

In focus

Opportunities for Income Investors: Going Beyond Cash

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Cash has become more appealing in the recent period of higher interest rates. But while it clearly has merits, there are also drawbacks, and several other asset classes can complement cash holdings.



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Many investors have been attracted by high rates available on cash in recent years. 5% rates in the US and UK and 4% in Europe have been a dramatic change from the near-zero on offer for most of the previous decade. Cash now not only provides investors with a store of nominal value and liquidity but has recently been providing a positive real return.

While the appeal of cash has clearly grown, it is not as “low-risk” as first seems. And although it currently offers inflation-beating returns, it is uncertain how long that will last, so it brings significant reinvestment risk. For investors seeking income, other options can mitigate some of the downsides of cash, without as much of an increase in risk as may perhaps be thought.

In this paper we look at popular assets that are often invested in for income, and assess the attributes and risks that each entails.

When it comes to generating income, there are four major risks which influence outcomes:

1. Reinvestment risk: the risk that your investment horizon is

longer than the period your income is locked-in for. This means you need to reinvest the proceeds at the prevailing market rate further down the line, which may be worse (or better) than the rate you see today

2. Inflation risk: the risk that the purchasing power of your investments are eroded by inflation

3. Fundamentals risk: the risk that the value of your investment is vulnerable to the financial health of the corporate sector or government. This applies to both bonds and equities

4. Volatility risk: the risk that the nominal value of your investments can fluctuate over time

Table 1 outlines some key risk considerations for income investors. There’s no perfect framework that captures all considerations independently, as there will be some interlinkages¹. Its aim is to show relative rather than absolute levels of risk and is based on qualitative judgement. Other factors such as liquidity risk will be important but are not covered in this paper.

Table 1: Considerations for income investors of selected asset classes

	Yield	Average maturity	Reinvestment risk	Inflation risk	Fundamentals risk	Volatility risk	Summary Explanation
Cash	5.25%	0 years	High	Medium	Extremely low	Extremely low	Cash provides high certainty of nominal value, but rates are variable and have been below inflation in recent years.
Short-dated government bonds	3.7%	3 years	Medium	Medium-high	Very low	Low	Government bonds have more inflation risk than cash ² but lock-in prevailing yields for longer. Volatility risk varies, with longer maturity bonds generally more sensitivity to changes in interest rates.
Government bonds (broad market)	3.6%	9 years	Low	High	Very low	Medium	
Long-dated Government bonds	3.7%	21 years	Very low	High	Very low	High	
Short-dated corporate IG bonds	5.0%	3 years	Medium	Medium-high	Low	Low	Corporate bonds have similar reinvestment risk to government bonds. But higher yields can mitigate some inflation risk. Volatility risk generally higher than government bonds but will also vary with maturity and credit quality
Corporate IG bonds (broad market)	5.1%	9 years	Low	High	Low	Medium	
Long-dated corporate IG bonds	5.6%	22 years	Very low	High	Low	High	
High yield bonds	8.0%	5 years	Medium	Medium	Medium	High	
Equities	1.8%	n/a	Very low	Low	High	High	Equity prices generally more volatile than bonds and highly sensitive to corporate financial health. But with no fixed maturity they carry lower reinvestment risk, have greater growth potential, and over the long run have given better protection than cash against inflation.

Past performance is not a guide to the future and may not be repeated.

Source: LSEG Refinitiv, ICE Data Indices, Schroders. Data as at 31 May 2024.

¹ For example, in the case of high-yield bonds, ‘volatility risk’ aims to capture the bond price sensitivity to changes in interest rates as well as creditworthiness (via credit spreads). Whereas ‘fundamentals risk’ aims to capture the risk of not being paid the income stream or principal, either through a bond default or in the case of equities, a cut to dividends.

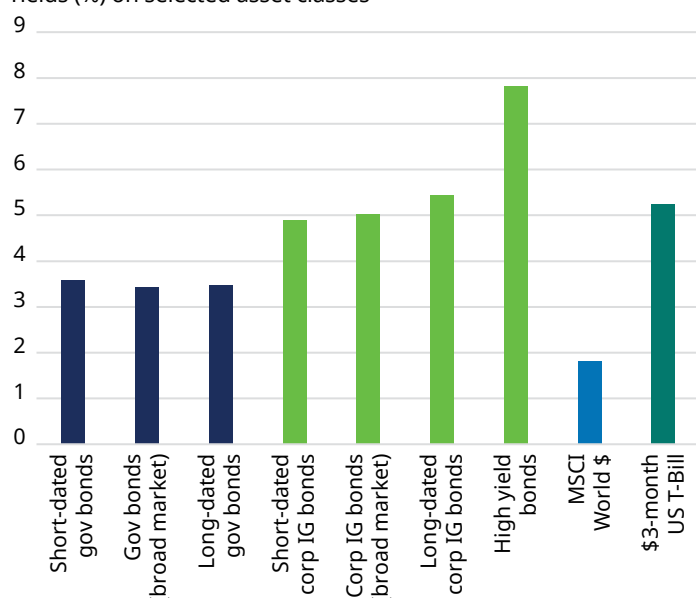
² In theory, cash has less inflation risk than bonds because cash rates can increase if inflation rises, whereas bonds lock in a fixed coupon that can lose purchasing power.

