A Turning Point
We may be at a turning point that alpha favours beta. It is possible that the job of investing, specifically the ability to deliver pure alpha, is about to get a lot more difficult. This is no longer a “buy and hold strategy” world. The challenge for investors, however, is not to be too late to these new rotations in this kind of environment.

Following are views we have about what is happening in these cycles and some points of awareness we’re contemplating as global investors. In the coming months we will regularly share with you our alternative views on the world of investing.

Rising Real Yields: Driving a Shift from Beta to Alpha
We believe potential danger lurks ahead as short-term rates are expected to rise. We are at the end of coordinated easing across global developed economies. As the Fed QE halts toward the end of this year, investors are changing their expectations on monetary policy. We expect developed economies like the UK, New Zealand, Canada and the US to begin increasing their short-term rates in 2015, while the EU, Japan and others contemplate additional stimulus measures.

This differential monetary policy drives a wedge in the high global asset correlations that we saw at the post-2008 global financial crisis (GFC). A likely scenario ahead is that inflation may surprise upward in countries experiencing more growth. Rising inflation in these countries would then force their central banks to bias monetary policy toward earlier tightening, moving faster toward exiting the negative real yield regime since 2008. On the other hand, EU and Japan are later in the cycle and will bias toward continued, and perhaps larger, stimulus to combat deflationary forces driven by such structural growth impediments as rapidly ageing population and the fiscal compact.

Conundrum: The Diversion on Bond Pricing
This was a surprise for most market participants. At the beginning of this year, most large brokerage houses and economists were forecasting for the US 10-year bond yields to rise to 3.5% by the end of the year. Obviously they were wrong. While many point to the mystery buyer(s) from Belgium that pumped estimated $215 billion USD this year into the Treasuries market, I am not convinced the story is that simple. Often large returns are attributed to significant fund flow, but prices can be set with only a single $1 of transaction by the marginal traders—the important price determinant is the fundamentals.

“One conundrum we saw play out this year was a sustained decline in long-term bond yields in the developed world.”

The key question to ask for long-term bonds is: Where are real yields? What is expected inflation? What are they likely to be in roughly 10 years from now and how do we get there?
Based on long-term demographic trends, we believe that the US economy will revert to normal growth and inflation patterns roughly 10 years from now. If this is the case, then these are our assumptions that follow:

- The yield of a 1-year forward rate 10 years from now should be about 5.5%, made up by 2.5% real growth and 3.5% expected inflation.
- Assuming linear normalisation of zero short rate to this 6%, a 10-year zero coupon bond should yield about 2.7% with no additional risk premium.
- Since the yields are so low today, the current 10-year benchmark Treasury has a modified duration of 8.7 years. As 8.7 years duration is close to 10 years for a zero, one can proxy the coupon-paying Treasury with a zero coupon bond.
- Hence, we believe a premia-free 10-year Treasury should be yielding close to 2.7.
- We don't expect to earn any interest rate risk premia for the next 10 years given the challenging demographics and the associated disinflation.
- So, the fair yield of a 10-year Treasury should be around 2.7%, which affirms our disagreement with the majority of forecasts that are calling for an imminent long-maturity bond yield rise.

### The “New Neutral” Is Myopic

There is vast speculation that equity markets are topping—the S&P 500 Index has returned 200% (including dividends) since March 2009 and 42% from 2013. The “equities are topping” argument goes as follows: with profit margins at historical highs, we should expect tough times ahead. While we recognize there is a potential for profit margins mean-reverting once labor income rises in the developed world, we are seeing this just beginning to happen in the US—but mean earnings yields are still significantly larger than bond yields. The reality is that valuation spreads argue for remaining exposed to risky assets, as the “New Neutral” view suggests. However, this perspective is myopic—we believe the problem investors going forward is that neither broad equity market indices nor bonds would sell off in a sharp correction. Additionally, it doesn’t seem likely that we’ll continue along on this risk on/risk off environment.

Rather, we believe the real problem for investors is that the high-realised Sharpe Ratios from long-only assets are no longer available. That is why we believe the “New Neutral” is myopic.

Rising real yields in the US and other countries experiencing steadier growth could drive real interest rates from negative toward zero. Normally, this can quickly induce volatility to return to the long-only markets as the expected risk premia increases through falling asset prices. Indeed, we have experienced a period of record low volatility. That is not likely to remain in place as we move toward the end of this year.

Considering yields, the influence of volatility on the Sharpe Ratio suggests the need for a broader—rather than myopic—view around yields, volatility and the risk premia.

That is why we believe the job of investing is about to get a lot more difficult. This is no longer a “buy and hold” world. For alpha investors, the good news is that we might be at a turning point again that favours alpha vs. beta. Investors may want to check their perspective so that they are able to realize the opportunities that put investors into this new rotation.

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**About Michael Ho**

Michael Ho is a seasoned investment professional who lives and breathes investing. He has more than 20 years of experience in absolute return, global macro, global equity, global fixed-income and currency investing. Michael is Senior Managing Director of SSGA and Chief Investment Officer for Active Emerging Market Equities and Global Macro. He is in charge of active investments in both emerging market equities and global macro. He holds a Ph.D. degree in Management Science Engineering, specializing in finance, from Stanford University. He graduated with a B.Sc. degree in Electrical Engineering from University of California, Los Angeles. Before joining SSGA, he was the CIO for Mellon Capital Management responsible for more than $220 billion of assets under management across all equities, fixed-income, global tactical asset allocation and alternative investments. He was responsible for all investment management, trading and research at Mellon Capital. Michael has extensive experience in both alternative and traditional long-only investments from alpha research and strategy design to portfolio management and implementation.
An Alternatives View | Insights From Michael Ho

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“Investing in foreign domiciled securities may involve risk of capital loss from unfavorable fluctuation in currency values, withholding taxes, from differences in generally accepted accounting principles or from economic or political instability in other nations. Investments in emerging or developing markets may be more volatile and less liquid than investing in developed markets and may involve exposure to economic structures that are generally less diverse and mature and to political systems which have less stability than those of more developed countries.” 90-day U.S. Treasury bills are insured and guaranteed by the US government. U.S. Treasury Bills maintain a stable value if held to maturity, but returns are generally only slightly above the inflation rate.