Elston

Elston Insights

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Yield is Back

- After a decade of suppression, yield is back
- Return of nominal (and real) yields forces asset repricing
- Yield can help underpin returns in uncertain times

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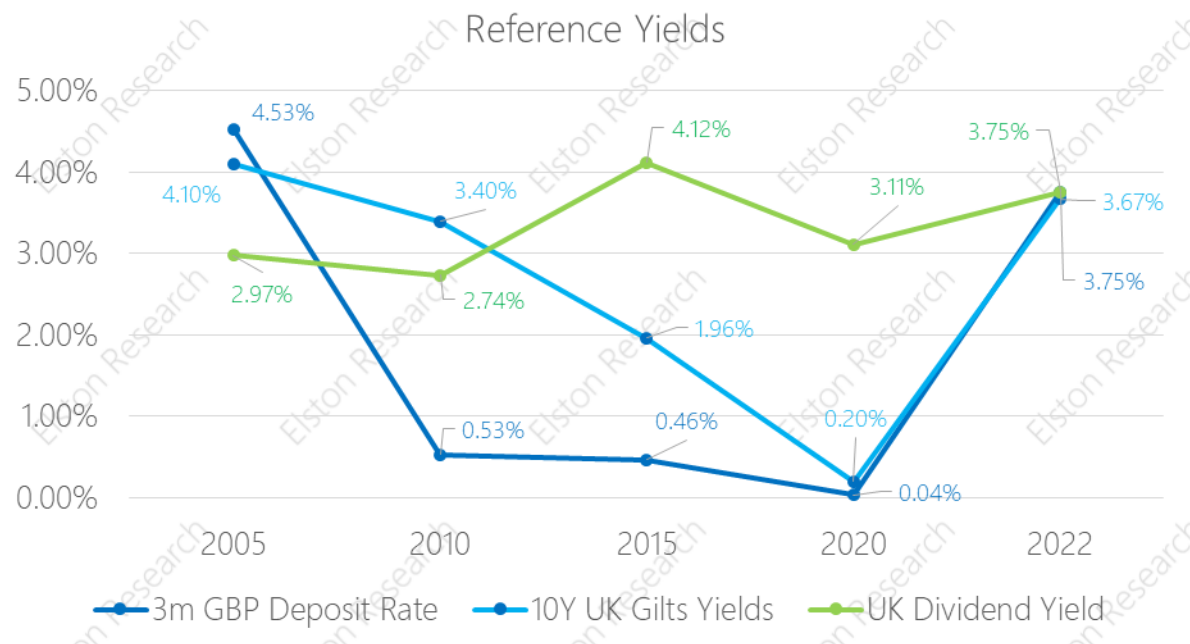
Yield is back

For equities, bonds and alternatives, the yield drought is over. Since the Global Financial Crisis, central banks' near-zero interest rate policy suppressed yields. As central banks now hike policy rates to fight inflation, interest rates are normalising. As a result, yield is back. Rising policy rates force a repricing of yield premia across all asset classes: equities, income-generative alternatives and bonds.

