Pearlstein's Corner

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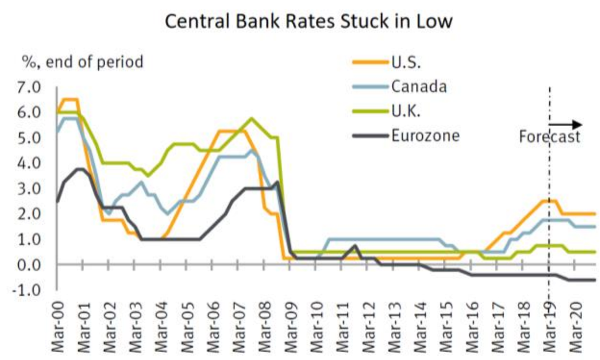
How to Invest in a Low Interest Rate World



Source - Bank of Canada, Federal Reserves Board, Bank of England, European Central Bank, RBC Economic Research

Do you remember back to 2006 when you could earn 4% to 5% on your money simply by investing in government bonds? I'm sure you do. For many investors, that made their bond investing easy – a no-brainer.

But those days are gone. For more than a decade, we've been experiencing an extremely low interest rate environment. How low?

Around the world, almost two-thirds of bonds pay less than 2%, and nearly one quarter pay negative interest. In other words, if you hold a negative interest bond to maturity, it guarantees that you'll lose money. Sub-zero rates on this scale have never happened in over 5,000 years of interest rate history.

On a short-term basis, no one can predict when this will change.

Why Are Interest Rates So Low?

Typically, interest rates function as a gauge of the supply and demand for money.

When there's strong economic growth on the horizon, rates go up because the market assumes there will be larger demand for money. When economic growth appears to be slowing, rates go down.

However, rates can also be arbitrarily set by central banks, which is what happened after the Great Financial Crisis of 2008/9.

At that time, central banks like the Bank of Canada, the US Federal Reserve and the European Central Bank, collectively declared an emergency and slashed short term rates, also called overnight rates in some countries.

The Bank of Canada cut rates to an unprecedented .5%. Borrowing at that level for many banks and large financial institutions was virtually free.

This brought the global economy back on side, by making it easier for corporations and individuals to borrow. Except, many savers and investors suffered, especially those who only invested in fixed income investments.

Since then, central banks have increased rates very gradually. Currently the overnight rate is 1.75% in Canada, with no indication that they will rise in the near term.

In fact, President Trump is pushing for even lower rates. In essence, the emergency rate cuts were never eliminated. Why not?

Simply, governments, investors and borrowers have become accustomed to these low rates. This has created a massive borrowing binge at every level, from governments to individuals with lines of credit. Some borrowers are now dependent on low rates and any increase could have a large negative effect.

If the central banks announced they were raising rates back up to 4% or 5%, it would cause a global panic.

What Can Investors Do in a Low Interest Rate World?

There are no easy answers. It's difficult to feel satisfied with such a low rate of return. That makes it tempting to chase higher returns on the stock market.

But I don't believe it's prudent to turn against principles and diversified investment models that have been successful over many decades.

Remember that return and risk walk hand in hand. Looking for higher returns also brings you greater risk.

Keep in mind that change can happen fast. Just read the headlines (or Twitter, if you can stomach it) as the world's two greatest economies are currently engaged in a trade war.

With so much tension in the air, something is bound to break. Where and when is hard to say, but it's the best reason to protect yourself from a whipsawing market.

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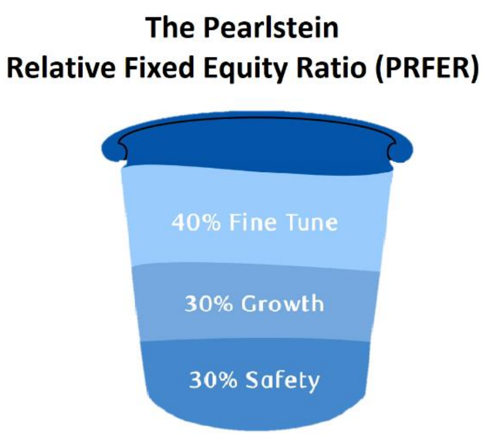
The Pearlstein Relative Fixed Equity Ratio (PRFER) Still Holds

Even in today's low-interest climate, there are real benefits in being diversified. The Pearlstein Relative Fixed Equity Ratio does just that.

PRFER is an asset allocation strategy that manages risk in good and bad times. The goal is to try and achieve 2% to 5% above the rate of inflation over the long term. Even when rates were at their lowest – below 1% – it worked and it continues to work.

Three Buckets



PRFER is a straightforward framework that accounts for each individual's risk tolerance. Working with clients, I create portfolios that have three buckets of investment types.

The first, which should account for about 30% of your portfolio's value is a safety bucket that contains bonds, GICs and savings accounts. The key for this bucket is that the principal and income are safe.

The second, which should also hold about 30% of your portfolio, is a growth bucket that includes equities. These investments potentially generate capital gains and dividend income to provide a partial hedge against future inflation.

Over long periods, equities have been shown to outperform fixed income investments by a wide margin.

The safety of the fixed income holding in bucket one and the growth potential of the stocks in bucket two work in tandem to fortify your overall investments against the ongoing volatility of market cycles.

The third bucket, representing approximately 40% of your portfolio, is where we can fine tune your investment savings to reflect your risk tolerance.

How you choose to allocate that portion of your savings is tied directly to your age, your investment horizon and what's happening in your life. The composition of the investments in that bucket will also reflect what's going on in the markets or the broader economy at a particular point in time.

A Portfolio Structured for Flexibility

The PRFER structure allows for flexibility when it comes to risk and return. Interest rates and stock markets are always going to be cyclical because that is their nature.

It pays to equip yourself with a portfolio that has the right asset allocation to avoid making panicky or impulsive short-term financial choices.

Even as the safety bucket loses some of its allure because of low yields, remember it has always been there to diversify, reduce volatility and have a ready liquid reserve to buy quality stocks cheaper. So, it still serves very important roles in asset allocation.

Second, it's crucial for investors to know that more stocks mean more risk. Low rates (and the central banks' low rate policies) have lulled some investors into believing that cyclicality in stocks can be controlled.

Except we are still susceptible to market cycles. They're inevitable. In the past 60 years, the average U.S. bear market loss was 34%, lasting on average 12 months. I can't say when a down market will happen, how long it will last or forecast its severity, but it will happen. Be careful of the collective amnesia of the herd.

Think of PRFER as reflecting your preferences for how much or little risk you're comfortable with in your portfolio. And remind yourself that we designed your portfolio to keep you on track to meet your financial and life goals.

If you have any questions, please call me at 416-733-5257 or email me at mark.pearlstein@rbc.com. I look forward to hearing from you.

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