Charles Schwab Investment Management

A lower-for-longer world

Investment considerations in a prolonged low-interest-rate environment

Moderator

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Panelists

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Executive summary

The Federal Reserve has reversed course on its target for short-term interest rates, as the trade war and other concerns have clouded the picture for economic growth. Outside the U.S., economic activity has been decelerating, leading to rate cuts by more than 30 central banks so far in 2019. In the U.S., federal funds futures are pricing in even more rate cuts, as global risks encroach on U.S. growth. So it feels like we're entering a new low-yield environment worldwide.

While this environment has helped fuel returns in both equities and fixed income, it may also present pitfalls. Investors who chase yield and performance may take on unintended risk. They may also inadvertently undermine the ability of their fixed-income holdings to buffer equity market volatility. Schwab's Tom Hagstrom asked three of the firm's investment professionals—Brett Wander, Jonas Svallin, and David Kastner—to share their thoughts about the new low-rate backdrop and what it might mean for investors.

Key takeaways

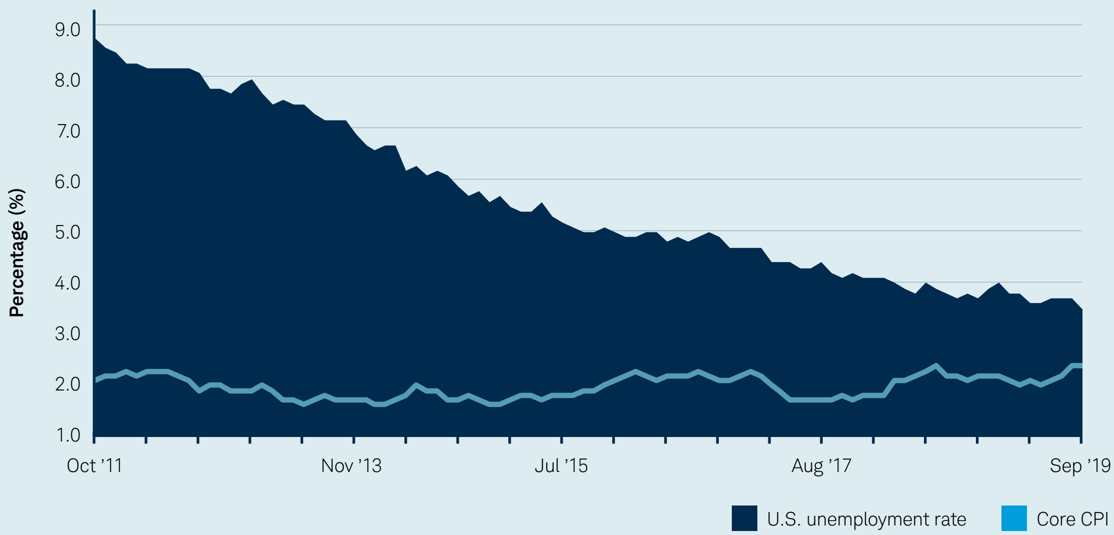
- Despite low unemployment and steady economic growth in the U.S., which have historically led to higher inflation, pricing pressures remain subdued. Interest rates could remain low and even go negative, though we think this is unlikely in the U.S.
- Investors should resist chasing yield in fixed income in a low-rate environment. Chasing yield can lead to adding lower-quality securities, which increases a portfolio's exposure to credit risk.
- In equities, investors should resist chasing performance. In a low-rate environment, higher-yielding stocks become more attractive, but valuations are high relative to historical averages, suggesting a correction is possible.
- A better way to invest in a low-rate environment is to take a total return approach and remain diversified, while rebalancing regularly.

Brett, can you give us the backstory on the shift in the Fed's posture this year? Could negative yields become a reality in the U.S.?

