The high price of safety

If you find mortgage repayments a burden, consider moving to Denmark, where Jyske Bank recently announced a 10-year fixed rate mortgage with an interest rate of minus 0.5%.

Copenhagen is lovely this time of year but not for much longer. A million-dollar house that can be paid off in a decade for just A$995,000 might get you through the long winters. And if a 10-year mortgage is a little too short, try Nordea Bank's 20-year mortgage at 0%.

These are strange times, and not just in Scandinavia. There are about $15 trillion in government bonds trading at negative yields around the world. Safety has become so highly prized that two years ago Austria successfully launched a 100-year bond with a coupon of just 2.1%. In June, it repeated the trick, this time with a yield of 1.2%.

Australia is slowly being dragged towards this perplexing low rate environment. Three months ago, interest rates were at 1.5%. After two consecutive cuts they're now at 1%, with most economists predicting further falls. We aren't far from the zero-rate world afflicting many moribund economies.

For retirees, faced with a choice between next to nothing on term deposits and apparently highly-priced defensive stocks, the situation could barely get much worse.

Let's walk through the options, using the price-to-earnings ratio (PER) as a tool to compare.

The first and safest option is cash, held in a term deposit rather than a hole dug under the gardenias. At an interest rate of 2%, cash trades on a PER of 50. In practice, this means it would take 50 years of interest payments (earnings) for an investor to recoup their initial investment.

What if that wasn't enough and income investors were prepared to accept more risk?

As of 31 July, the ASX 200 AREIT Index Dividend has a PER of 19.2 and an average yield of 4.43%. Compared with cash, this doesn't seem too demanding. The reward for taking on the additional risk of investing in shares effectively doubles the return and offers the prospect of real-world growth.

Many income investors have already made their choice. No longer are they prepared to pay an apparently high price for safety.

Instead, they've opted for so-called bond proxy stocks like Transurban and Sydney Airport - up 36.2% and 27.2% respectively this calendar year - and AREITs, which arguably offer a more secure source of income and potentially less growth. The ASX 300 Property Trust Accumulation Index has risen 22.6% since 1 January this year and yields 4.42%.

This shouldn't be a surprise. As Howard Marks of Oaktree Capital said in a recent memo, "Low rates reduce the discount factor used in calculating the net present value of future cash flows. Thus, all else being equal, there's a direct connection between declining interest rates and rising asset prices." The rise in share prices in general and bond proxies in particular seems to bear this out. Marks goes on to say that "low rates on savings and fixed-income investment drive investors to accept increased risk in order to pursue decent return in a low-return world".

The AREIT Index offers a case in point. As we explained in Visible performance and hidden risks, the best performing AREITs over the year to 30 June 2019 were Charter Hall (ASX:CHC), up 72.4% and Goodman Group (ASX:GMG), up 59.9%.

And yet just 34% of Goodman's earnings came from rents whilst Charter Hall's proportion was just 39%. The rest were delivered by development and funds management activities, both significantly more volatile sources of revenue than rent. In the case of the AREIT Index the reward is clear, the risks much less so.

Can income investors do any better?

We think they can. The APN AREIT Fund has minimal exposure to Goodman and Charter Hall because of their low levels of income (2%/3.4% respectively) and the higher risk nature of their earning. As an income focused manager, the risk/reward ratio is not in our favour.

The strange thing is that in avoiding these risks potential investors can access a higher reward. In a further example of strange times, the AREIT Fund currently yield's 5.78%[1], a substantial premium on the ASX 300 Property Trust Accumulation Index overall.

We think the price of safety in this environment is too high. Nevertheless, when you're considering alternatives, do so in light of the risk/reward trade off. The reward gets our attention; the risk is what brings us undone.

1. Current running yield as at 21 August 2019. It is calculated daily by dividing the annualised distribution rate by the latest entry unit price. Distributions may include a capital gains component. Past performance is not an indicator of future returns.

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