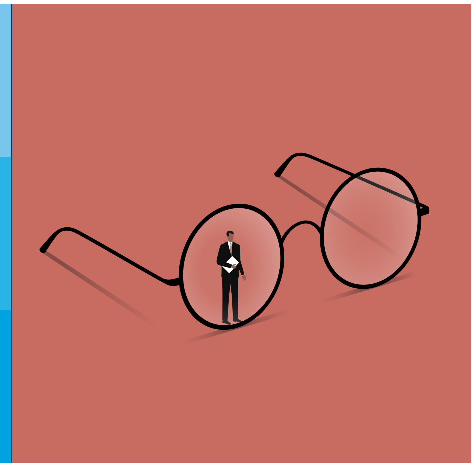
The pitfalls of fixating on yield



Key takeaways

- Targeting a yield level orients investors in the wrong direction.
- An additional +0.5% in yield generates the same incremental income, whether rates are low or high.
- When investors overemphasize yield, they also tend to make incorrect assumptions about interest rates.
- The role of fixed income should be the same in a low-rate environment as in a high-rate environment—it should always be a staple for a well-diversified portfolio.

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Introduction

It's incredibly tempting to fixate on yield. As a portfolio metric, yield feels like a uniquely tangible forecast of future returns. Yield seems more concrete than predictions about asset correlations, expected volatility, credit losses, or liquidity. It seems simple and straightforward. But it's this simplicity that can lead investors to folly. When investors overemphasize yield, they seem to think of it as a dial that can be cranked up or down to control portfolio returns, without much consequence. We believe this false sense of control gives investors a certain sense of comfort, when in reality it's all an illusion.

In fact, overemphasizing yield cuts other crucial factors of fixed income investing out of the picture. In this paper, we walk through four common misconceptions that we see among investors who fixate on yield.

"I am more concerned about the return of my capital than the return on my capital."

–a quote often attributed to Mark Twain.

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Misconception: "As the Fed raises rates, bond yields will rise."

In an environment where investors focus too heavily on yield, we find that they also tend to make incorrect assumptions about interest rates. The most common version is the idea that rate hikes by the Federal Reserve (Fed) are a rising tide that will lift all boats, or all yields, across all bond maturities.

In reality, the Fed's targeted rates only affect an extremely narrow portion of the yield curve—the shortest-term rates connected to overnight lending, the Fed's actual target. For the rest of the yield curve, Fed moves are only one input among many, and a really minor input at that. In fact, longer-term rates can actually decline on days when the Fed raises its overnight rate target—something we saw in 10-year Treasury rates when the Fed hiked rates in 2015, 2016, and 2017. Rather than rate hikes, expectations for economic growth and inflation have a much stronger influence on intermediate- and long-term rates. So if you're expecting longer-term bond yields to rise just because the Fed raises rates, think again.

Misconception: "When rates are low, any incremental yield is helpful."

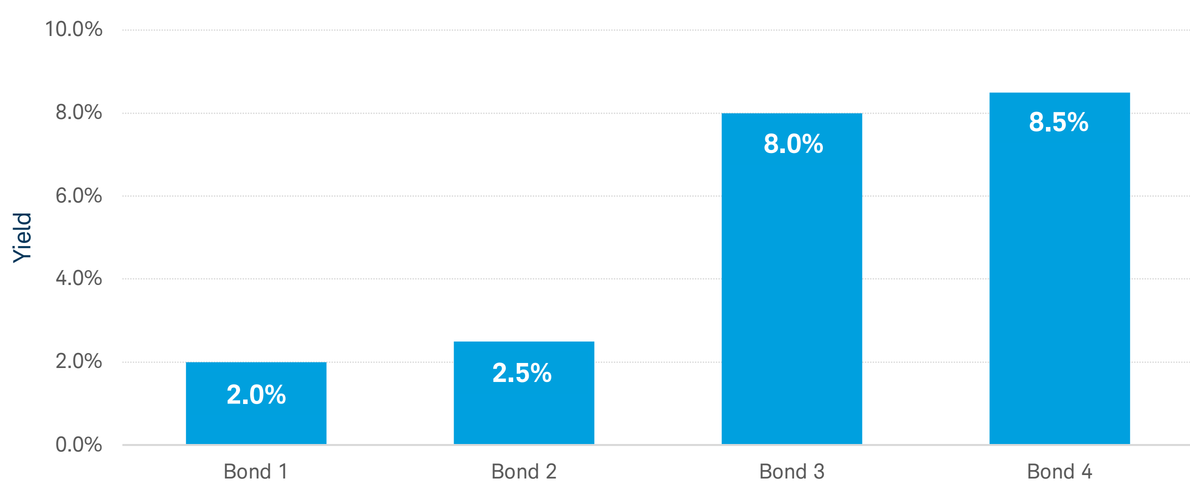
"How can I boost my yield?" is one of the most common questions we hear from investors. Yet, this question seems unique to low-rate environments. In other words, when rates were higher, investors rarely focused on how they might get 0.5% more yield—a slightly higher yield didn't seem like a big

The reality is that...an additional +0.5% in yield is worth the exact same incremental dollars, whether rates are low or high.

Half-point reality check

Whether a bond's yield is high or low, an additional half-point of interest generates the same level of additional income.

Hypothetical 10-year Treasury bond yields



Hypothetical example for illustration only.

