The Search for Income May Lead to Equities, Not Bonds

CALAMOS INVESTMENTS

Solutions for the next decade: Finding income and risk-managed equity opportunities in a changed world.

Transcript of a video recorded 10/14/19.

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The "search for income" has gotten harder. In a world of low interest rates, the challenge for investors is deciding upon the right and wrong places to be reaching for yield.

After a decade of hyperactive monetary policies by central banks, the traditional trade-off between yield and capital opportunity across equities and fixed income is a far cry from the past.

Historically, the fixed income component of portfolios benefited from higher income and less capital risk. The equity component aimed for capital growth, but assumed more capital risk and less yield. Today, those rules of thumb are less clear.

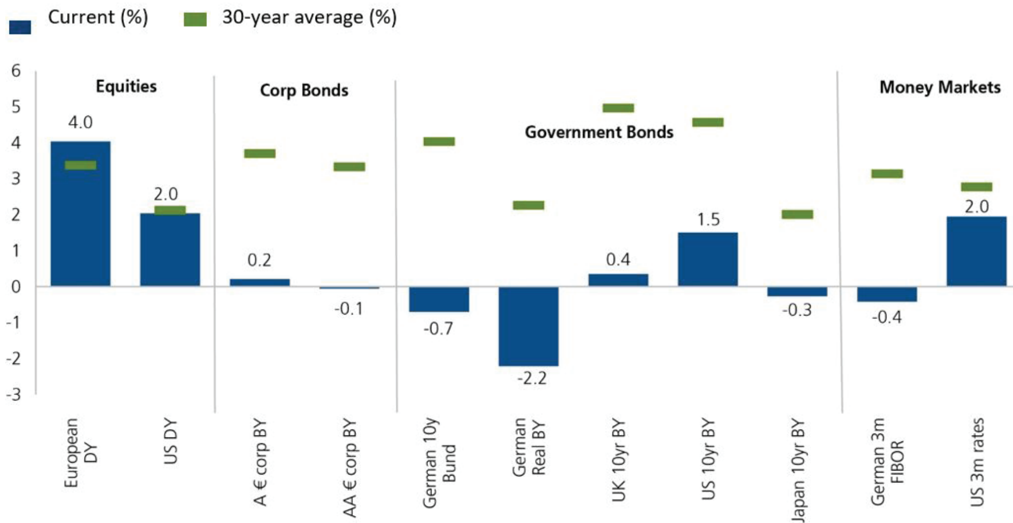
In many parts of the global landscape, equities yield more than bonds when we compare the dividend yield to the interest coupon. In some cases, bonds offer negative yields and thus, are guaranteed to lose capital for clients.

This seems like an upside down world for the traditional allocation model, especially as sovereign bonds were assumed to be the risk-free component. These are unusual times that force investors to think differently about the best approach for generating income.

This dilemma is especially apparent in Europe, where aggressive quantitative easing (QE) policies by the European central bank have distorted capital markets. This is illustrated by comparing today's yield across major European assets classes—equities, corporate bonds, government bonds and money markets—versus the 30-year average.

Current bond yields are significantly lower than historical averages

Yield versus history across different European asset classes



Central banks have re-defined the meaning of “risk free”

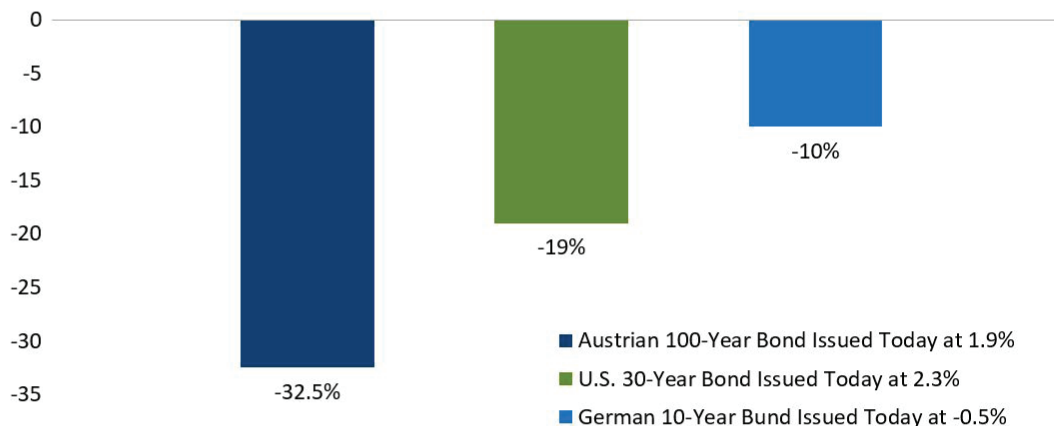
Past performance is no guarantee of future results. Source: UBS, UBS European Equity Strategy, Thomson Datastream

When interest rates become so low in both absolute terms and relative to the past, one conclusion is that capital risk and volatility must be higher in the future.