Yields of dreams?

There's no avoiding that current cash yields are attractive compared to some other assets. Cash (as proxied by 3-month US Treasury Bills) is yielding higher than many government bonds and similar levels to many corporate bonds (Chart 1). However, while cash can play an important role in portfolios for many investors, it is not the low-risk asset that might be thought, as we will show in this paper.

Chart 1: There's no avoiding that current cash yields are attractive compared to some other assets...

Yields (%) on selected asset classes



Source: LSEG Datastream, ICE Data Indices.

Data as at 31 May 2024. Yield to maturity for bonds, dividend yield for equities, and cash is proxied by 30-day US treasury bills.

Inflation risk

Interest rates on cash have been below inflation for much of the last two decades...

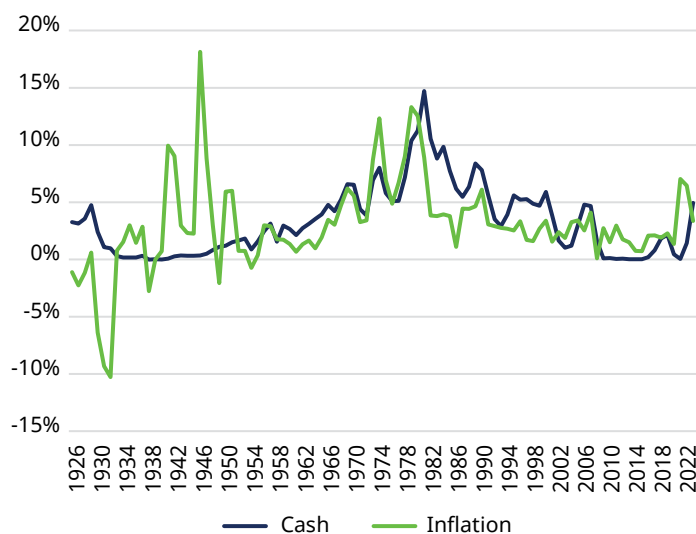
A 5% cash rate may look appealing, but if inflation runs higher, then the real value of that cash holding falls. And the longer the investment time horizon the worse that impact becomes. A US dollar invested in cash in 2014 would be worth \$1.12 in nominal terms but only \$0.85 in real terms 10 years later.

In the past cash rates often exceeded inflation but that hasn't been the case for a long time (Chart 2). On a 10-year horizon cash has beaten inflation 55% of the time since 1926. But most of this is driven by data further back in history, the last 10-year period in which cash beat inflation was 2000 to 2010. Indeed, since the global financial crisis (GFC), developed market cash interest rates have been below inflation, even during the past couple of years in which central banks have raised policy rates significantly.

With the recent declines in inflation, cash currently offers an inflation beating rate. This is not surprising but could be temporary. Central banks have been waiting for confirmation that inflation has been tamed before cutting rates. Once that confirmation is there, then cash rates could follow inflation lower. While market expectations for the path of US policy rates are above that of expectations for inflation in the years ahead, it's not possible to say with any certainty how long this will continue and by how much.

Chart 2: Cash rates have been below inflation for much of the past two decades...

Annual cash return vs. Inflation



Past performance is not a guide to the future and may not be repeated.

Source: Cash by Ibbotson® US (30-day) Treasury Bills and Inflation is Ibbotson® SBBI® US Inflation. Data January 1926 – December 2023. Morningstar Direct, accessed via CFA institute and Schroders.

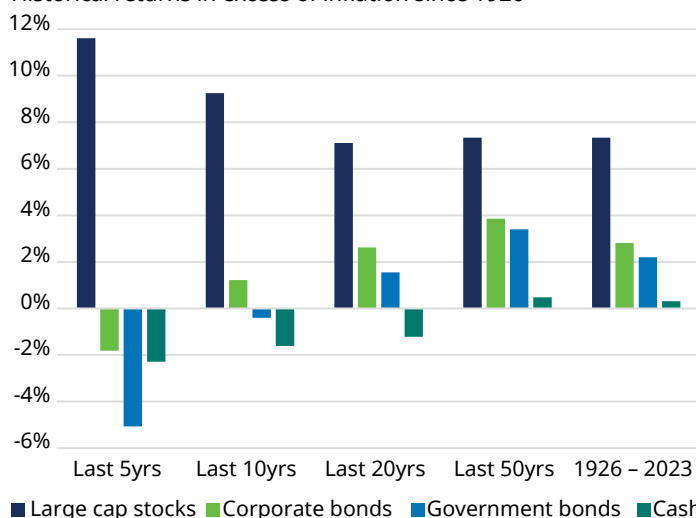
When it comes to beating inflation, equities have outperformed both bonds and cash...

