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Investment viewpoint

In this low-rate environment, all roads lead to Swiss corporate bonds

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Does it make sense to invest in Swiss franc (CHF) denominated bonds at a time when interest rates are low?

This question been raised repeatedly during the last 20 years, even though CHF bonds have performed very well thanks to steadily declining interest rates. At the start of the millennium, many investors believed that a yield-to-maturity of 2.5% for 10-year Swiss government bonds was too low, given they were being compensated with more than 4% for the same risk in the 1990s. Yet, interest rates have continued to fall, particularly in the aftermath of the global financial crisis, and even slid into negative territory at the beginning of 2015 following an intervention by the Swiss National Bank (SNB). So, the topic of whether it makes sense to invest in CHF bonds remains pressing.

In November 2021, 10-year Swiss government bonds had a yield-to-maturity of around -0.23%. In the past, investors have demanded a premium for forgoing consumption by holding these instruments, yet they now seem prepared to pay a premium just to 'park' their money in the safe bonds.

The traditional bond diversification argument

The traditional argument as to why bonds should be an integral part of any balanced portfolio is based less on expected returns and more on diversification considerations. Since a well-diversified equity portfolio with a long time horizon is likely to yield around 3 to 4 percentage points more per year than a balanced bond portfolio, over an equivalent timeframe an investor could conclude that they should invest their money exclusively in equities over the long-term – if they were focused on pure returns.

The problem with this strategy, however, is that the interim volatility of an equity portfolio's performance can be considerable and, with the risk of substantial losses, many investors do not have the courage or the ability to remain invested exclusively in equities. In order to counteract the high volatility of equities, other asset classes with the ability to make positive and stabilising contributions to performance can be added to a portfolio – especially in periods when equity markets are weak.

As has been shown in the past, bonds have these characteristics and have traditionally been used as a diversifying element in portfolio construction – creating the so-called balanced portfolio. For example, the Swiss equity market has been known to lose almost 40% of its value over a 12 period, while the maximum 12-month loss recorded by a balanced CHF bond portfolio has never exceeded 4%. Depending on the desired performance outcome, risk tolerance or maximum acceptable portfolio loss, the proportion of bonds included in a balanced portfolio is variable. The more bonds a portfolio contains, the less its performance should fluctuate and any potential losses should also be smaller.

Correlations with CHF corporate bonds remains attractive

However, in the current low-interest-rate environment, it has become necessary to consider whether the diversification properties of bonds remain intact. Figure 1 shows the correlation between Swiss equities and bonds in recent years and highlights that Swiss government bonds (as measured by the Eidgenossen Index), in particular, have lost some of their diversification qualities since interest rates turned negative in 2015. Interestingly, however, CHF corporate bonds (as measured by the SBI A-BBB index) exhibited a slightly lower correlation with equities over this period than they did prior to 2015. In our view, this may be linked to a change in investor behaviour. When selling equities, investors are no longer primarily switching into low-risk bonds due to the expected returns; instead, they are likely to invest in investment-grade corporate bonds.

Analysing the composition of the CHF bond and equity investment universes shows that the security-specific risk across the two asset classes is fairly well diversified. If we compare the list of companies that currently have investment-grade CHF bonds with those in the broad Swiss Performance Index (SPI), the overlap is strikingly small. Of around 200 issuers in the CHF corporate bond market, about 150 have not issued any equities to date. Together, these analyses show that the diversification provided by CHF corporates over the 2015-2021 period was almost as effective as that of Swiss government bonds, given they delivered a similar level of performance, with much lower volatility.

Should investors seek other diversification options?

Today's low-interest-rate environment means there will be little room for the SNB to make interest-rate cuts in response to any upcoming crises. As a result, it can be assumed that bonds' time-honoured role as a safe haven will likely be somewhat diminished. Does this mean investors should therefore avoid CHF bonds completely and look for other diversification candidates that promise better performance?