Let’s examine what happens to a bond’s value if interest rates rise by 100 basis points. Here we compare the decline in value of the 30-year U.S. Treasury, the 10-year German Bund and the 100-year Austrian Government Bond. If we are near the lows in interest rates, cyclically or from a secular perspective, higher price volatility would seem inevitable.

At current rates, global bonds face perilous drawdowns following a 1% rise in interest rates

Capital decline in bond value



Past performance is no guarantee of future results.

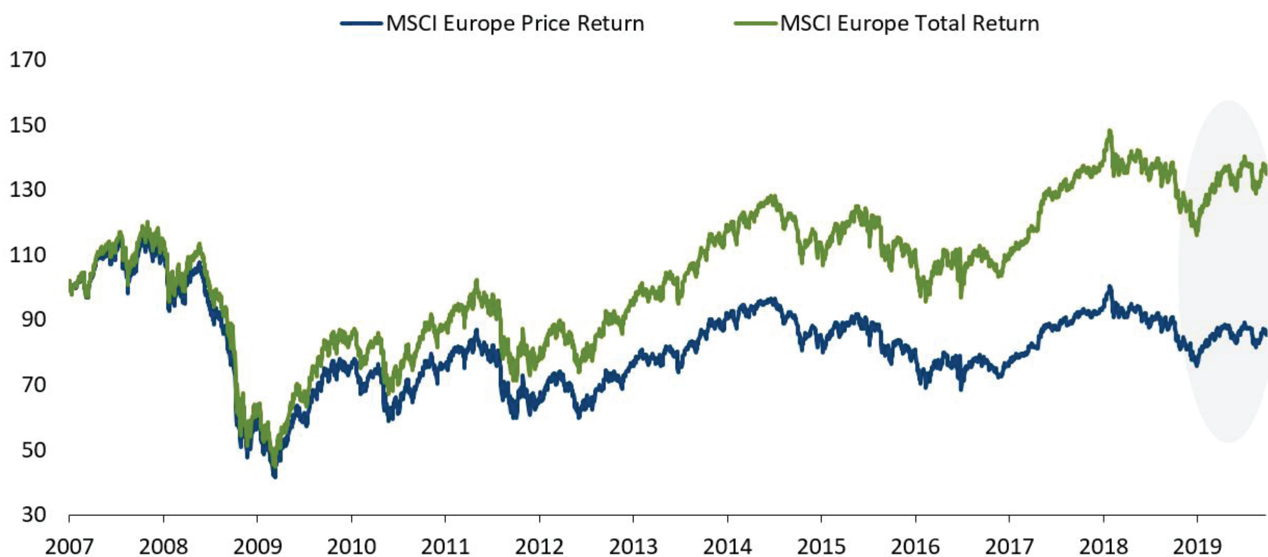
The dividend yield on equities is striking amidst today's prolonged level of interest rates. Across developed markets, equity dividends outpace the coupon available in sovereign bond markets. And unlike most fixed income, where the interest rate is fixed through maturity, equity dividends have typically grown over time.

Of course, equities must be hedged against capital loss because there is less security of capital versus the more protected stake of the bond investor. On the other hand, equities offer the potential for capital gains, with the bulk of their historic return arising from capital growth rather than dividends.

With equities now benefiting from higher yields, the intriguing question is whether equities could prove to be both the tortoise and the hare over any extended period. Investors "searching for income" in equities rather than bonds could outperform in both upside and downside scenarios over the next 10 years.

If equity markets generate little capital growth in the coming decade, the dividend component of the total return outcome can be decisive. Using Europe as the example, dividends have comprised about one-half of an investor's total return due to the underperformance of those markets post-2008. In other words, the value of client portfolios was 40% higher as a consequence of dividends.

If equities see minimal growth in the coming decade, the dividend component of total returns will be decisive



Past performance is no guarantee of future results. Source: Macrobond. The MSCI Europe Index is designed to represent the performance of large- and mid-cap equities across 15 developed markets.

Any search for yield today must start in the right places. This is as true in equities as it is in bonds, which is why we favor an active cross-asset approach.

Our fixed income team articulates this philosophy well: it is a "market of bonds, not a bond market." Blending the distinctive features of higher yielding credit with a dividend yield of a hedged equity portfolio can lead to strong and uncorrelated alpha.

Investors need income to achieve their long term financial goals, but the world has changed. Interventions by central banks have altered the traditional roles of equity and fixed income in a balanced portfolio.

We favor a more active, more selective and risk-adjusted approach to investing in both equities and bonds.

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