Good Harbor's Peplinski: Rate-Rise Primer

By Cinthia Murphy | May 30, 2013

Share:

Sure, yields are heading higher—and perhaps sooner rather than later—according to Neil Peplinski, a managing partner at Good Harbor Financial, the money management firm that produces asset allocation plans for a coterie of registered investment advisors that together have assets under management of almost $6 billion.

And sure, finding yield until the day yields on 10-year Treasury debt normalize to 7 percent from around 2 percent currently, is going to be a tough row to hoe, Peplinski told IndexUniverse.com contributor Cinthia Murphy during a recent visit to his Chicago headquarters.

But that doesn't mean investors should get too worked up. Instead, he says they should be open to alternative yield-generating strategies such as dividend-paying stocks and high-yield debt, all while remaining true to the undeniable reality that reaching for yield in today's bond market of suppressed expected returns could lead to trouble.

IU.com: There seems to be a growing perception that the economy is stabilizing, and investors are taking on risk like they haven't in a long time. How do you view this current environment?

Neil Peplinski: Somebody brought it up to me the other day that this is the most hated bull market that we've been in in a long time. And I think that has some interesting connotations to it because when you label a bull market as the most hated bull market, that reflects that people haven't gotten fully onboard with the underlying fundamentals of the rally. And therefore, they believe that it's due to correct, or that it's not a sustainable rally.

This is the interesting part about that whole risk-premium view. What that tells me is that, even though prices are rallying, there's probably still some headroom left for people to relax their risk premiums. They're stepping in somewhat cautiously now, or they're getting irritated that they're not in, and that's why they hate the bull market, because it keeps going up, and it's getting away from them.

To me, that says there could be some life left in this rally. And you have that capitulation point where you tend to see real turning points in the market. In our model, we've been 100 percent exposed to equities for the first four months of this year. We did reduce some exposure for May, seeing a little bit of trepidation in some of our input data that translated into a mixed portfolio state for us. But as May has unfolded, a lot of that has been undone. And the equity environment is still looking pretty interesting.

IU.com: Do you see fundamental support for this rally?

Peplinski: The economic data have been steadily improving for quite some time, and it hasn't been rapid. We still have 7-plus-percent unemployment, and we have what looks to be very tepid growth. But everything is moving in the right direction, and sometimes that's what really matters. It can go unnoticed because it's not moving at the rate that people want it to. But I think, first and foremost, if the direction is right, we can't discount that piece of it. In our own models, we're still seeing some appetite for risk, and we think that appetite could grow.

IU.com: Aside from risk, investors seem to be wavering on their views on interest rates, moving back and forth from short to midterm debt. How do you see that playing out?

Peplinski: You have to respect the fact that we're going to move into a rising interest-rate environment at some point. Remember, we've been getting some interesting language from the Fed over the last few days about that.

From my perspective, that's probably healthy. We're going to see rising rates because we do see the stabilizing econom—something that's more broadly accepted as a healthy economy. So, I'm not even worried about inflation—I think the rate rise will be steady enough to keep inflation in check. And ultimately, rising rates will be a sign of a favorable economic backdrop.

That said, if you're a fixed-income investor, and you're expecting a rising rate environment, you either need to go with floating-rate instruments, or you need to stay shorter if you're going to do fixed rate. And if we're moving into a rising rate environment, obviously the math suggests you want to be shorter dated.

But I think a lot of the sloshing around that we might be seeing between medium-term and short-term debt is really people looking for yield. That's why we've seen a lot of popularity in the high-yield space, for instance. There's just no place to get return right now in the fixed-income space that's overly comfortable for people.

That's to say that I think a lot of that moving around is maybe less a view on rates, as much as just an attempt to get yield.

IU.com: That's also driving demand for other sources of income, like dividend stocks, right?

Peplinski: Dividends are dividends. In some businesses, there might be negative pressure on dividends in a rising rate environment, but in others, rising rates could be favorable for dividends. So I think the dividend component, in and of itself, is always worth taking a look at.

We have a strategy called our Tactical Equity Income, which has a yield component driven, predominantly, by dividends. I think that's a good space to be in. And it's always something to look for, regardless.

Granted, it's become more popular now, because if you can get a dividend yield of 5 or 6 percent, that looks a lot more attractive than a 1.8 percent 10-year Treasury yield. There's no denying an increase in demand in that space, which is favorable for product launches like we're doing.

IU.com: Has the role of fixed income changed in an investor's portfolio?

Peplinski: Basically, if you think about when rates are in what I'll call a "more normal" environment—in that 5 to 7 percent 10-year Treasury range where you can get some real yield off of Treasurys—I'd certainly look at them again as low risk. So, when you look at retirement portfolios, and you talk strategic allocation, the classical thinking is you need to have some fixed-income portion. You're still going to have equity exposure, and maybe you'll throw some alternatives in there, but the general strategic allocation is going to be based on your risk appetite, tthe classical view being that as you get closer to retirement, you want less risk in your portfolio.

Peplinski (cont'd.): Now, when you're in retirement, how is that fixed income often structured? Well, it's structured as actual bond holdings to generate a yield component to support your cash flow needs in retirement. And what I think we're facing now in this ultra-low-rate environment is that it's difficult to construct fixed-income portfolios with low risk that can meet cash flow needs.

That is a structural issue that we have to deal with in the context of how portfolios would normally be driven as people come closer to retirement. You can no longer afford to shift 90 percent of your portfolio into fixed income on a yield that might be 1 or 2 percent, if your cash flow needs are, say, 5 percent. And this is something that I think advisors and clients are going to struggle with until rates get back up into more favorable levels from that perspective.

IU.com: It goes back to your whole idea of why tactical allocation makes so much sense,

especially in a market environment such as right now.

Peplinski: Yes. I think tactical needs to be viewed as a technique, maybe as other techniques would be. But one of the things that it does highlight is that when you're in this low-rate environment, if you need to step out of your risk comfort zone because you need to get your yield up in order to support your cash flow to save for your retirement, you now expose your principal to a loss.

Say you build a portfolio of dividend stocks to find that yield; what you're effectively doing is increasing your equity risk exposure, and you can't afford the capital loss. This is where having a tactical or active approach, in my opinion, could potentially add some value to help you preserve capital in these stressful times.

IU.com: Should we be bracing here for some serious volatility in the bond space?

Peplinski: Sure. If we're eventually going to move into a rising rate environment, I would expect to see an increase in volatility, but I wouldn't get too worked up about it.

I think where that might be subject to a little more scrutiny is if you start talking about, say, risk parity approaches, and you're saying, "Hey, I'm going to overexpose myself. Or I'm going to lever up, say, Treasury space or fixed-income space to try to bring that risk in line."

I think the danger there is that, because we're in a historically low-volatility environment for fixed income, if you go to that risk-parity approach, and now you see even a modest increase in volatility, you have to respect the fact that you've just levered that up to try to make it risk parity. That could be something to be concerned about.

But outside of that, if you're in a high-yield space, you should already be expecting volatility. In the end, we have to make sure that we don't falsely reduce our expectations about volatility. I think history tells us that low-volatility periods are followed by high-volatility periods, so we have to be positioned for that.