In the long run, both in terms of inflation beating returns and the odds of outperforming inflation, equities have beaten bonds which have beaten cash. Over shorter horizons performance can vary, of course.

Equities have generated a return above inflation for various look-back periods, whether that be in the last 5 years (c.12%) or 50 years (c.7%) (Chart 3). Over longer look-back periods such as 20 or 50 years, bonds have also delivered a greater than inflation return. But it is less the case for shorter look back periods, as in recent years bonds have suffered from the rise in inflation and corresponding higher interest rates. Indeed, over the last 5 years government bonds have done worse than cash as a protection against inflation. Within bonds, corporate bonds have tended to beat inflation by more than government bonds.

Chart 3: Equities have historically fared better than both bonds and cash when viewed against inflation...

Historical returns in excess of inflation since 1926



Past performance is not a guide to the future and may not be repeated.

Source: Stocks represented by Ibbotson® SBBI® US Large-Cap Stocks, Corporate bonds by Ibbotson® SBBI® US Long-term (20-Year) Corporate Bonds, Government bonds by Ibbotson® SBBI® US Long-term (20-Year) Government Bonds, and Cash by Ibbotson® US (30-day) Treasury Bills. Data to December 2023. Morningstar Direct, accessed via CFA institute and Schroders.

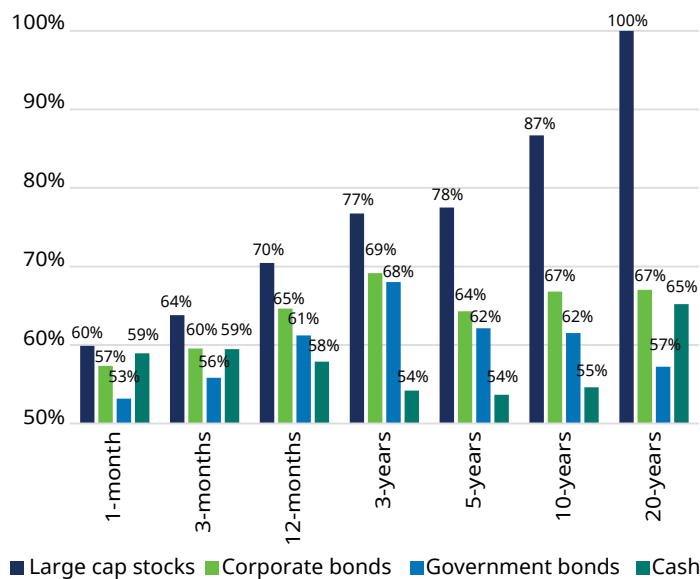
In terms of the odds of beating inflation, Chart 4 shows historic returns on various assets over a range of timeframes extracted from 98 years' data. It then sets these against inflation over the same timeframes. In other words, for every 20-year timeframe in the past 98 years, equities delivered inflation-beating returns. So while stock market investments may be risky in the short run, when viewed against inflation they have outperformed cash in the long run. That's not to say equities haven't struggled at times during very high inflation periods and not all sectors have fared equally against inflation.

The picture for bonds is more complicated. While not as high as for equities, bonds have a better track record of beating inflation than cash over the 1, 3, 5, and 10 year horizons. But, on a 20-year horizon, they have performed less convincingly – corporate bonds have performed marginally better than cash but government bonds have fared worse.

Interestingly, intermediate (c.5 year) government bonds have a much better track record of beating inflation over long time horizons than longer maturity (c.20 year) government bonds (78% vs. 57%).

Chart 4: Equities have historically had better odds of beating inflation than both bonds and cash...

Percentage of time periods where stocks, bonds, and cash have beaten inflation since 1926



Past performance is not a guide to the future and may not be repeated.

Source: Stocks represented by Ibbotson® SBBI® US Large-Cap Stocks, Corporate bonds by Ibbotson® SBBI® US Long-term (20-Year) Corporate Bonds, Government bonds by Ibbotson® SBBI® US Long-term (20-Year) Government Bonds, and Cash by Ibbotson® US (30-day) Treasury Bills. Data to December 2023. Morningstar Direct, accessed via CFA institute and Schroders.

Reinvestment risk

Reinvestment risk is where the investment horizon is longer than the period the income is locked-in for. This means proceeds will need to be reinvested at the prevailing market rate further down the line, which may be worse (or better) than the initial rate. The longer the maturity of the investment, the lower the reinvestment risk.