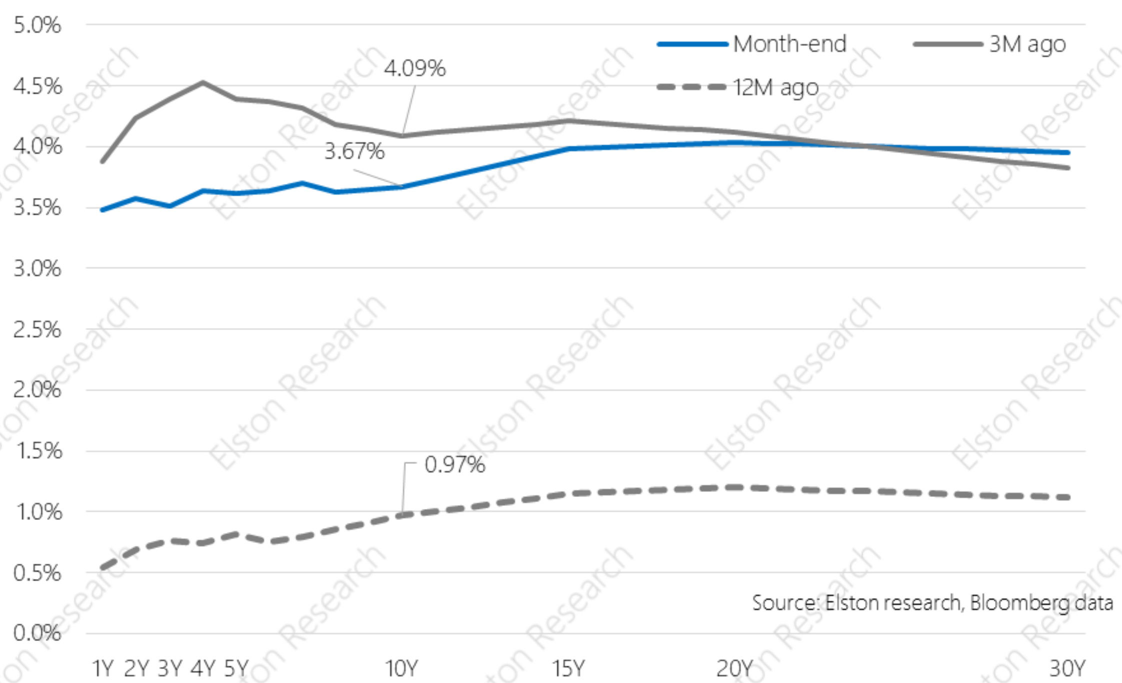
Yield can help underpin returns in uncertain times. From a portfolio construction perspective, income diversification becomes as important as asset diversification. As investors seek to build up diversified income streams, sizing risk across asset classes is key.

Fig.1. Indicative reference yields for GBP cash, bonds and world equities



Comparing UK Government Bond yields (risk-free rate) across maturities shows the extent to which the yield curve has shifted up compared to 12 months ago. The benchmark 10-year gilts yield is at 3.67% in Dec-22, up from 0.97% in Dec-21, albeit slightly down from 4.09% in Sep-22 following the Truss/Kwarteng budget. The yield curve changes force a repricing over returns for given terms across asset classes.

Fig.2. UK Yield, by term as at Dec-22.



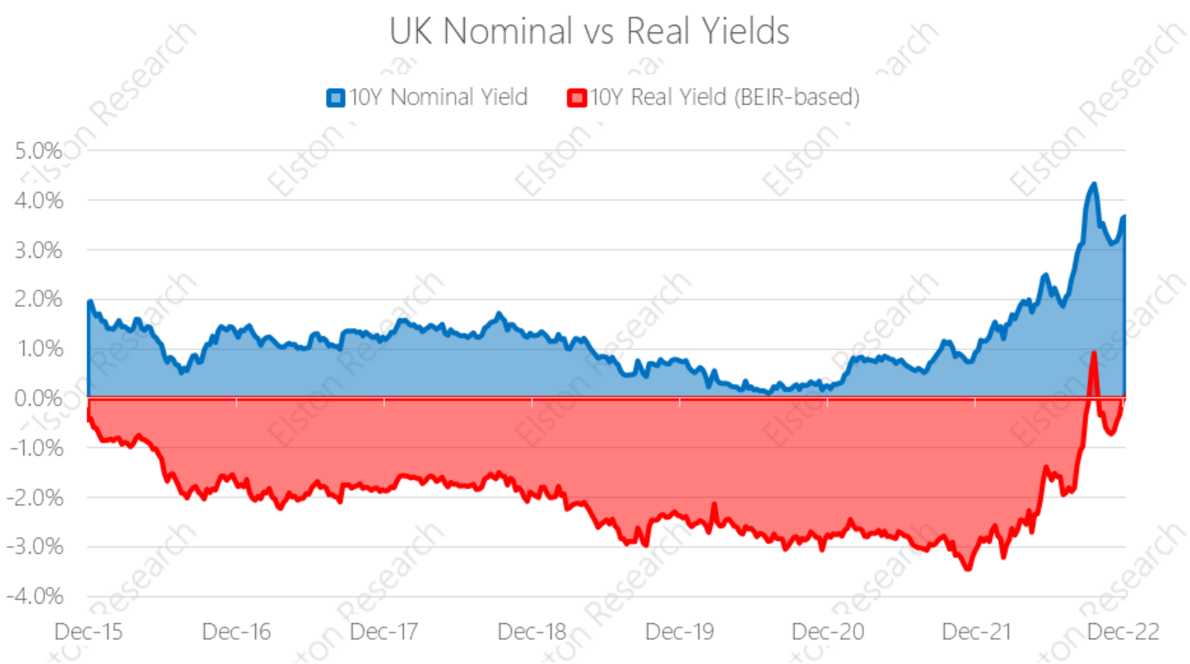
Not only have yields increased in nominal terms, but they have also started to increase in real terms.

