

The Investment Challenge for Central Banks¹

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For many years, central bank reserve managers have been guided by the objectives of safety, liquidity and return. This ordinal ranking of investment objectives is no longer a useful guide. If you have not already done so, you should replace the old guidelines with a different trilogy: a conscious balancing of volatility and liquidity constraints against an income objective.

For a generation, we have lived in a world where central bank reserve managers could achieve safety, liquidity and return without making difficult judgments and tradeoffs. We no longer live in that world, and it is time to adapt. In the new world, the risk-free rate is lower than you think, and your portfolio is riskier than you thought.

While the old trilogy always had its limits, the investment environment fostered by deflation fears and extraordinary monetary policies has rendered it of little practical use. If you want the same safety and liquidity as you had before, you will have to accept much lower returns. If you want returns equal to even a portion of those you have experienced, you will have to take greater and different risks, and accept lower levels of liquidity. As a guide in taking on new risks, you will need the discipline of clear volatility and liquidity constraints within which you can build a diversified portfolio of income producing assets.

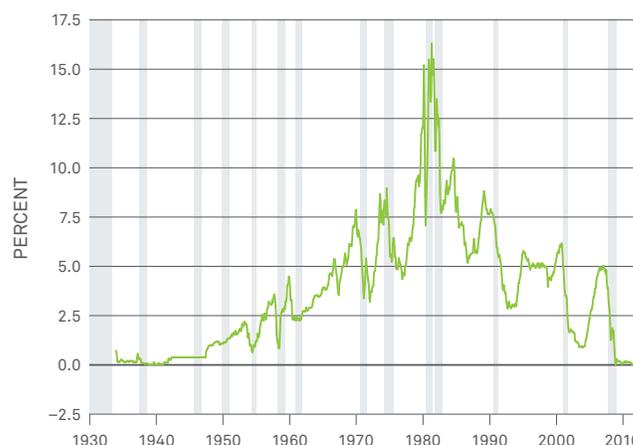
RISK-FREE RETURNS GREATER THAN THE GROWTH OF NOMINAL GDP

Beginning in the early 1980s, the major central banks pursued disinflationary policies that anticipated and then followed the “Taylor Rule” as a guide for monetary policy. As a consequence, short-term interest rates were, on average, higher than the sum of the real growth rate plus the inflation rate—excepting only those periods of economic weakness when the Taylor Rule called for short-term interest rates just a little bit below the sum of real growth plus inflation. While these concerted disinflationary policies were being pursued, the returns offered by short-term government bills—what investors call “cash” or “cash equivalents”—were, on average, a little higher than the nominal growth rate.

For 30 years, we were able to invest in an instrument that gave us, on average, a return greater than the real growth rate and inflation without taking any risk.

Whenever we got nervous—or when we felt a need to focus on “safety and liquidity”—we could hide our money in the short end of the yield curve and earn this rather handsome return. Central bank reserve managers did not need to make any serious tradeoffs in order to build portfolios that provided safety, liquidity and return.

FIGURE 1: RISK-FREE RETURNS NOW ARE APPROXIMATELY ZERO



Note: Shaded areas indicate US recessions.

Source: Federal Reserve Bank of St. Louis, 1934–2012.

When we speak of “cash,” we are usually referring to something that provides perfect liquidity with zero volatility (it is widely accepted at par) but offers zero income. That is what we get with the cash in our pockets. But as investors, we have come to expect more than a modest return on our cash; we actually became habituated over the decades to a return on our “cash” and cash equivalents.

¹ Based upon remarks given at The World Bank Reserves Advisory and Management Program, Executive Forum in Washington, DC, on April 22, 2013.

But in the absence of a concerted effort to squeeze inflation out of our economies, we should not expect such returns. Indeed, in the presence of a concerted policy effort to avoid deflation, we should expect the thing we call the “risk-free” rate to offer us zero return.

In many ways, this is a better starting point. For taking zero risk, you should receive approximately zero return.

This is effectively where we are today. Yields on short-term US government securities—both one month and three months—are less than 10 basis points. We have had a zero risk-free rate in US-dollar assets for the last four years.