Cash rates are not fixed, so future income levels can be uncertain...

For long term investors cash doesn't provide a stable or predictable income stream. Interest rates on cash are not constant over time. When central banks start to cut policy rates they often do so at pace, particularly if heading into a recession. Recession isn't the central expectation in this cycle but short-term interest rates are not expected to stay at current levels for the long term, even if they're unlikely to fall back to the ultra-low levels seen in recent years. The central expectation of members of the US Federal Reserve's (Fed) rate setting committee is for rates to be cut to 2.5% in the longer run, so 5% rates are not expected to last long.

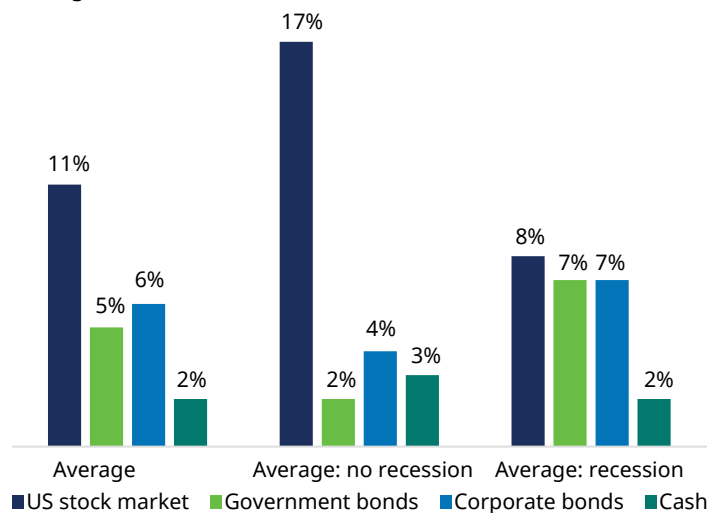
In contrast, bonds lock in yields for longer. For example, investment grade corporate bonds are currently yielding around 5-6% with an average maturity of 9 years. And given extremely low default losses (described later), for long term investors that are less concerned about short term price movements, these may be an attractive option.

And when central bank policy rates do start to fall, stocks have outperformed bonds which have beaten cash...

Each easing cycle is different and there's a wide variation in how asset classes perform. However, previous analysis has shown that on average when interest rates start to fall, real returns on cash are below that of equity, government bond, and corporate bond returns. In the 12-months after the Fed starts cutting interest rates, the average return from US stocks has been 11% ahead of inflation. Stocks have also outperformed government bonds by 6% and corporate bonds by 5%, on average. Cash has been left even further in their wake. Stocks have on average beaten cash by 9% in the 12 months after rates start to be cut (Chart 5). Bonds have also been a better place to be than cash.

Chart 5: Stocks have outperformed bonds which have beaten cash when the Fed has started cutting rates, on average

Average 12-month real returns from the date of first cut, since 1928



Past performance is not a guide to future performance and may not be repeated.

Data May 1928-December 2023. Source for return data: CFA Institute Stocks, Bonds, Bills, and Inflation (SBBI®) database, and Schroders. Source for Fed Funds data: Post-1954 is direct from FRED. Earlier data is based on the Federal Funds rate published in the New York Tribune and Wall Street Journal, also sourced from FRED. An approach consistent with that outlined in A New Daily Federal Funds Rate Series and History of the Federal Funds Market, 1928-54, St Louis Fed, has been followed. For that earlier data, a 7-day average has been taken to remove daily volatility i.e. the month-end figure is the average in the 7 days leading up to month-end.

Volatility risk and fundamentals risk

Locking in the current yields requires taking risk, but maybe less than initially thought...

For those investors with a longer-term perspective, reinvestment risk can be reduced through investing in bonds that can lock in higher yields for longer. But many investors also care about volatility risk and relatedly the risk that price falls lead to losses.

That said, for bonds there's more cause for optimism than has been the case for many years. With bond yields now at levels much higher than for most of the post GFC period, the amount by which yields would have to further increase before investors would wipe out a years' worth of yield is larger (Chart 6).