BW: There are three fundamental changes that are having a significant impact on the Fed. The first is a sense that the U.S. economy can have reasonable growth and strong employment and still have low inflation. That's a big change from the past. It used to be that a strong economy and job market would result in higher inflation. But the unemployment rate has dropped from almost double digits several years ago to an all-time low of around 3.5% in September, and inflation hasn't budged.

Inflation has not responded to declining unemployment

In the past, a tight labor market resulted in higher inflation—but low inflation persists even with record unemployment.



Sources: Bloomberg, Charles Schwab Investment Management. Data from 10/31/2011 to 09/30/2019.

The second fundamental change relates specifically to the Fed. In the past, for the Fed to cut rates, they would need to see a significant deterioration in the economy. But today, the Fed is not waiting for that. For the first time in quite a while, they are trying to get ahead of a potential downturn with "insurance cuts."

The third fundamental change concerns negative rates. For a while, negative rates, which have appeared in Europe and Japan, were considered something we would never see in the U.S. And though it's still not likely, it's certainly a possibility. If I had to put a probability on it, I would say it may be something like 20% to 25%.

David, you manage portfolios made up of bond and stock ETFs. Can you talk about the impact of lower yields on your strategies and positioning?

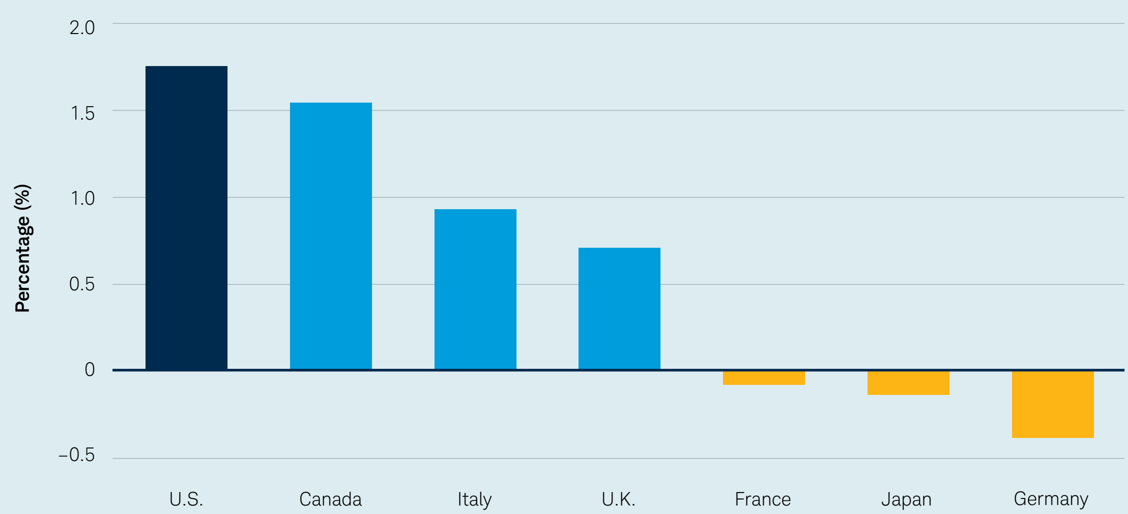
DK: We've seen an atypical decoupling between interest rates and risk assets. Usually, these are positively correlated. Historically, when interest rates go up, it's because the economy is strong, and risk assets tend to also go up. But over the past year, as interest rates have fallen, we've seen Treasuries, corporate bonds and stocks do well.

In fact, the sharp drop in U.S. rates helped the more conservative portfolios—which have a high allocation of bonds—keep pace with the more aggressive portfolios led by the interest rate–sensitive utilities and real estate investment trust (REIT) sectors. Yet as the U.S. economy continued to grow at a still-solid pace, some of the growth-oriented equity sectors also outperformed the broad market.

Although U.S. interest rates are low, they are still high relative to those in other developed markets. That, and a flight to safety related to trade tensions, has resulted in a strong U.S. dollar. The strong dollar has been a headwind for commodities and emerging market stocks relative to those in the U.S.

