Can investors replace bonds?

Roman from Ah [i]

Bonds remain one of the most important asset classes even in times of low interest rates and attractive equity returns. They cannot be substituted with equivalent risks. Substitution leads to higher and different risks.

Why are bonds held?

- Coupons: Regular income stream, unlike equities where neither the amount nor the timing of dividends is known exactly.
- Conservative investment (low volatility): the fluctuation in value - especially in the home currency - is significantly smaller than that of equities.
- Diversification: Stocks and bonds do not move 1:1, with risk-reducing portfolio effects ("diversification benefits").
- Protection against economic downturn and deflation: Inflation brings higher prices for goods and services. This is not good for bonds, as their (constant) nominal income stream loses purchasing power. An economic slowdown has the opposite effect: slower growth lowers inflation; the fixed income stream of bonds gets higher purchasing power. At the same time, corporate earnings growth declines, which makes bonds more attractive than equities.
- Other reasons: Hedging of long-term payment obligations ("asset-liability management"), compliance with capital requirements on the part of supervisory authorities, influence on interest rates when central banks purchase large quantities of bonds ("quantitative easing"), etc.

Bond reduction in favor of real estate is popular with institutional investors. In this way, they want to escape the guaranteed capital destruction of bonds. As the chart shows, the majority of CH bonds remain in the capital destruction range far beyond the next 10 years.

In contrast to bonds, real estate prices depend on many more risk factors than just interest rates (interest rate sensitivity "duration"). A variety of contract options have an impact, as shown e.g. by Mihnea Constantinescu ("what is the duration of Swiss real estate? ") of the University of Zurich:

- Interest rate option: higher / lower rents depending on mortgage rates
- Inflation option: higher / lower operating costs depending on inflation
- Renovation option: higher rents after renovations
- Reset option: without significant renovations, the new tenant can request that his rent be close to that of the previous tenant
- General market forces affect changes in rents. Real estate cash flows are also influenced by factors other than changes in interest / discount rates

Real estate gives an entitlement to future cash flows. Market conditions, embedded options, and risk-adjusted discount rates result in a variable income stream. Therefore, real estate is by no means a special rate, but an important asset class in its own right.

Other popular investment extensions are also not bond substitutes, with in some cases significantly different return and risk characteristics:
- Subordinated loans, high yield, local emerging bonds: bond market segments with increased default and currency risks

- Insurance-linked bonds ILS: Income depends on (securitized) underwriting risks
- Large (small) shares: subordinate to bonds in bankruptcy cases, subject to higher risks of loss; neither fixed maturities nor fixed dividends, traded on stock exchanges (small shares are less liquid)
- Private market investments "Private Equity PE, Venture Capital VC": ditto, plus concentrated business models, long holding periods (even higher illiquidity), no stock exchange trading
- Infrastructure assets "Infra": To be assessed analogously as a segment of PE
- Hedge Funds "HF": most diverse strategies with similar correlations to equities as PE

Investments are exposed to interest rate, credit, equity and liquidity risks. These are linked to growth, recession, inflation, balance of payments, currency, fiscal or political institutional risks.

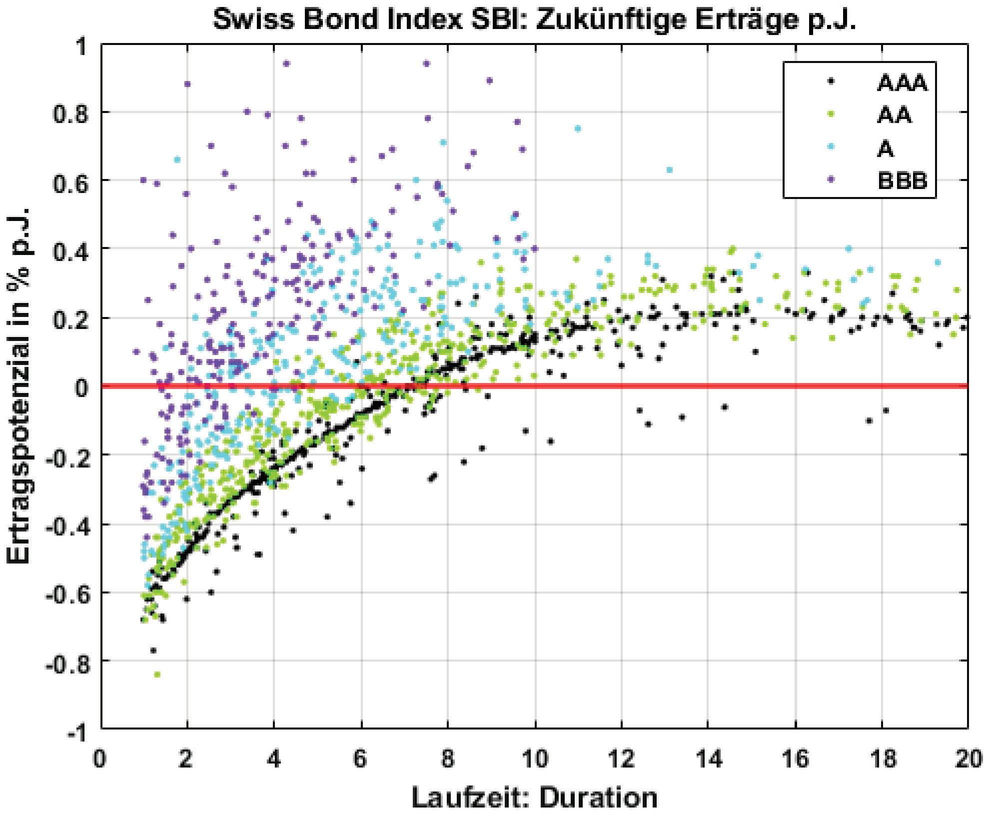
Alternative investments "AI" (PE, VC, Infra, HF) are to a large extent subject to the same risk factors as the classic investment categories cash, bonds, real estate and equities. Financial market research shows that the assumed return of AI is often overestimated and the volatility is also significantly underestimated. Smoothed return patterns (high autocorrelations), underreported volatilities and/or correlations substantially overstate diversification benefits.

Conclusion

There are no opportunities without risks, but many risks do not generate returns. Successful investing exploits opportunities for returns and consistently refrains from financially uncompensated risks. Asset classes are effectively remunerated sources of risk, i.e. they cannot be further diversified. The optimal mix of cash, bonds, real estate and equities largely determines investment success. Bonds cannot be equally substituted because putative alternatives have different return, risk and correlation characteristics. Without a comprehensive and in-depth understanding, disappointments - especially in crises - are once again inevitable.

Text box & graphic

Bonds are mostly interest-bearing securities with a limited maturity issued by governments or companies to raise capital. In contrast to shareholders, creditors of corporate bonds are given preference in the event of the debtor's insolvency. The chart shows the expected returns (Ertragspotenzial in % p.J.») of Swiss bonds in the Swiss Bond Index SBI for the next 20 years («Duration»), depending on their creditworthiness. The points below the red zero line show all the bonds that will lead to capital destruction with a guarantee over the corresponding term (duration in years).



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