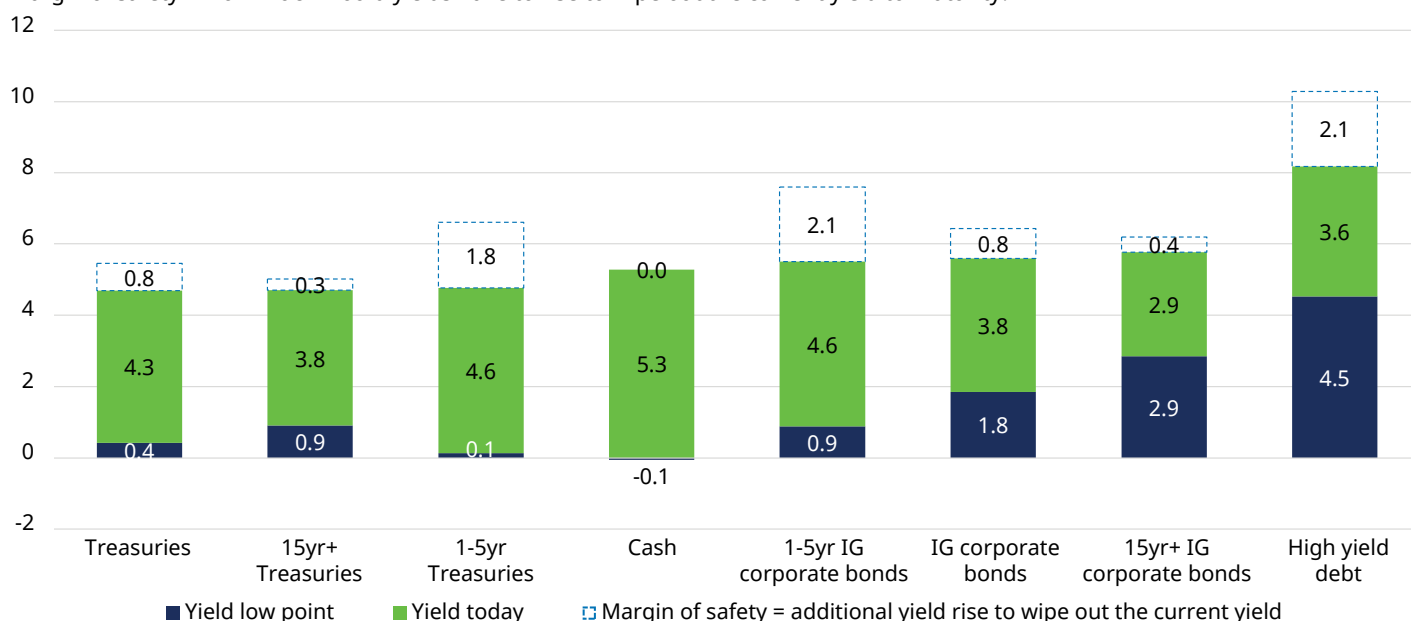
For example, investment grade bond yields would have to rise by a further 0.8% to wipe out the current yield and Treasury yields

almost as much. Shorter-dated investment grade corporate bonds stand out for offering the ability to lock-in attractive yields for several years, with the downside risk mitigant that yields would have to rise by more than 2% more before investors would lose money. High yield bonds can absorb a 2.1% rise in yields.

This assumes a one-year holding period. If yields rise tomorrow then prices will fall immediately. If they don't rise for several years, then bond investors can absorb an even bigger rise before their returns would turn negative. This margin of safety doesn't eliminate risk but it does add a larger buffer than at any point for years. This elevated margin of safety should provide some reassurance to long-term investors worried about the risk of further price declines.

Chart 6: Higher yields have brought a bigger margin of safety against further interest rate rises...

'Margin of safety' = how much would yields have to rise to wipe out the current yield to maturity?



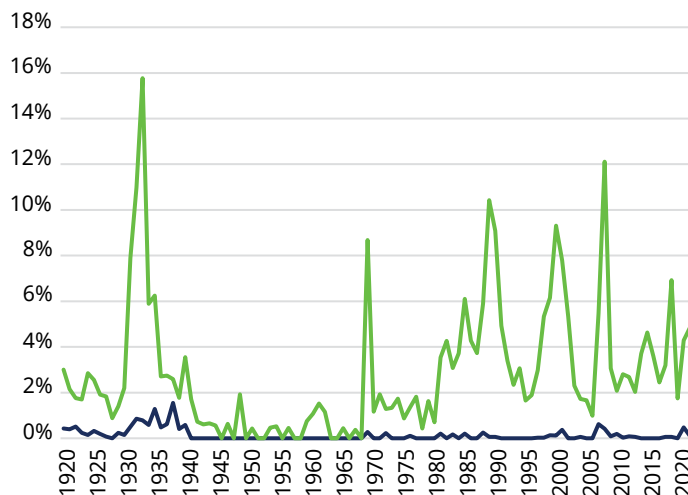
Source: ICE Data Indices, LSEG Datastream, JP Morgan, and Schroders. Data as at 31 May 2024. Yield low point is the minimum since 2020 onwards. All bonds are USD Denominated bonds. Based on ICE BAML bond indices for Treasuries, Corporate bonds, and High-yield bonds. Cash is USD 3-month treasury bill. Bond prices move inversely with yields so a rise in yields leads to a fall in price. The 'margin of safety' is how much of a rise in yields they can absorb over the next 12 months before investors would lose money. This assumes a one-year holding period.

