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Curves (part 1) – not only a topic for race drivers

Johann Griener

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Have you ever been to the Monte Carlo F! Grand Prix? If so, you may have witnessed the problem of turning into a curve too late. The race car hits the crasher barrier faster than the driver can react, and a lot of money has to be thrown at the repair job.

So, what does a car race have to do with financial markets? The bond markets show similar performance criteria. If you are positioned at the wrong end of the yield curve, it may cost you a lot of money.

Germany has the yield curve with the best rating

The yield curve, or more precisely, yield structure curve, shows the yield with reference to the remaining time to maturity. Usually, the longer the money is tied up, the higher the yield is (longer remaining time to maturity = higher risk = higher yield). Let’s have a look at the current yield curve for European benchmark bonds (German government bond).

The chart illustrates the German yield curve as of 4 April 2017 for a remaining time to maturity of two to ten years:

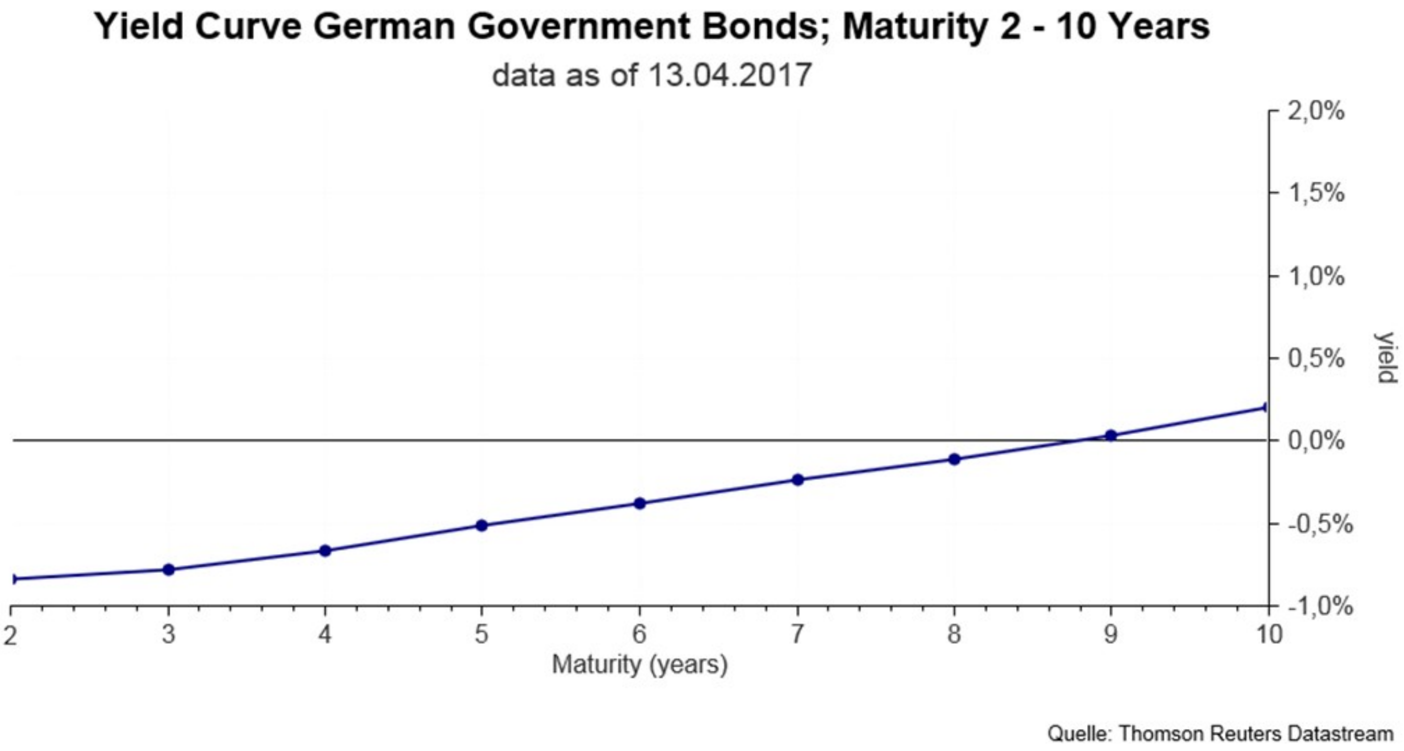

Chart: Yield structure curve for German government bonds 2Y to 10Y

Sources: Datastream, as of 4 April 2017

The chart also contains the zero percent line. Curve-sketching involves a number of aspects. We shall start with the objective criteria “location of the curve” and “yield in percent”

