Financial Newsflash

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capital at work
Wealth Management Foyer Group

Financial update

Equity markets in short hardly performed in the first quarter of the year, while our fixed income investments with the help of decreasing interest rates were able to recover last year losses. At the same time, and for the longer run, this creates a dilemma:

How to invest in a world of low yields?

It is a fact, fixed income yields are low today, which is no good news for an investor going forward. Low yields mean your invested capital may generate only low returns.

From the start of the banking crisis in 2008 and followed by the economic recession, many central banks did whatever it took to lower market yields, such that cash money today yields nothing. This looks like a continuation of a trend that started in 1981.

In August 1979, the US Democrat president Mr. Jimmy Carter appointed Mr. Paul Volcker as president of the Federal Reserve on a mission to reduce the then high inflation levels, with a peak in 1981 at 13.5%. He succeeded in his mission by raising the 'Fed Funds Rate' to above 20%. The next thirty years market interest rates gradually declined almost uninterrupted to the current levels. The 10-year US Treasuries today yields 2.70%, while the 10-year German sovereigns yield 1.60%.

Back in 1981 you were able to buy a 30 year US Treasury bond with an annual coupon of 13%. Just imagine over the past thirty years you got paid year after year, a 13% coupon in 1981, 13% in 1982, … and to your regret, you just received your last pay-out of 13% in 2011. This US Treasury bond probably was one of your best investments you could have made over this past 30 year time horizon. The S&P 500, the US equities index, performed an annualized return of only 10.4% over this time period 1981 - 2011.

The continuously declining market yields gave fixed income investors considerable tail wind. Whenever they bought fixed income, almost always prices went up immediately, generating a false confirmation on the purchase decision made. Unfortunately this tailwind today has vanished. Just let's assume interest yields will not decline further. Nobody wishes for a Japanese scenario with rates below 1%. An investor in longer maturities issued by solid issuers only is able to acquire running yields of between 2% and 3%.

In today's world, the market yields you are able to invest in are the best forecast of the return you can expect for in fixed income. Unfortunately your portfolio manager is no magician tripling low market yields.

In this market context, corporate bonds still today offer an interesting alternative for 'risk-free' sovereigns. While many sovereigns and private persons carry high debt loads, many corporate offer bright spots in the global economy. Over the past ten years, companies were able to reduce their indebtedness and have gradually raised their profitability. It is not only the Apple's of this world that sit on a mountain of cash. You can question whether sovereign issues of France or Italy are safer than bonds issued by Volkswagen or United Technologies. The answer to this is not straightforward, but raising the question is interesting. Reality is corporate bond yields are higher than most sovereign issuers', on average by about 1.50% more. As usual, an investment is a continuous consideration whether expected returns sufficiently remunerate the risks incurred.

In the current environment of low yields, we invite you to put your capital at work. And with that we also mean investing in companies. Let's go back to basics for a while. Too often people confuse equity investments with speculation. Every day they check stock prices, charts, the latest news in media, and 'specialists' opinions. Often this is a recipe for a mediocre investment strategy. Often people seem to have lost what is the essence of equity investments. Buying equities means becoming the co-owner of companies, be it marginally.

Companies where in the morning employees arrive, they produce things or deliver services. Value gets created by the interaction of different stakeholders, the employees, management, the shareholders, capital and technology.

It is possible to estimate the intrinsic value of a company, and consequently the intrinsic value of one share. This is what our analysts do every day. They do this, remote from stock exchange screens where instant prices pop up and fluctuate. Of course this is no exact science, but these valuations offer a benchmark. The valuations of most companies evolve gradually, and usually in-line with corporate results. Our analysts regularly meet with 'our' companies, and adapt their valuation models based on these interactions and quarterly financial information.

And we have the stock exchanges, or 'Mister Market', where these companies' shares trade. The good news is investing in listed companies allows for a continuous price at which equities, that little piece of a company, can be bought or sold. This is unique. This aspect is also called liquidity, and is absent for investments in real estate or in private equity. The value of a company evolves gradually, and often slowly. Stock prices however can be very volatile. This may depend on various economical or even political factors. Mister Market can be very emotional and can be euphoric or manic depressed.

An asset manager assesses these daily stock price fluctuations and compares them to their intrinsic value as estimated by the analysts. Here resides the opportunity for a calm investor who sees himself as the longer run co-owner of a value and jobs creating company. When the stock price is below the estimated intrinsic value, a buy opportunity originates. The higher the difference gets between the stock price and the intrinsic value, the higher the margin of safety and the bigger the probability of getting a decent return on the invested capital. However when the stock price is above the estimated intrinsic value, it might be better to wait to invest, or when invested it offers an opportunity to move on.

First and foremost, diversification is very important. There are sufficient investment opportunities in all kinds of industries.

Also obvious is the distribution of investments over equities and fixed income, taking into account your personal requirements, crucial for the risk profile and consequently for the expected return of the portfolio.

For further information, please contact us via info@capitalatwork.com.