Corporate defaults have been extremely rare in investment grade...

Investors with a longer time horizon, that aim to hold bonds until they mature, will be less concerned with any change in bond prices. They should be more concerned with potential defaults, where coupon income and/or principal losses are incurred. Historically investment grade defaults have been very rare (Chart 7). For example, in 59 out of the last 103 years there have been no investment grade defaults and the average annual default rate is 0.1% of issuers. Even within high-yield where default rates can spike much higher, the long term average annual default rate has been around 4% in the last four decades (2.9% since 1920). Put differently, on average 99.9% of investment grade issuers and 96% of high yield issuers have not defaulted in any given year. So there remains significant scope for active managers to avoid bonds of those issuers most at risk of default. And even if there is a default, everything is not lost as recovery rates on defaulted bonds have averaged around 40% over the long term³.

Chart 7: Corporate defaults have been extremely rare in investment grade...

Annual issuer-weighted corporate default rates

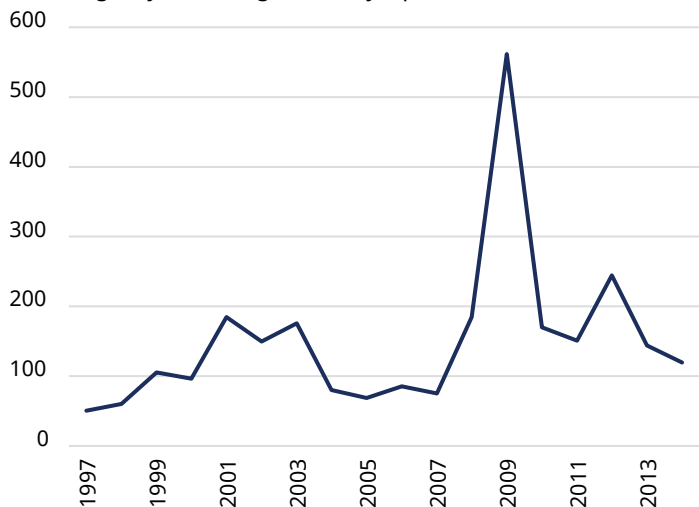


Past performance is not a guide to future performance and may not be repeated. Source: Moody's Investors Service, 2024 Annual default study. Data to December 2023.

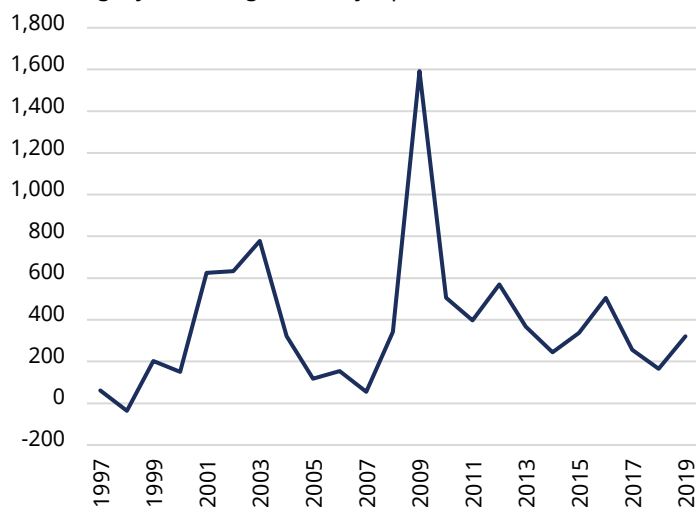
³ Average annual defaulted corporate bond recoveries have averaged around 43% between 1983–2023 as measured by trading prices. Recovery rates vary across time and type of bond (e.g. unsecured bonds tend to have lower recovery rates than secured bonds). Source: Moody's Investors Service, 2024 Annual default study.

Chart 8: Even after accounting for defaults, corporate bonds have typically offered a spread pick-up above government bonds

USD IG credit spread – subsequent realised default losses, assuming 10-year average maturity, bps



USD HY credit spread – subsequent realised default losses, assuming 5-year average maturity, bps



Past performance is not a guide to future performance and may not be repeated.

