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# What will end the search for yield?

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*Investors have been increasing their exposure to the highest yielding — and riskiest — areas of the bond market. But when will it stop?*

Jim Cielinski, CFA
Global Head of Fixed Income

Global investors' voracious appetite for yield has been a near-constant theme since the end of the financial crisis. After monetary policy drove yields on relatively safe government bonds to almost zero (or even below zero), income-seeking investors were forced to put their money elsewhere to get a higher yield. And as investors moved into riskier segments of the fixed-income market, such as corporate and emerging market debt, the demand has driven stellar returns. These assets have endured some wobbles in recent years, but they generally bounce back — seemingly stronger than before.

Achieving a higher yield requires taking greater risk, and in recent years investors have increasingly adopted the following strategies:

- **Increasing exposure to credit risk.** Corporate bonds, emerging market debt and mortgage bonds can be an efficient way to boost portfolio yield.
- **Extending duration.** Yield curves are upwardly sloping, offering investors higher yield for buying longer duration assets.
- **Using less-liquid instruments.** Illiquid assets can provide higher yield than highly liquid assets of similar quality.

### A sudden shift in demand could put returns at risk

There are some valid concerns about investors using these strategies for pursuing extra yield. As Colin Moore, our global chief investment officer, has said, "The premium that people are prepared to pay for a higher current yield, or current income, is concerning. They don't always consider that if they're getting a higher current income, it's because they're taking a higher level of risk."

On the other hand, what would happen if investors *stopped* searching for yield? What if Treasury yields went up to a point where a large number of investors concluded that the yield on Treasuries was high enough, and they didn't *need* to stretch for yield

anymore? The result could be a shift in assets away from the riskier sectors of the market and back toward safer government sectors. In the short term, it could have an immediate effect on the remaining investors through negative performance in corporate and emerging market debt. In the longer term, it could have a fundamental effect to companies — if they needed to pay higher interest rates, higher expenses could hurt their businesses and lead to an increase in defaults.

### The search for yield is likely here to stay

But for those worrying about the long-term sustainability of the search for yield, stop worrying. This trend has staying power. The shorter term view is more cyclical and warrants more caution, but we believe short-term corrections will be just that — corrections.

The macro environment will change. Fiscal and monetary policies will change. Geopolitical risks will shift. But we believe the long-term appetite for yield will persist, driven by the following:

- **Interest rates are low.** We believe rates will rise, but the speed limit on global growth is constrained by low productivity and tepid labor force growth. We expect central bank rate increases to be contained: a 3% yield on 10-year U.S. Treasuries, if achieved, would still leave yields very, very low, and low rates entice investors to seek better yields.
- **Higher risk fixed income is now mainstream.** Investors often split their investments into a safe bucket and a risky bucket. And traditionally, investors leaned toward relatively safe fixed-income exposure in their portfolios to complement risky equities. But a better understanding of risk and return has broadened the ability to include many yield-oriented fixed-income investments. There remains a challenge, however, to ensure that investors fully understand the risks they're assuming with these investments.
- **Few investors need heavy exposure to the quality, or the liquidity, of government bonds.** Liquidity comes at a cost of lower yield, and investors have become aware that they don't need to sacrifice yield if they can accept greater risk.
- **Aging demographics are driving many investors to allocate away from equities and toward safer assets.** The next rung down on this ladder encompasses the higher yielding segments of fixed income.

### Danger is lurking: the short to intermediate-term view

We expect the long-term trend of investors searching for yield will remain an important tailwind, but the short to medium outlook poses challenges. Fixed-income valuations remain expensive, although they're not at bubble levels. This makes it near impossible for investors to repeat their recent strong performance.

We also believe an increase in volatility would seriously undermine the search for

yield. Low volatility is the ingredient that perpetuates and reinforces the search for yield. One of the defining characteristics of the post-crisis growth trajectory has been its stability, and it doesn't get much better than this when it comes to drawing out a search for yield. Over the next year, monetary policy changes, interest rate increases and politics may drive volatility in higher risk fixed-income sectors, but investors should filter through the noise and maintain their focus on long-term factors.

## Bottom line

Absent a fundamental threat to the current low growth, low inflation environments, the long-term trend of investors searching for yield is likely to continue, supporting prices of higher risk fixed-income bonds. Without a change in underlying fundamentals, short-term corrections are likely to be just that — corrections. The demand for yield is a defining characteristic of this decade's investment environment. And it shows no signs of going anywhere over the long term.

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