The chart below shows the evolution of 10-year nominal gilt yields against 10-year real gilt yields (after adjusting for 10-year break-even inflation rates, a market implied measure of forward-looking inflation).

For the last several years, the persistence of negative real yields has forced investors into risk assets in order to obtain returns. As a result there was significant interest in higher risk public markets (high yield bonds, property, infrastructure, and dividend-focused equities). Negative real yields also forced investors to consider less liquid asset classes such as private markets (private equity, debt, infrastructure), and for some investors this led to a flurry of interest in speculative assets such as cryptocurrency.

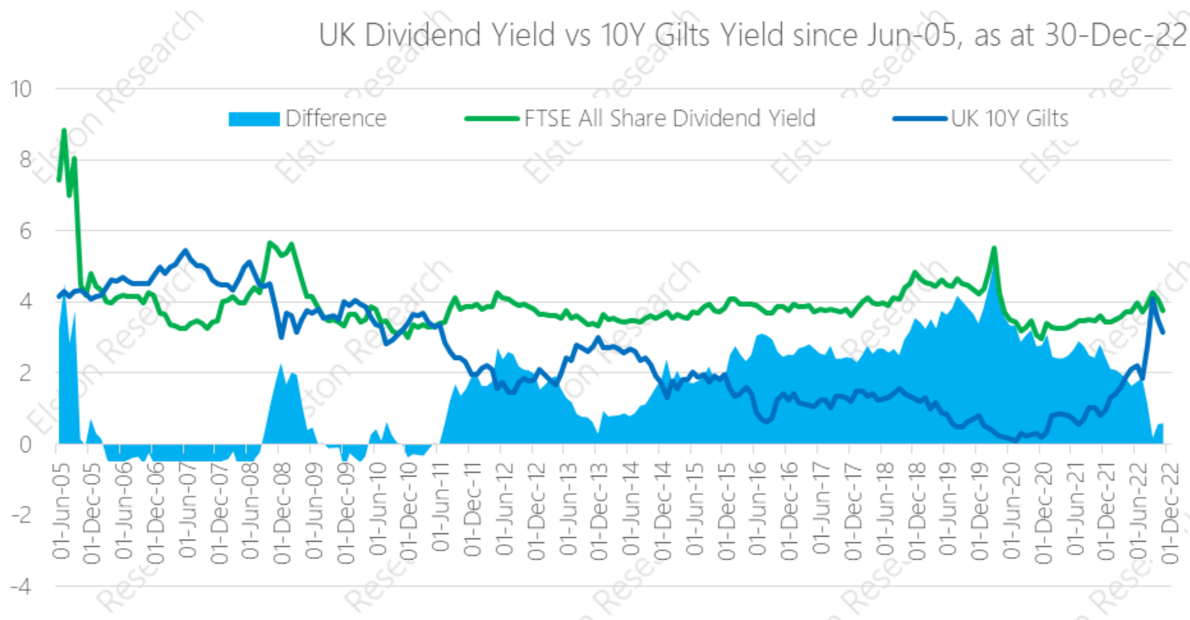
However with nominal yields now back and real yields closer to zero, investors can seek nominal returns with bonds once more.

Fig.3. UK Yield, by term as at Dec-22.