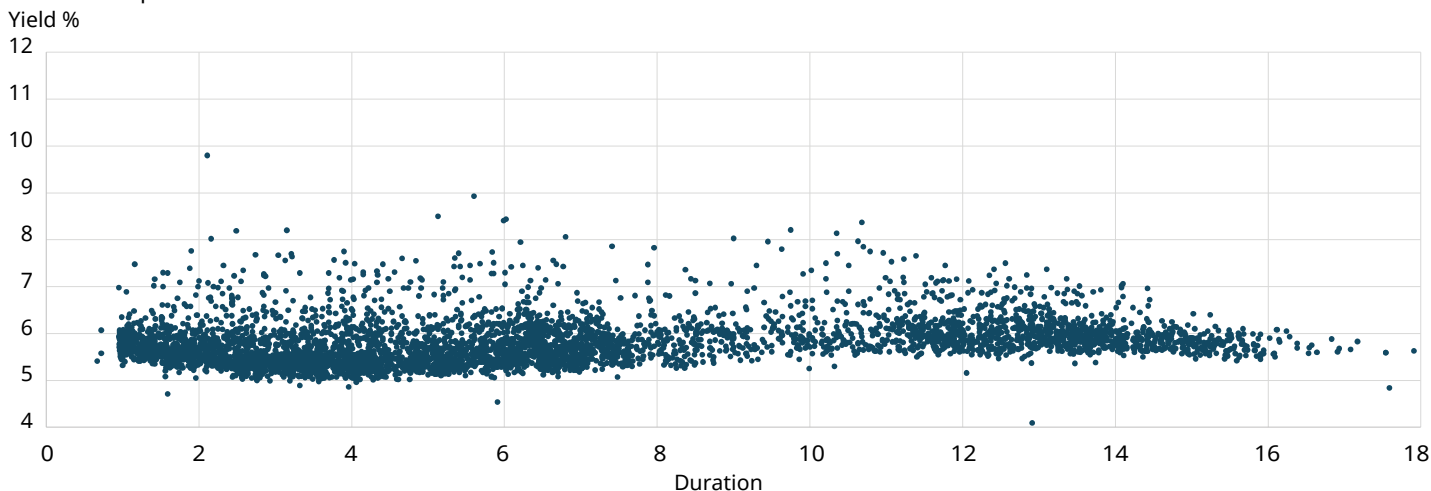
Source: LSEG Datastream, ICE Data Indices, Moody's Investor Services, and Schroders calculations. Data as at 31 May 2024. Calculated as credit spread minus (default rate * (1 minus recovery rate)). Analysis is based on the assumption of holding bonds until maturity. As such, defaults are based on subsequent realised defaults over a 10-year basis for IG and 5-year basis for HY, on a rolling basis.

We can think of the 'net credit spread' as the spread on a given date adjusted for the level of defaults that occur over the life of the investment. Chart 8 shows historic spreads for USD investment grade and high yield. These have typically provided a premium over future default losses. Although there can be volatility in price moves, the ultimate risk of not being repaid has been low.

Even within the USD BBB corporate bond index, there's a significant range of yields available depending on investors' appetite for taking duration and credit risk (Chart 9). While bonds with higher yields may reflect greater risk, active management can try to tailor holdings to meet investors unique risk and return preferences.

Chart 9: There's a significant range of yields available within a corporate bond index...

USD BBB corporate bond index: Yield to worst vs. Duration



Source: LSEG Datastream, ICE indices, Schroders calculations. Data as at 31 May 2024.

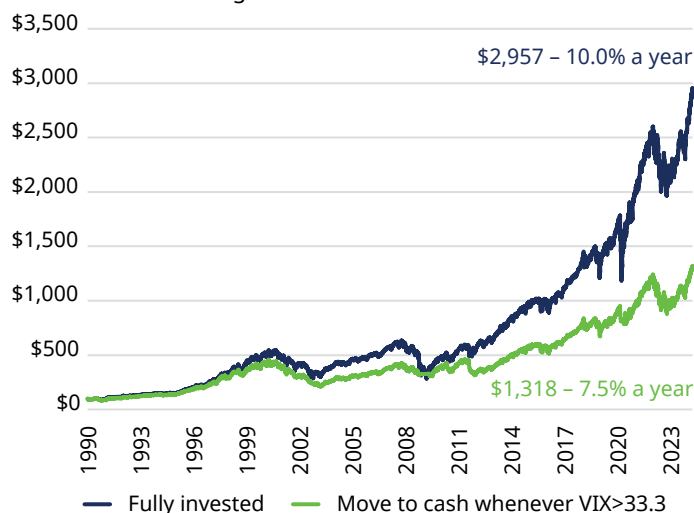
Volatility risk and fundamentals risk is part of life when investing in equities...

Equities are more volatile than bonds which in turn are more volatile than cash (Chart 10). But long term investors should beware of making knee-jerk reactions to increasing equity volatility. Historically, staying invested has proved a better strategy. One way to see this is comparing a strategy of staying invested with a switching strategy, which sold out of stocks (S&P 500) and went into cash on a daily basis whenever the VIX was above 30, then shifted back into stocks whenever it dipped back below. This approach would have underperformed a strategy which remained continually invested in stocks by 2.5% a year since 1991 (7.5% a year vs. 10% a year, ignoring any costs). A \$100 investment in the continually invested portfolio in January 1990 would have grown to be worth over two times as much as \$100 invested in the switching portfolio (Chart 11).

