
Summer Is Almost Over. So Is QE

By Editor Test *Wed, Aug 28, 2013*

"The unwinding of QE is a place we have never been before," says Phil Chiricotti, president of CFDD. The effects, and the end, of quantitative easing were also on the minds of Vanguard's Ken Volpert and the analysts at Cerulli Associates.

As the summer of 2013 coasts toward its unofficial end, the thoughts of many financial observers are focused on the beginning of the end of the Fed's "quantitative easing" program, and the potential impact on the markets.

In anticipation of rising yields and falling prices as the Fed buys fewer bonds in 2014, investors have been herding money from bonds to stocks. Pundits call the re-allocation process part of a "great rotation" (an expression not heard much until recently).

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Will we miss QE, and the floor that it helped establish under the prices of risky assets during the last few years? Ken Volpert, the head of Vanguard's taxable bond group, clearly will not. He recently wrote a blog post entitled, "Goodbye (and good riddance!) to financial repression."

Rather than dread falling bond prices, Volpert welcomes an end to the period of negative real yield that the Fed's bond-buying activity has visited on the overall bond market, as measured by the Barclays Aggregate Bond Index. He hopes for a return to an era when investing in a bond index fund offers an inflation-beating return.

He doesn't expect bond yields to return to their 10-year averages (\$1.9% for Treasuries and 3% for corporate bonds) very soon, however, thanks to a combination of above-normal unemployment, conservative spending by government and consumers, and the effect of "reverse QE" as the Fed gradually sells assets and absorbs some of the excess cash it put into the banking system.

"My expectation is that the continued slow growth will lead to a gradual increase of this real yield back to about 1% for the Aggregate Index over the next two years—a move that is likely to keep total returns in very modest positive territory for the total U.S. bond market over this period," Volpert wrote.

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While a firm like Vanguard, which manages huge bond index funds, wants to calm its shareholders about rising yields and prevent flight from existing bond funds, more opportunistic firms have capitalized on investor anxiety by creating new types of actively managed bond funds.

In the lead story in the *August U.S. Monthly Product Trends* edition of the Cerulli Edge, for instance, Cerulli Associates notes that QE has had a significant impact on product development in bond mutual funds.

At the beginning of the financial crisis, when yields were higher, money flowed heavily into intermediate bond funds, Cerulli said, with a peak of \$119 billion in 2009. By the second quarter of 2013, however, flows into those funds had turned negative.

Some of that money went into stocks, but a chunk has gone into “non-traditional,” actively managed retail bond funds that follow “benchmark agnostic” strategies. Going forward, the two most likely categories for new product development in bonds are “unconstrained” and multistrategy funds—basically, actively managed bond or income funds—and bank-loan funds, according to a Cerulli survey.

Bank-loan funds buy the speculative-grade and/or variable-rate loans that are used in leveraged buyouts. They offer higher yields than conventional bonds and reportedly have little or no exposure to duration risk. But they come with more risk than the typical bond investor might have an appetite for.

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Phil Chiricotti, the president of the Center for Due Diligence (CFDD), a Chicago-based organization for retirement plan advisors, has also been pondering the potential effects of the end of quantitative easing.

“The unwinding of QE is a place we have never been before and while the modest recovery has continued, it is still fragile. In other words, the ability to absorb higher interest rates remains an unknown,” he writes in his August 28 report.

In particular, he’s interested in the risk exposures of the target date funds (TDFs) that are the default investments in so many 401(k) plans. His report reminds us that different TDFs will respond to changing conditions in very different ways. He’s been tracking the performance of the major TDFs and found big discrepancies in their returns over the past year.

Even among TDFs with the same maturity, returns have varied widely. Within the 2015 “class” of TDFs, performance differed by as much as nine percentage points, depending on their exposure to the booming stock market. Performance has also varied by maturity, with bond-heavy 2015 TDFs underperforming 2045 TDFs by eight percentage points in the year ending June 30, 2013.

“The easy money has been made and TDF holdings beyond cash, stable value and short term fixed income have elevated risk on both the equity and fixed income side,” Chiricotti wrote. He welcomes a return to a period when the invisible hand of the market—as opposed to the hand of Ben Bernanke—sets asset prices.

“Assuming no new shocks—something investors can never be sure of—and no more than a moderate increase in rates, economic fundamentals should eventually replace monetary policy as the key driver of asset class valuations,” the CFDD president wrote.

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I hear relatively little about the vulnerability of equity prices to the end of QE. Many people acknowledge that low interest rates have helped drive the stock market indexes to new (nominal) highs. But there

doesn't seem to be a whole lot of concern that higher yields might trigger a reversal in stock prices. The assumption may be that if the U.S. economy is healthy enough to tolerate higher rates, it will be healthy enough to sustain the bull market.

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