- Slope of the curve: the yield of short remaining time to maturity is significantly below that of the yield of long remaining time to maturity. In this case, the yield curve is referred to as steep (which, historically, is the normal state of affairs; it is therefore also called the “normal yield curve”).
- Location of the yield curve: the yield in percent, i.e. the absolute height of the curve, is more interesting. In view of the delineated zero-percent line, it is easy to see that up to a remaining time to maturity of 8Y, bond yields are negative. The yield only switches into positive terrain from 9Y onwards (albeit at low levels).

We can now take the next step and ask ourselves what this means for potential investors:

- Nominally speaking, German government bond yields are negative or at least very low (at long maturities). Taking into consideration fees at the time of purchase and for the depositary account during the life of the bond, this investment is not particularly attractive in terms of return rates.
- The adjustment for expected inflation yields the “real rate of return”, which is even less attractive for this investment.

Why yields are currently so low and the prices of these bonds are so high

High prices manifest high demand. But who buys such bonds? Buyers are mainly institutions and institutional investors who (have to) invest in these bonds for various reasons such as:

- The European Central Bank within the framework of the bond purchase programme
- Insurance companies and pension funds
- Banks for their own account
- Investment funds due to the fund terms and conditions

We would like to use an example to show what such an investment means for a retail investors.

The aforementioned yield curve depicts the yield of actual bonds. For this example, we have chosen a bond with 2Y of remaining time to maturity. Specifically, this is the 0.00% Bundesrepublik Deutschland 2017-19 (ISIN: DE0001104677) bond.

Bond profile:

- **Launch date:** 2 March 2017, issue price 101.89 %
- **End of maturity:** 14 March 2019, redemption price 100.00 %

A negative yield means: investors who have paid EUR 101,890 at issue will not be receiving any interest for two years and at the end only get EUR 100,000 back. This means that an investment in this bond clearly results in a certain loss of capital!

What this means for our investors

An investment where it is clear in advance that capital will be lost cannot be called a good investment opportunity. Investments in euro government bonds with top to high ratings are not particularly attractive. This also applies to investment funds that invest in such bonds. Investors should therefore look for alternative investments. Going back to the F1 Grand Prix in Monaco: it is time for a pit stop and a change of tyres.

Conclusion:

As the example of the German government bonds shows, euro government bonds with very good to good ratings are currently very expensive. This translates into the yield level, which in some cases is even negative. And a negative yield means that investors know in advance that they will get back less money than they paid in.

There are also investments with attractive yields. However, they come with a certain degree of risk – because without risk it will be impossible to achieve a positive performance in the coming years, both nominally and even more so in real terms.

For risky investments, broad diversification is key, much like investment funds offer it.

Johann Griener

Johann Griener has worked at Erste Asset Management in Sales Retail since 1 January 2001. In this function he supported for example the Sparkasse banks in Austria, with a current focus on Upper Austria. His scope of duties includes the servicing, training, training and education of Sparkasse employees who work in the securities field. This means creating and holding presentations in the local branches and in Erste Asset Management for the purpose of promoting sales of ERSTE-SPARINVEST, Ringturm, and Erste Immobilien KAG funds. He also supports the Sparkasse banks (Austria-wide) in their own investments (nostro business). In addition, Griener is developing numerous publications for internal and external use. The “1x1 of Investment Funds” that he wrote is found in all of the branch offices of Erste Bank and the Sparkasse banks as basic reading and an introduction for customers on how investment funds work.

Griener began his career in 1988 as an employee at the bank counter in a local Sparkasse bank. There he learned the banking business, from a savings book to loans to investment operations. After a few years at the Sparkasse, he decided to continue his studies at the Vienna University of Economics and Business, with a focus on “banks” and “securities”. After completing his master’s degree, he remained loyal to the Sparkasse sector and has been working at Erste Asset Management since.

His motto: “Only a day with laughter is a good day”