## 2014 will be a challenging year for fixed income investors

- Interest rate forecasts are frequently misleading
- Forecast-free concepts based on a risk parity approach avoid the mistakes of discretionary decisions and systematically skim off risk premia

**Hamburg, 6 February 2014.** At the start of every new year, economic magazines are quick to offer more or less astute analyses of how markets can be expected to develop. Experts are asked to comment on where they think important equity indices might be by the end of the year, how important exchange rates might develop in relation to each other and in what direction yields on important bonds are likely to be heading by year-end.

The question concerning almost all institutional investors is how yields on key benchmark bonds, such as 10-year US Treasury bonds, are likely to develop. What could be more natural than to rely on the advice of the supposed experts? Fortunately it's easy to check in hindsight whether the professionals' premonitions were right or not. The Wall Street Journal, for example, carries out a half-yearly survey among a good 50 esteemed investment experts. So how did they see interest rates developing in 2013?

In December 2012, the yield on 10-year US Treasuries was 1.67 percent. The average forecast of these some 50 experts for twelve months later panned out at 2.26 percent, with the expectations ranging from 1.5 percent to 4.34 percent. Interesting how experts can come to such different conclusions using the same data. In fact, at the end of 2013, the yield on 10-year US bonds was 3.03 percent. Only one pair of analysts came close to making an accurate forecast. Investors who based their decisions on individual interest rate forecasts or even on the average of all forecasts were wrong. In effect they had simply taken a view, nothing else.

So what should be done? With conditions still characterised by low interest rates and the expectation of rising interest rates in the future, investors feel compelled to act. A reallocation into another specific sub-class from the fixed income area would appear to make sense. But it's dangerous to place one's bets on one asset class. Whether sovereign bonds, corporate bonds, emerging markets bonds or inflation-linked bonds – here again, the starting point of each investment is a discretionary decision – with all the same potential dangers of making the 'wrong' decision that apply when drawing on an individual interest rate forecast.

We believe that the goal of capital growth in times of unchanging or even rising interest rates can best be achieved by means of a forecast-free approach. That's why we've also applied our time-tested risk parity concept to the fixed income area. We work on the general assumption of efficient markets and therefore refrain from taking any position with regard to the level or the slope of a yield curve. How do we systematically skim off yields? By using four sub-asset classes with a low degree of correlation: Sovereign bonds, inflation-linked bonds, corporate bonds and carry positions in emerging markets, and by balancing these according to their level of risk. This mixture makes it possible to exploit positive return opportunities in all phases of the interest rate cycle – even when interest rates are climbing or are unchanged.

However, our fund – the ACQ - Risk Parity Bond Fund (EUR A: A1H5AH) – doesn't just invest in these four different fixed income segments, it also

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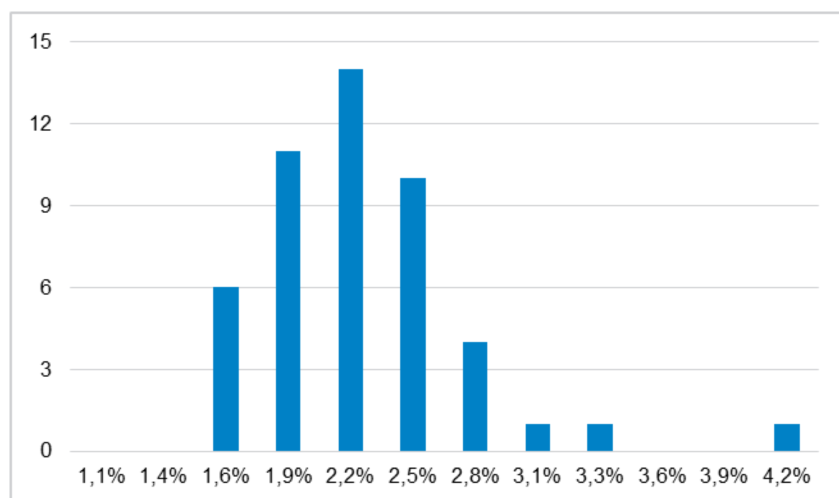
diversifies geographically and across different durations. When interest rates are falling, the fund profits from the development of the overall return on markets. When interest rates rise, the lack of correlation between the asset classes createsreturn opportunities. This method should be applied by investors over a longer period of time, if possible over the entire interest rate cycle.

But the crystal ball method continues to be applied, regardless. In the FAZ dated 4th January 2014, 24 analysts were asked where they believed that the yield on 10-year US Treasuries might lie at the end of 2014. The average answer was 3.35 percent. But beware. A year ago, the experts in the FAZ survey were as wrong with their estimates as their US colleagues from the Wall Street Journal survey. With an average estimate of 2.23 percent yield, their estimates were even slightly worse than those of the US economists. But maybe they'll have better luck this year.

**Chart 1: Yield forecast for 10Y US Treasuries**




*Source: The Wall Street Journal, 2013.*

*In December 2012, 48 analysts made their interest rate forecasts for 10-year US Treasuries for the end of 2013. The actual interest rate stood at 3.03 percent at the close of the year.*

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