Yields have not only increased in absolute nominal terms and real terms, but have increased in relative terms too. Since 2011, the dividend yield on UK equities has been at a premium to UK 10-year gilts. Again this forced income seekers to up-risk portfolios.

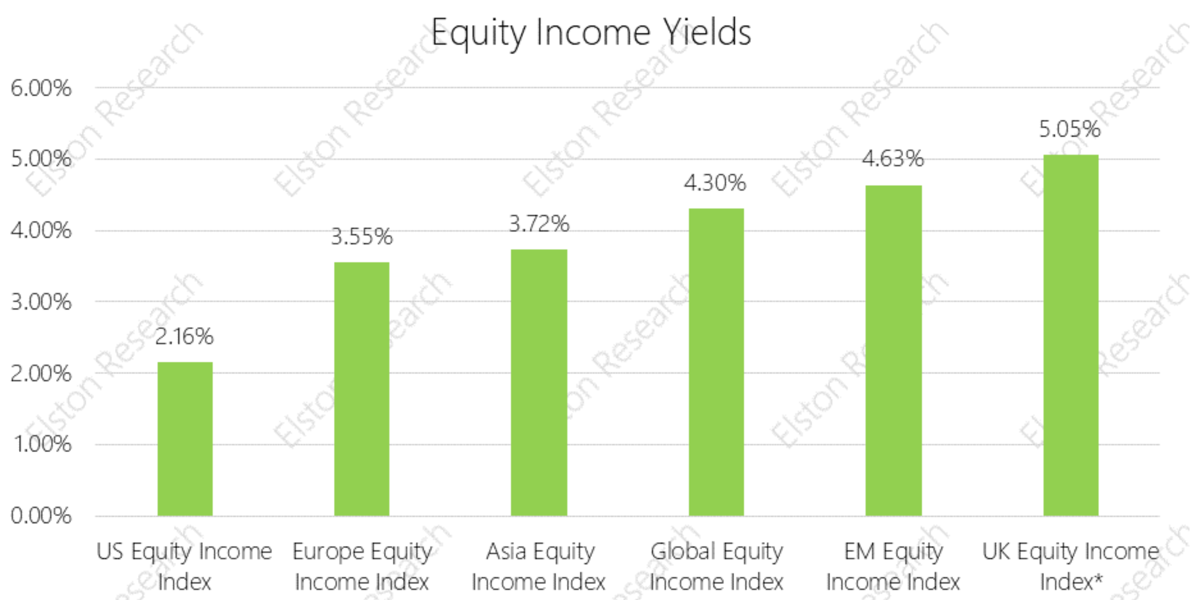
Fig.4 UK Dividend Yield relative to UK Gilts, as at Dec-22.



Source: Elston research, Bloomberg data

In the second half of 2022, this yield premium has all but eroded and for the first time since 2010, bond yields and equity income yields are commensurate. This means that equity income investors will have to work harder to secure a yield premium, relative to bonds. Our Elston Smart-Beta UK Dividend Index is an equity income index that is currently yielding 5.05%, higher than equity income indices for other regions. This is owing to the index construction methodology that is 1) dividend-weighted, 2) forward-looking and 3) updated monthly.

