dispute certain facts. In many European countries investors have had to accept negative returns when lending money to governments. The situation is most pronounced in Switzerland but many are surprised to discover that Spanish government bonds offer negative returns for the next three years.

$2.75bn

In June 2017 Argentina issued government bonds worth $2.75bn that mature in 100 years. The income was very appealing at 7.9%. However, Argentina has defaulted six times in 65 years.

This has led to bizarre consequences, such as tax authorities in Switzerland requesting that tax payments be delayed and some mortgage holders being sent cheques by their bank when the interest rate on their mortgage turned negative!

Pitifully low and negative government bond yields have forced investors to accept lower quality and less liquidity in their hunt for income.

By way of example, in June 2017 Argentina issued government bonds worth $2.75bn that mature in 100 years. On the face of it, the income was very appealing at 7.9%. However, Argentina is a serial defaulter – six times in the last 65 years, with two of those since 2000.

Much closer to home, bond prices have exhibited wild volatility. The yield on Ireland's 5-year government bonds hovered around 2% before the crisis, soared to 17% in 2011 and dipped below zero in 2017. This is not the type of ride for which we would wish to purchase a ticket. Further, today's ultra-low yields represent unattractive risk/reward for us as investors.

Edging down the quality ladder we can peer at the decline in corporate credit standards. With the supply and demand equation favouring companies that borrow, the market is seeing more and more "covenant-lite" bonds. This is where loan agreements don't include the usual security for the benefit of lenders.

Consider Tesla: in August 2017 the electric car maker issued a $1.8bn bond. Tellingly, the company was able to do this without bond holders securing any rights on its Gigafactory in Nevada, reputed to have the largest footprint of any building in the world. This type of situation is not attractive to us.

We like to operate within a margin of safety, where we prepare for what could be the worst outcome for an investment. Take a company like Unilever: if one brand from the group's collection runs into trouble, many more can provide support – a margin of safety we like. On the other hand, if an unprofitable company with only one or two core products faces difficulties, it would concern us to not have a claim on some of their most valuable assets.

As overall quality in the fixed income universe is being driven down, it's no wonder that the average bond issue in the US is now classed as junk. Marketeers prefer to call junk bonds 'high yield', but that hardly seems appropriate given current prices. The highest yielding bonds may seem relatively attractive now, but we should be wary about potential default rates: they are low during good times, perhaps 3–4%, but can soar to 10–15% during a recession. That's an unwelcome risk.

Around the 17th century, Thomas Hobson owned a livery stable in Cambridge. As the story goes, rather than prospective customers having their pick of the stable's steeds, Hobson operated a strict rotation policy, with customers only allowed the horse in the stall nearest the door – "this one or none" – Hobson's choice. A bond investor requiring income is left with Hobson's choice – 'this low quality bond or none'.

In the interests of our clients we will likely pass.

Examining income from equities

Having exhausted the supply of income in fixed income markets, some investors have sought reliable income streams from stocks. In our view this may have led to distorted valuations in parts of the equity markets. Because we take an approach to investing called 'bottom-up', whereby we pick individual investments on merit, we can avoid assets we don't like. Often with good reason.

When companies offer high dividends, this usually comes at the expense of capital growth. Therefore many companies that grow fast, such as technology stocks, don't pay any dividend at all. They reinvest excess returns to grow even more rather than returning money to shareholders – who are generally happy to accept this compromise. For instance, Google (now renamed as Alphabet) has never paid a dividend.

Researchers at the Universities of Chicago and South California* found widespread evidence of behavioural effects when it comes to dividends. They discovered that many individual investors – but also investment funds and institutions – behave as if the returns from dividends and share price gains are not connected.

As any amateur gardener can attest, it is reasonable to pick the fruit from the tree, but using the branches as firewood will limit future growth.

We are also wary of equities that have become 'bond proxies'. After the financial collapse of 2007/8, investors seeking better rates of return than the safe havens of cash chased these stocks – which essentially are companies that offer a stable and low risk income like bonds but higher numbers. Often much higher.

Yet bonds will pay back all of their debt on maturity unless they default. Company shares that act as bond substitutes – such as found in the utility sector – perform poorly if interest rates do begin to rise, or even if there is discussion, for example, of changing monetary policy such as reducing QE. Bonds are affected under such circumstances and so are bond proxies.

We are mindful that you can't have a high dividend yield and high growth. Not in a durable sense at any rate. Pay the shareholder or invest in the company is the obvious trade-off, but you can't consistently have both.

A benefit of our total return approach (mentioned previously) is that we are often happier to see our portfolio companies invest in their businesses or buy their own shares back (when prices are cheap) rather than pay dividends.

New asset classes or emperor's new clothes?

What about sources of income outside of conventional asset classes? The list of these investments includes: catastrophe bonds, infrastructure, leasing, litigation funding, peer-to-peer lending, solar farms... this is far from an exhaustive inventory.