Low rates, worldwide: 10-year government bond yields

U.S. interest rates are low but remain higher than in other developed countries, as represented by G7 10-year yields.



Sources: Bloomberg, Charles Schwab Investment Management. Data as of 10/18/2019.

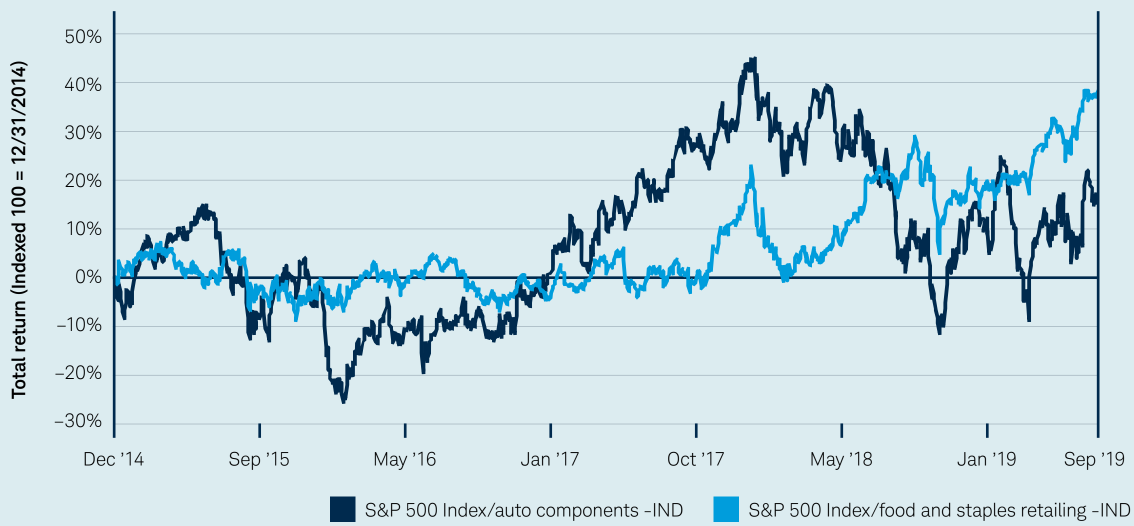
Over the last several quarters, we've responded to these conditions by implementing a mix of defensive and pro-cyclical positions. In fixed income, we've extended duration while maintaining credit exposure. In the equity space, we've maintained an overweight to U.S. technology and consumer discretionary—both cyclical sectors—while also increasing exposure to consumer staples and real estate and underweighting financials. So we've moved to a portfolio that has a neutral beta to the benchmark but with increased duration.

Jonas, your team manages active equity strategies, and I'm sure falling rates impact securities, sectors and countries differently. How does this environment affect your team's management process?

JS: Falling rates have had a dramatic impact across the entire market, but in the past one to two years, we've observed that the deep value names, the so-called cyclicals, have been especially affected. They've declined disproportionately versus many other value companies. So we've been careful to differentiate among value names.

Deep value stocks have underperformed

Cyclical stocks have underperformed compared with other value companies, as seen by the recent-year returns of the auto components industry versus the food and staples retailing industry.