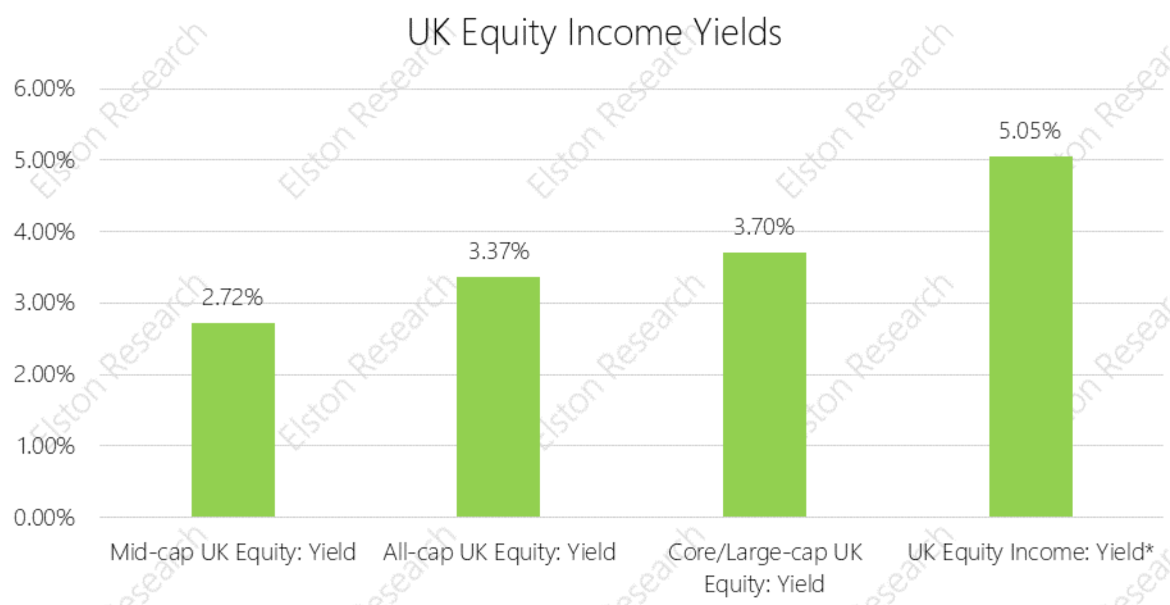
Fig.5. Equity Income Yields, by region, as at Dec-22



Source: Elston research, Bloomberg data. *Elston Smart-Beta UK Dividend Index [Ticker: ELSUKI]

Within UK Equities, an equity income-focused strategy can increase the yield available.

Fig.6. UK Equity Income Yields, by segment as at Dec-22

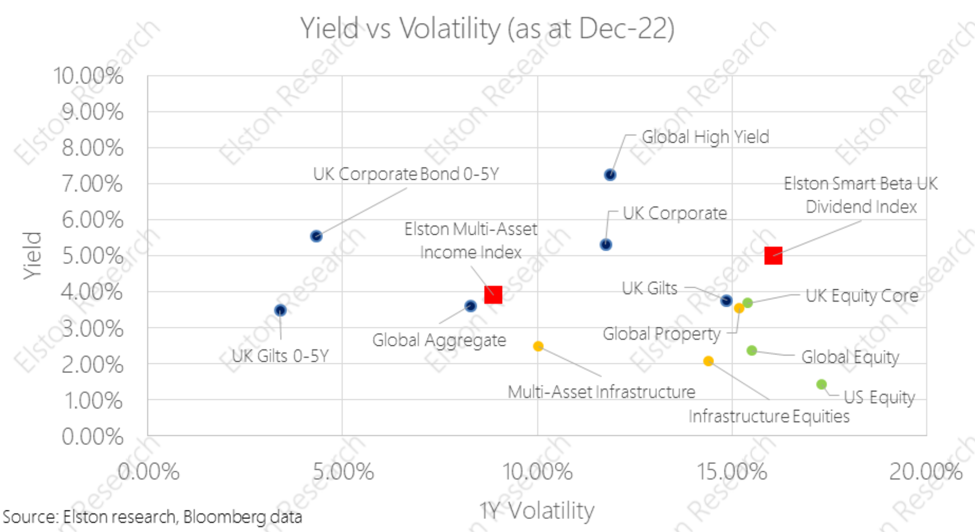


Source: Elston research, Bloomberg data. *Elston Smart-Beta UK Dividend Index [Ticker: ELSUKI]

The challenge for investors seeking additional yield to underpin returns is how best to size risk.

The chart below maps out current yields of key exposures across equities, bonds and alternatives, relative to realised 1 year volatility as an actual measure of ex-post risk. While bond yields are more certain than equity yields, the realised volatility of some bond exposures (e.g. Gilts) has been surprisingly commensurate to the volatility of Property Securities, Infrastructure Equities, and close to UK and Global Equities. Investors should consider the actual volatility and correlation structure of portfolio exposures beyond labels or long-run expectations alone.