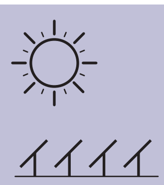
While we are not dismissing all of these investments – which may work well for some investors – our analysis suggests the amount of risk we must take to gain acceptable rewards is unattractive in many cases. As with the bond and equity sectors we have discussed, the pursuit of income has made the return too low and the risk too high.

We are confident we are not doing our clients a disservice by steering clear of instruments such as catastrophe bonds. These are used by insurers to pass the risk of such disastrous events as hurricanes on to investors.

While it is too early to tell what impact the cyclonic onslaught that tore through the Caribbean and the Gulf of Mexico before pummeling the US in August and September will have on these bonds, our analysis has concluded that the return on offer is unattractive for the level of risk.

The Chairman of Lloyd's of London said in his 2016's end of year statement, "Current year underwriting is not profitable in aggregate at the moment... this is a matter of great concern to us."

We would approach some of these new sources of income with the same apprehension.



Sources of income outside of conventional asset classes include: litigation funding, peer-to-peer lending and solar farms.

We are confident we are not doing our clients a disservice by steering clear of instruments such as catastrophe bonds.

A final note of caution

To serve as an addendum to what may be more tangible – or more visible at least – income assets, we should briefly look at the worrying trend (in our view) of income being brought in through derivatives markets.

Derivatives are securities whose price depends on their underlying assets, which may include shares, bonds, currencies, commodities, market indexes and more. Their composition is not always noted for their transparency.

**The Dividend Disconnect*, 25th April 2017, Samuel M. Hartzmark – University of Chicago Booth School of Business, David H. Solomon – University of Southern California Marshall School of Business.

In recent years there has been a big increase in structured products and funds employing derivatives to offer enticing levels of income. While not wishing to get into the pernickety details of how these work, in many cases the source of the income is effectively insurance premia from selling protection against large falls in markets. For these investors receiving the appetising income, it's a bit like insuring your neighbour's house – you receive her premium each year, but if her house burns down, you face a massive claim.

Ironically, the popularity of this insurance underwriting has led to lower premia (lower income) yet arguably increased risk. Long-term readers of our letters perhaps won't be surprised to learn that rather than invest in these structured products and funds, we have been the ones buying the cheap insurance instead.

We invest across generations – we recognise the potency and consequences of financial seizures. And the frequency with which they occur.

An article in the *Financial Times* by Gillian Tett** in August this year shared our concern. She pondered whether exchange traded funds, such as those that trade in volatility, hold the seeds of the next crash. While Tett did argue that such a shock is unlikely to be imminent she has some form in anticipating events – she was one of the few who predicted the previous financial collapse.

On paths not taken and flights of fancy

Many of us would take confidence from the chair of the US Federal Reserve Janet Yellen's assertion in London in June 2017 that another financial crisis is unlikely "in our lifetime". But we should also bear in mind her comment in May 2016 at Harvard University when she said, "We really didn't see that coming" when referring to the Fed's analysis of the GFC.

While we could be impish and suggest that "in our lifetime" is a rather short-term view for our thinking – we invest across generations – we recognise the potency and consequences of financial seizures. And the frequency with which they occur. The scarcity of income is distorting markets and we sympathise with the difficulties faced by investors who need income.

** "The next crash risk is hiding in plain sight", 10th August 2017, Gillian Tett. *Financial Times*.

However, as prudent shepherds of our clients' money, we don't need to pursue this path.

It's not that we are averse to trying new things. We pore over countless income opportunities, including the sources we have discussed. We analyse the great, the good and the ugly, assessing each on their empirical qualities.

A correction of some sort may come, although we don't believe this will happen soon. Yet the financial historian Charles Kindleberger concluded in *Manias, Panics and Crashes*, after trawling through almost 400 years of records, that such shocks occur every 10 years or so on average. Former Fed Chairman Paul Volcker was reported to agree when he waggishly stated that "about every 10 years, we have the greatest crisis in 50 years".

Once the inevitable happens, new asset classes and some of the more opaque income sources may bear the brunt first.

Conclusion

We recognise that an attractive income yield can be emotionally reassuring, but for now our portfolios are steering clear of excesses (as we see them), in the pursuit of prudent and responsible wealth management.

Our focus on total returns gives us the freedom to avoid the limitations of Hobson's Choice. We can buy what we want, when we feel it is appropriate. By not pursuing income at any cost, we better serve the long-term interests of our clients.

Notes

At Rothschild Private Wealth we offer an objective long-term perspective on investing, structuring and safeguarding assets, to preserve and grow our clients' wealth.

We provide a comprehensive range of services to some of the world's wealthiest and most successful families, entrepreneurs, foundations and charities.

In an environment where short-term thinking often dominates, our long-term perspective sets us apart. We believe preservation first is the right approach to managing wealth.