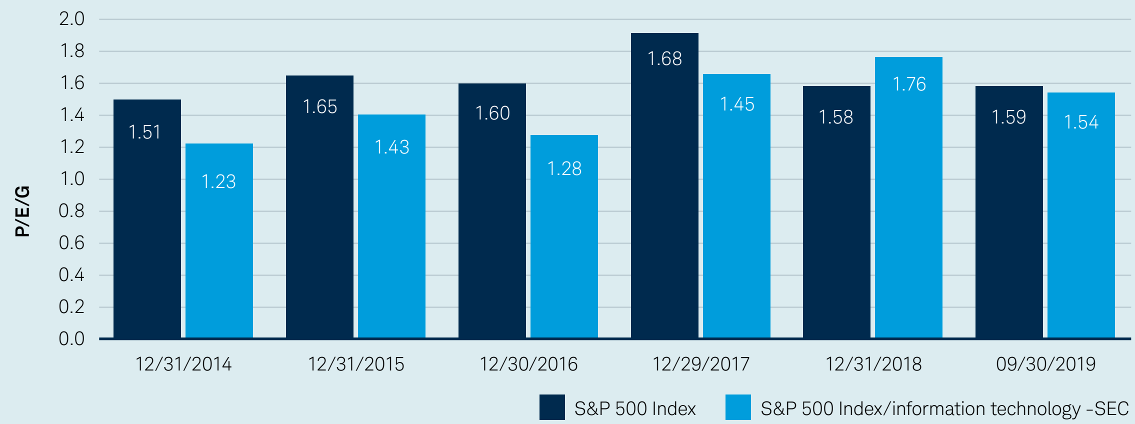


Sources: FactSet Research Systems, MSCI, and Charles Schwab Investment Management. Data from 12/31/2014 to 09/30/2019.

Another thing to recognize is, where growth is scarce, investors will bid up the prices of growth stocks disproportionately. That is, they will be willing to pay a high premium to access growth. We have introduced additional growth measures to find securities that are generating growth but trading at a reasonable price, that is, GARP securities. Software has performed well and by conventional value measures has become expensive (based on price-to-book), but once you take into account growth, it looks more in line with the rest of the market.

Tech: The price is right

Information technology may seem expensive from a P/E standpoint, but thanks to software stocks, we consider them GARP opportunities after accounting for growth.



P/E/G is (Price/Earnings) / Forecast Earnings Growth.

Sources: FactSet Research Systems, MSCI, and Charles Schwab Investment Management.

Although macroeconomic forces do impact the market, our process is built on minimizing that impact. This requires finding high-quality companies that don't exhibit too much cyclicality. We might be splitting hairs, but we simply don't want too much cyclicality, given where we are in the business cycle.

Brett, can you discuss the "chasing yield" phenomenon that investors can fall prey to and why this might lead to undesirable outcomes?

BW: Chasing yield is one of the biggest mistakes investors frequently make in a low-rate environment. A 2.0% yield on a Treasury may not seem compelling, so investors might think, "I could double my yield by going into the high-yield market." But that might add only 150 to 200 basis points and could add a tremendous amount of risk, especially credit risk.

Want a 5% yield?

Treasury bond yield	Investment-grade corporate bond yield	High-yield corporate bond yield
June 2007	August 2009	September 2019
5.0%	**5.0%**	**5.5%**

Don't chase a moving yield target

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

Sources: Bloomberg, Charles Schwab Investment Management.

Also, if the purpose of fixed-income holdings is to buffer equity market volatility, shifting from high-quality to low-quality securities may be self-defeating. It means you're converting your bond portfolio into one that's likely to be highly correlated with the equity market.

David, there is an equity equivalent to "chasing yield," and it's called "chasing performance." Can you explain how investing in a managed solution like Schwab Managed Portfolios™–ETFs can help clients avoid falling into this trap?

DK: Investors who chase performance assume the market's hottest segments will continue to be hot. Often these are high-beta stocks, such as in the technology sector. This performance chasing is often referred to as momentum, which our research and academic literature show works at various times.

As we've seen with fixed-income investors, equity investors have been looking for yield, and they've been buying into higher-yielding sectors, including real estate, utilities and consumer staples, which have led the market over the last year. However, the risk is that this momentum trade could come to an end or even reverse quickly as valuations in utilities, for example, are trading more than 1.5 standard deviations above their long-term mean, as shown in the chart below. So, many investors might be overly concentrated in those stocks.

Utilities sector is a good example of chasing yield

In recent years, P/E ratios have ramped up as investors have chased performance of stocks that offer attractive dividend yields.

Sources: Bloomberg, Charles Schwab Investment Management. Data from 03/31/1990 to 10/22/2019.