The reality is that we all tend to think in relative terms, but an additional +0.5% in yield is worth the exact same incremental dollars, whether rates are low or high. For example, in a $100K portfolio, an investor adds $500 per year in interest income by going from a 2.0% to 2.5% yield. An investor would also add $500 per year in interest income by going from 6.0% to 6.5%, or 10.0% to 10.5%—yet in the higher-yield environment, far fewer investors seem concerned about adding another 0.5%.

Misconception: "Yield targets make sense."

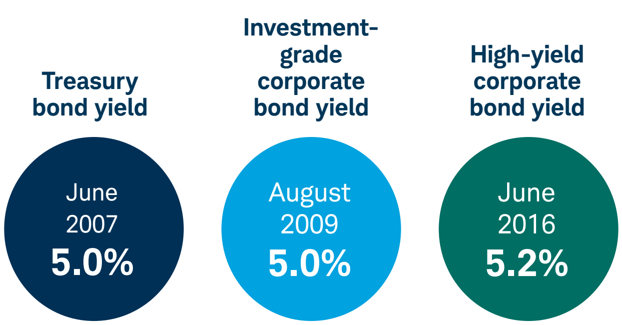
Just as there is no free lunch, there is no free yield. Any incremental boost comes with incremental risk—credit risk, duration risk, and/or liquidity risk, to be exact, regardless of whether the general rate environment is low or high. Anyone who started investing (or even had a savings account) more than a decade ago remembers when rates were higher.

Perhaps that's why we still see evidence that investors believe a target yield is a reasonable goal. Indeed, as recently as 2007 (pre-financial crisis), it was common among institutional and individual investors to set a 5% yield goal, a portfolio that included a mix of Treasuries, and call it a day. The problem is that some investors have carried this assumption into the present, despite the tectonic shift in the level of interest rates. In fact, structuring a lower-yielding portfolio makes them feel they are losing something in the deal.

The prudent and rational approach is to target the appropriate level of risk for a portfolio, and accept that the nominal yield matching that risk level will change over time.

Targeting a yield level orients investors the wrong direction. The more prudent and rational approach is to target the appropriate level of risk for a portfolio, and accept that the nominal yield matching that risk level will change over time. The "appropriate" yield level changes over time. And it's a huge mistake to think otherwise.

Want a 5% yield?



Sources: Charles Schwab Investment Management; Bloomberg.[1]
Past performance is no guarantee of future results.

Don't chase a moving yield target

Think that a 5% yield target represents the same level of credit risk in the current environment as it did a decade ago? Think again!

Misconception: "The current low-yield environment is temporary."

Quite a few investors still believe that today's low rates don't make sense. How can we be lending money for 10 years at less than 3% per year? This fundamental view leads to another flawed conclusion: that the low-yield environment just can't last.

In this case, we remind investors that a low-yield environment is the product of a low-inflation environment. Similarly, a high-yield environment is the product of high inflation. We may think we prefer higher nominal yields, but that requires high inflation. It's easy to forget that when yields on 10-year Treasuries were in the double digits back in the early 1980s, inflation was skyrocketing.

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Nominal yield is easy to focus on, but real yields (which are adjusted for inflation) are a far better gauge to focus upon. Only real yield actually increases the future purchasing power of invested dollars. And real yields today are not all that low compared to the past, as shown in the chart below.

Inflation-adjusted yields are entirely respectable

Yields on 10-year Treasuries minus changes in core consumer prices are not all that low compared to the past.[2]

Real yields today are not all that low

Sources: Charles Schwab Investment Management; Bloomberg; Bureau of Labor Statistics.
Past Performance is no guarantee of future results.

Conclusion

The current preoccupation with yield may lead investors to take a myopic view of fixed income. Yield itself shouldn't drive an investor's fixed income allocation—the role of fixed income should be the same in a low-rate environment as in a high-rate environment. For most investors, fixed income is the anchor of a portfolio, deployed for the key goals of preserving capital, diversification, and some form of income. The hunt for yield can obscure these crucial inputs to portfolio design.

We caution investors to look beyond nominal yield. Instead, focus on the role of fixed income in an overall portfolio. Allocations to fixed income should be set not with a yield target in mind, but with a balanced view that incorporates the role of bonds, real yields, expected volatility, correlation, and liquidity considerations. By comparison, an approach that overemphasizes yield is sure to encounter pitfalls.

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Brett Wander is Senior Vice President and Chief Investment Officer of Fixed Income for Charles Schwab Investment Management, Inc. (CSIM). He is responsible for all aspects of the firm's fixed income and money market portfolios, leading a team of more than 20 investment professionals.

With more than 25 years of investment management experience, Mr. Wander has been intimately involved in the design, development and oversight of a wide range of active, indexed and alternative fixed income strategies. His expertise spans a wide range of global and domestic markets and sectors. Prior to joining CSIM in June 2011, Mr. Wander was senior managing director at State Street Global Advisors, where he managed and directed the firm's $30 billion active fixed-income enterprise. He also held senior fixed-income leadership positions at Loomis Sayles, State Street Research and Payden & Rygel. In those roles, he designed investment processes, developed risk management methodologies, managed investment teams, and consistently generated strong investment performance track records.

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1. "Treasury bond yield" represented by the Bloomberg Barclays U.S. Treasury Index, "Investment-grade corporate bond yield" represented by the Bloomberg Barclays U.S. Corporate Investment-Grade Index, and "High-yield corporate bond yield" represented by the Bloomberg Barclays Ba-Rated U.S. High-Yield Index. For additional information about the indices shown, please visit www.schwabfunds.com/glossary.

2. The chart shows the yield of the 10-year Treasury minus changes in the core Consumer Price Index for All Urban Consumers. Data from 10/31/12 to 10/31/17.

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