Fig.7. Current Yield vs 1Y Historic Volatility



Source: Elston research, Bloomberg data

Towards a balanced approach

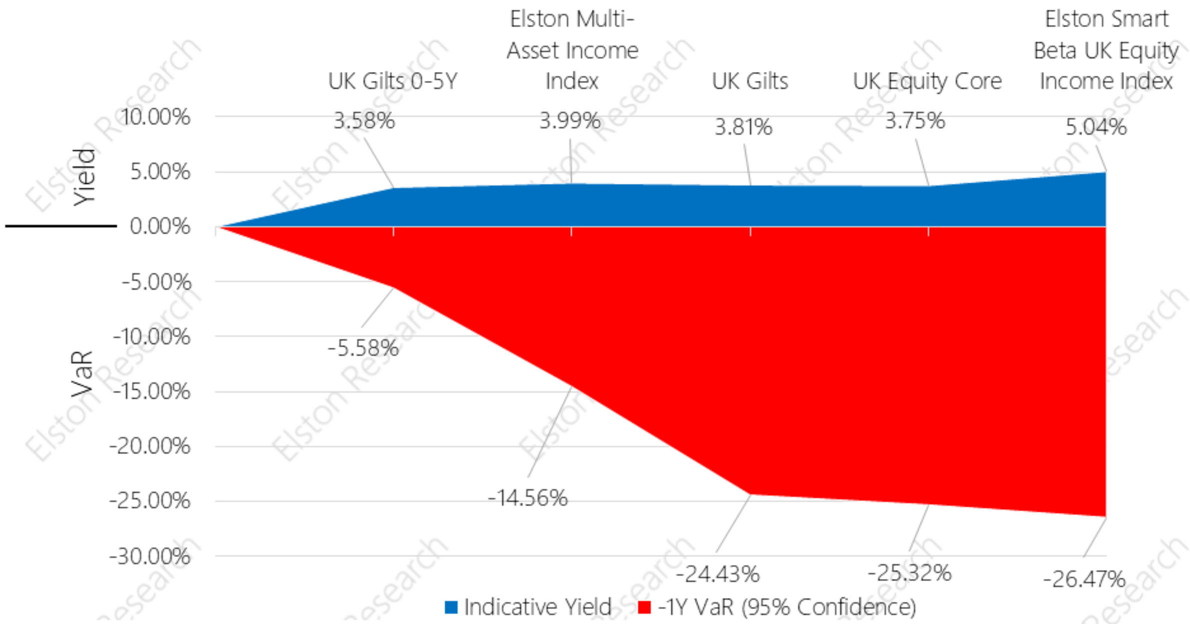
If we look at the Yield and Value at Risk or (VaR) of short-term <5y gilts, UK gilts, UK Equities and UK Equity Income, there is a clear trade-off between yield capture and downside risk.

For risk-averse investors, short-dated bonds have begun to look attractive but will struggle to keep pace with inflation, even as inflation moves past the peak.

For return-seeking investors, the yield on equities can still look attractive. It comes with capital risk but has potential to keep pace with inflation.

For those seeking a balanced approach, a multi-asset income strategy combines equity income yield from dividends, alternative income from property rents and infrastructure tariffs and traditional bond income. This enables significant yield capture, diversified income stream and risk mitigation.

Fig.7. Yield vs VaR for selected exposures, as at Dec-22



Source: Elston research, Bloomberg data

Conclusion

Yield is back, and this can help underpin returns.

For equities, focus on how best to maximise dividend yields while ensuring quality and persistency of that income stream. For alternatives, property is more cyclical and infrastructure equities and bonds are more defensive. For bonds, there is a trade-off around certainty (volatility risk) and purchasing power (inflation risk).

Sizing risk becomes key and allocations are a function both of risk budget and investors' return outlook. For a balanced, diversified income approach, a multi-asset income strategy captures income streams across asset classes, creating higher potential for returns compared to bonds without the increased downside risk associated with equities. As such an income diversification strategy could be considered as part of an Alternatives allocation, alongside asset diversification and risk diversification strategies.

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Our Research & CPD focuses on multi-asset strategies, index funds and ETFs.

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