Schwab Managed Portfolios bring three benefits to the table. The first is diversification, both at the security level, using indexed ETFs, and at the portfolio level, because they're diversified across 16 asset classes, including domestic stocks, international stocks, bonds, real assets, and cash.

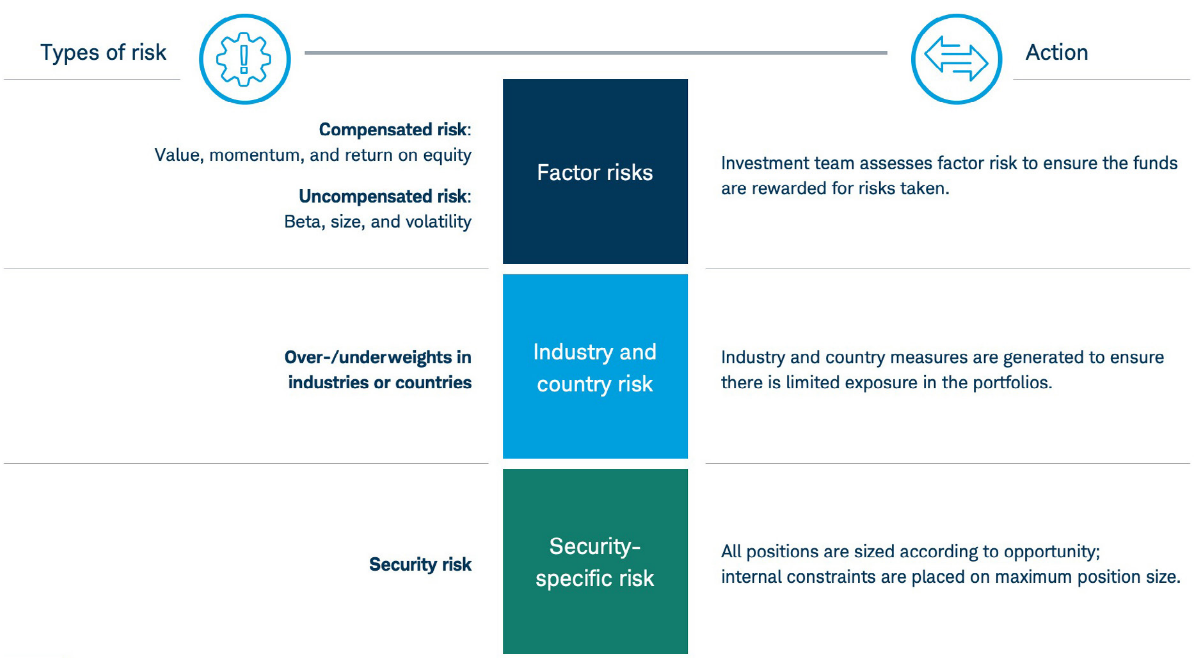
Second, we rebalance the asset classes that have outperformed and become over-allocated. This brings these portfolio allocations back down to the target level. Third, we do tactical asset allocation, giving clients the opportunity to take advantage of market trends and potential mispricings but in a risk-controlled manner.

Jonas, at Schwab we spend a lot of time reflecting on the behavioral finance aspects of investing and how biases may impede investor performance. Can you discuss how your security selection process for the Schwab Active Equity portfolios tries to minimize behavioral pitfalls?

JS: We use a systematic process to try to take some of the behavioral biases out of investing, because we know that we all exhibit these biases to varying degrees. By using a systematic process, we strive to make sure that the portfolio includes only securities that meet our investment criteria and excludes stocks that would be there because of the effects of anchoring, overconfidence, and other behavioral biases.

Investment process: Risk management

Our commitment to risk management is inherent throughout the investment process.



One way we do this is to represent each of the industries we're covering in the portfolios. If you know you're going to pick one or two names in each industry, you can put together a portfolio that has the systematic properties you're looking for while minimizing the biases.