Also for those long-term income investors that are taking the dividend income they may be less concerned with temporary falls in equity prices. Companies tend to be very reluctant to cut dividends so income investors may not directly feel the weak corporate performance so long as they receive the dividends. And if the firm manages to increase dividends per share over time, then the yield on the initial investment can grow substantially. For example, investments made 16 years ago would now be yielding around 5.4% for MSCI USA and 4.3% MSCI Europe (Chart 12).

Chart 11: Investors should beware of making knee-jerk reactions to increasing volatility...

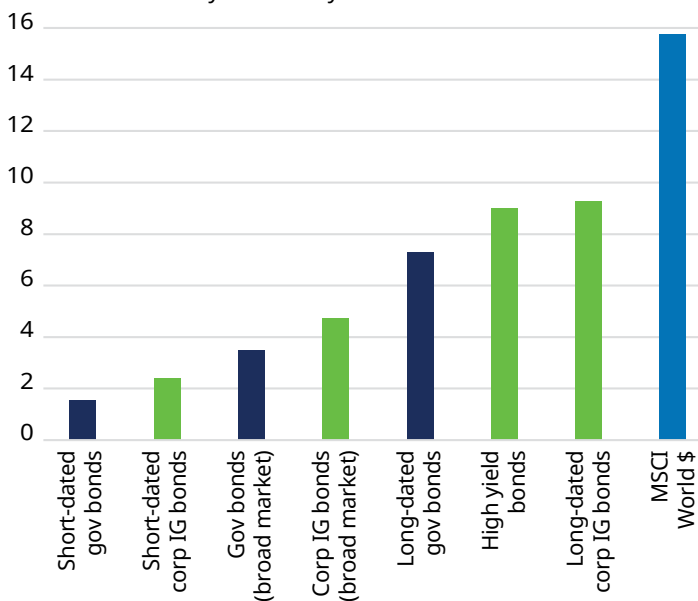
Growth of \$100 fully invested in stocks vs. switch to cash when VIX is high



Past performance is not a guide to future performance and may not be repeated. Source: LSEG Datastream and Schroders calculations. Data as at 31 March 2024. Levels in excess of 33.5 represent the top 5% of experience for the VIX. Portfolio is rebalanced on a daily basis depending on the level of the VIX at the previous close. Figures do not take account of any costs, including transaction costs.

Chart 10: Volatility risk is part of life when investing in equities...

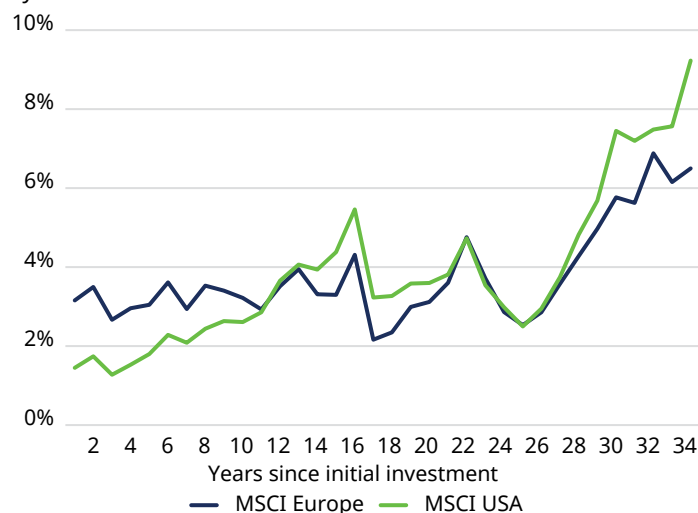
Annualized volatility of monthly total returns



Past performance is not a guide to the future and may not be repeated. Source: LSEG Datastream, ICE indices, Schroders calculations. Data as at 31 May 2024. Annualised volatility of monthly total returns since Jan 1998.

Chart 12: Dividend yield on an initial investment can grow over time...

Book dividend yield on initial investment by time since initial investment



Past performance is not a guide to future performance and may not be repeated. Source: LSEG Datastream and Schroders calculations. Data to 29 December 2023. Calculated as 2023 dividend divided by the index value on initial investment date. 2023 dividend is calculated in inflation-adjust terms, which varies with the initial investment date.

Conclusions

As with all investing there is a trade-off between risk and returns. Current high cash interest rates may appear attractive but over the long term too much invested in cash can have drawbacks. While cash can provide certainty of nominal value, it is exposed to more reinvestment risk than assets such as bonds which can lock in current

elevated interest rates for longer. And while past performance isn't a guide to future performance, over the longer-term equities have done better than cash at protecting against inflation risk. So for long term income investors that are willing to see some price volatility a diversified mix of asset can be attractive.

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