First of all, it is worth noting that the return expectations of most other worthwhile diversification candidates are also significantly below their long-term averages. The knock-on effect from risk-free bonds having extremely low (even negative) risk premiums is that the risk premiums for other asset classes is also lower.[1] Additionally, the investment opportunities posed by the wider bond universe is often many times greater, more balanced and more liquid. Many alternative diversification candidates are less easily traded, may not be valued on a daily basis, could have a much smaller total market volume and often focus on niche topics, sectors or regions. Valuation difficulties can often mean the diversification properties of these alternative candidates are difficult to determine and can be overestimated.

Select CHF corporate bonds boast good risk/return profiles

We have shown that CHF bonds offer good diversification characteristics even in a low-interest-rate environment. They can also be traded and valued on a daily basis and their investment universe is sufficiently large and well-diversified, with a very good average credit rating. Accordingly, we believe that CHF bonds should remain an integral part of every balanced portfolio in the future.

FIG 1. CORRELATION BETWEEN CHF BOND INDICES AND THE SWISS PERFORMANCE INDEX (SPI)

	2008-2014				2015-2021			
CORRELATION MATRIX	SBI AAA-BBB INDEX	SBI A-BBB INDEX	CH GOV. BOND INDEX	SPI	SBI AAA-BBB INDEX	SBI A-BBB INDEX	CH GOV. BOND INDEX	SPI
SBI AAA-BBB Index	1.00				1.00			
SBI A-BBB Index	0.80	1.00			0.90	1.00		
CH gov. bond Index	0.82	0.37	1.00		0.96	0.75	1.00	
CH gov. bond 1-10 Index	0.73	0.29	0.93		0.92	0.73	0.93	
CH gov. bond 10+ Index	0.84	0.42	0.97		0.94	0.73	1.00	
SPI	0.13	0.45	-0.21	1.00	0.00	0.19	-0.05	1.00
Annualised return (A)	4.03%	3.97%	4.46%	5.21%	1.02%	0.99%	1.36%	9.22%
Annualised volatility (B)	2.81%	2.94%	3.89%	13.18%	3.59%	2.99%	5.70%	12.06%
Risk-adjusted return (A/B)	1.44	1.35	1.15%	0.40	0.28	0.33	0.24	0.76

Source: Bloomberg, monthly total returns in the period 31 January 2008 – 31 August 2021.

[1] The risk premium of an asset class is the sum of the premiums received for the various risks that the asset class entails. The basic premium for all asset classes is the "forgone consumption premium" – i.e. the premium for risk-free/low-risk bonds.

However, we also believe that, going forward, it will be important for bond investors to rethink how they structure their CHF bond portfolios. Whereas in the 1990s investors could focus almost exclusively on low-risk bonds in the AAA-AA segment, today they must also contend with credit risk. By carefully selecting corporate bonds, it is possible to improve the performance of the asset class without losing its necessary and desired diversification potential.

An investment approach based on in-depth credit analysis and the careful integration of targeted sustainability criteria can lower the default risk of investments in A-BBB corporate bonds. Additionally, switching the focus of the bond allocation of a portfolio away from just low-risk bonds means the exposure to interest-rate risk should be reduced, while the return potential of the bond exposure could increase by up to 1 percentage point without encountering substantially higher volatility or risk of loss. That said, the default risk of such a bond portfolio will be marginally higher in the A-BBB range.

Essentially, structuring the 'optimum' bond exposure within a broader portfolio is about striking the right balance between return, risk and diversification. By reducing the interest-rate risk of the bond exposure, the diversification potential of bonds is not sacrificed and investors can even benefit from lower interest-rate sensitivity in the event of rising interest rates. The loss of any maturity premium can be more than compensated for by investing in corporate bonds in the A-BBB bracket. Corporate bonds also tend to outperform low-risk bonds with the same maturity when interest rates rise, because credit-risk premiums normally shrink during the course of an economic recovery, resulting in a positive contribution to returns.

Taking all these factors into account, we conclude that the comparatively good risk/return profile of CHF corporate bonds remains attractive and is also enhanced by the effective diversification properties of these assets. As such, we believe they deserve a place in any balanced portfolio.

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