Another way of thinking about this is how we screen for stocks. Most fundamental investors might say, "I'm just going to screen out the names that have a price-to-earnings ratio higher than X." Because P/E ratios vary in different market conditions, that absolute approach can eliminate a lot of names at different times. So you need to screen in a way that is appropriate for the environment you're operating in.

Also, we don't build a portfolio that's necessarily designed for the short term. We build one that we believe is going to work over a full cycle, or as long as 10 to 15 years. On top of that, we use a framework to recognize the different phases in the cycle, which gives us some tactical flexibility.

Brett, what are some of the rules of thumb that can help clients navigate the fixed-income world?

BW: Here are several that come to mind.

No. 1: Fixed income makes more sense in your portfolio as your time horizon gets shorter. Generally, as you age, you're going to want more bonds than you would in younger years.

No. 2: In a low-rate environment, fixed income is still relevant. Investors may think, "If interest rates are low, I need to reduce my fixed-income allocation." But if they think in terms of real returns, meaning the return after inflation, they'll find that those returns are just as high when interest rates are low.

No. 3: Watch out for the "chasing yield" trap. Remember that additional yield comes with additional risk.

No. 4: Active management has a role in fixed income. But if it's nothing more than overweighting credit and high yield, what you're getting is not true active management. All you're getting is a higher-risk strategy.

No. 5: When liquidity dries up, investors would be well served to hold mutual funds and ETFs. These vehicles provide greater liquidity than individual bonds as well as greater diversification.

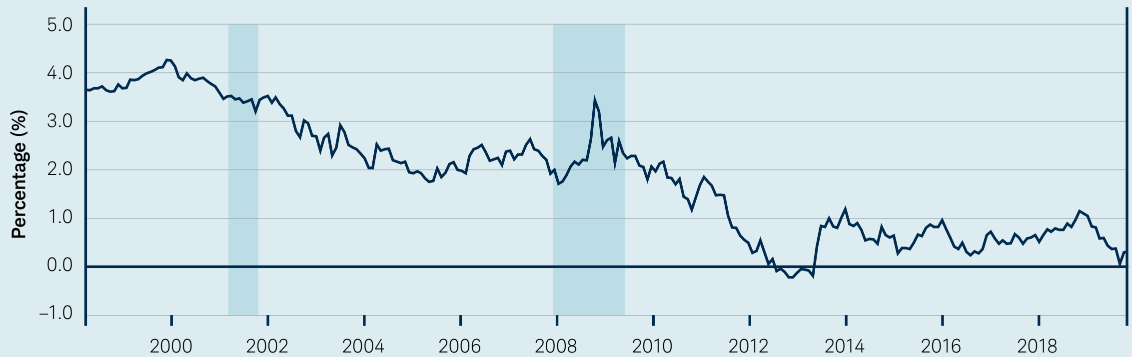
Jonas, is there anything about this low-interest-rate environment that seems new, or does this feel similar to other periods in our financial history?

JS: I hesitate to say there's anything new, because we're familiar with many aspects of this environment, either by direct experience or historical analysis. When you look at the historical data, you realize we've seen many of these conditions before.

Real interest rates, however, have declined over a long period. Nominal rates and inflation have fluctuated widely over the last 30 years. This has to do with demographics to some extent, especially in the rest of the industrialized world. And this trend is finding its way into the U.S. as well.

A low-rate environment years in the making

U.S. real interest rates have been grinding lower and lower over a long period.



Shaded areas indicate U.S. recessions.

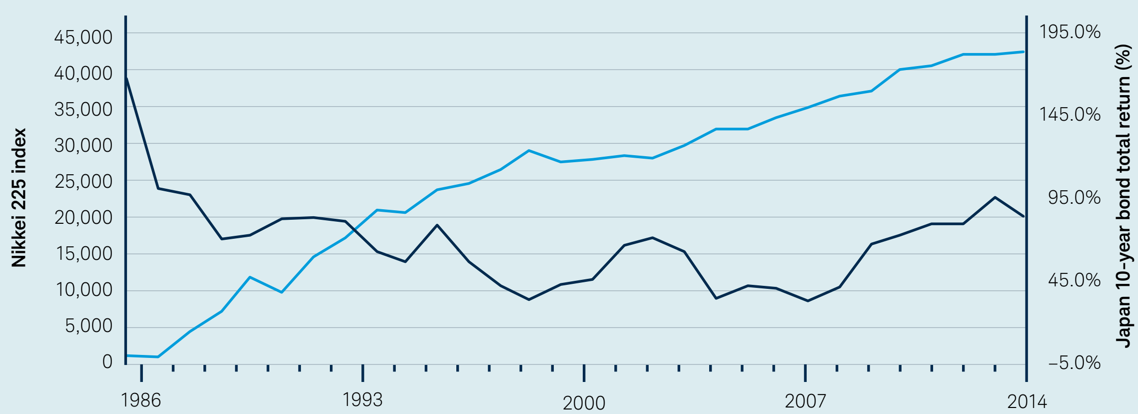
Sources: Charles Schwab Investment Management, Dow Jones & Company, Federal Reserve Bank of St. Louis, FRED.

David, what are your thoughts about the relevance of investor experiences in Japan and Europe with respect to low yields?

DK: In the late 1980s and early 1990s in Japan, interest rates fell from 9.0% to less than 2.0%. And after that happened, Japanese investors made a sizable shift from fixed income to equities, seeking higher returns. But that was a poor strategy, because in Japan stocks lagged bonds over the long term. In fact, returns for stocks were negative, while returns for bonds were positive, not just relative to stocks but in absolute terms.

The fallacy of chasing returns

As some Japanese stock and bond investors have learned, the bullish pursuit of returns can lead to unfortunate outcomes.



Sources: Bloomberg, Charles Schwab Investment Advisory, Inc.
Data from 02/28/1986 to 12/30/2014.

This should be a warning flag for U.S. investors. We're seeing some people repeat the mistakes of Japanese investors because they're taking on too much risk while chasing their desired returns.

In fixed income, there are still potential gains to make from a total return approach. As in Europe and Japan, the path to lower interest rates brings higher total returns to fixed income. So, although we have a low-interest-rate environment, now is not the time to abandon fixed income. As in Japan and Europe, rates in the U.S. may go even lower.

In this environment, investors should remain globally diversified. Thirty years ago, Japanese investors who recognized the risk of home bias were well served by investing overseas, as global equities largely outperformed Japanese equities.

Any closing thoughts? Would you like to expand on any of the topics we have discussed today?

JS: Although we are currently in a low-rate environment, historically, when rates have moved higher, they have often moved very rapidly. So, when this environment changes, it could happen more quickly than many expect.

Investors with a long investment horizon shouldn't build their portfolios only with this current environment in mind. I think it behooves investors to stick to a long-term plan that can see them through the various environments of a full market cycle.

DK: Investors should also note that in the past the Fed has sometimes been successful in averting economic downturns. So, although it looks like a recession may be imminent and that rates are going lower, the Fed's recent actions could bring about a sharp reversal.

If so, the yield and performance chasing by some investors represents some peril. This underscores that investors should take a well-diversified, total return approach. This can be the best way to satisfy income needs and meet financial goals.

BW: In the midst of a lot of headlines and volatility out of Washington, D.C.—political activity, impeachment talks, etc.—it's notable that the financial markets seem pretty unresponsive and uncaring about the specifics going on in the political realm.

Whatever your investment philosophy, approach and strategies may be, chances are they are as applicable in the current low-rate environment as they would be in a higher-rate environment. So, if you value liquidity, diversification, thoughtful risk-taking, and competitive returns over time, your use of fixed-income strategies should be generally consistent and not fluctuate significantly based on the level of interest rates.

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