If the observed risk-free rate over recent years is zero but we are still building portfolios based on our habitually received ideas of the risk-free rate—some average over the last decade or so—then our portfolios are much riskier than we thought. Maybe the risk-free rate is about to revert to something more normal, or maybe after four years we should accept that a much lower risk-free rate is a feature of the financial landscape.

My own view is that we need to accept a much lower risk-free rate. It does not feel to me as if central banks are about to try to squeeze inflation out of the system any time soon. I am also a member of the human birth cohort that is both the largest ever in human history and has the longest life expectancy ever in human history. So, while each of us around the world attempts to save for our individual, extended retirements, we are collectively attempting to save, at the same time, more future purchasing power than mankind has ever previously attempted to do. While we adjust to a world awash in surplus savings, I would not be surprised if returns to capital remain quite low.

You will need to make your own decision about the appropriate risk-free rate. But clearly, many investors have not yet adjusted their portfolio construction process to reflect a zero (or near zero) risk-free rate. Those who have adjusted to a much lower risk-free rate are taking correspondingly less risk.

LIQUIDITY TRAP: THE ASYMMETRY OF FIXED INCOME RETURNS

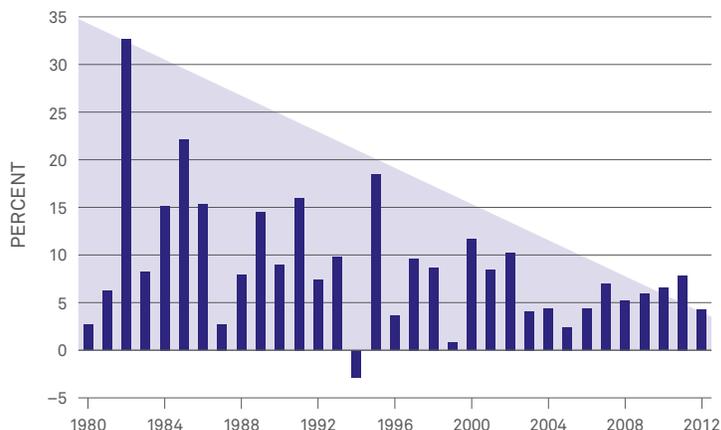
In my own career as a central bank reserve manager, “safety” did not just mean zero tolerance for default risk; it also meant zero tolerance for a loss of principal caused by a backup in interest rates. This effectively dictated that central bank reserves be invested solely in short-term government bills—at the risk-free rate. But as inflation and interest rates declined, even central bank reserve managers became comfortable

FIGURE 2: US INFLATION AND 10-YEAR YIELDS HAVE FALLEN IN TANDEM



Source: Federal Reserve.

FIGURE 3: PROSPECTIVE US FIXED INCOME RETURNS HAVE DECLINED WITH INTEREST RATES



Source: Barclays.

holding government bonds farther out the yield curve, as falling nominal rates provided attractive total returns.

Today, we face a very different situation. Notwithstanding the central banks’ commitment to extended periods of accommodative policies, even central bank reserve managers face an asymmetry of risk in their bond portfolios: at these extremely low levels of nominal rates, over the next five years it appears more likely that rates will go higher than they will go lower.

The current coupon on longer-term government bonds is so low that it does not appear to compensate you for the potential future volatility of your bond portfolio. Many investors are

responding to this “liquidity trap” by holding shorter-duration assets and reducing their risk.

This is not what quantitative easing policies are intending. Rather, by hoarding duration risks, extraordinary monetary policies are seeking to get investors to look for other sources of risk and return away from government bond markets. And many investors—even some central bank reserve managers—are increasing their allocation to credit and equity markets in some parts of their portfolios.

WHAT SHOULD YOU DO?

First, begin with brutal candor about how much volatility you can absorb and set your volatility budget. It would be nice to think that central banks could have long investment horizons and correspondingly high volatility budgets. The reality is that public accountability tends to lead to short-horizon accounting periods and a corresponding intolerance for volatility. (The principal advantage of sovereign wealth funds is that they can aim for a longer horizon and absorb more volatility.)

Second, determine how much liquidity you need as if it were a liability, entirely divorced from the (low) volatility characteristics of cash and short-duration instruments. Many policymakers are uncomfortable taking risk and, therefore, they like to insist on being liquid. But by separately identifying your volatility and liquidity constraints, you can establish a liquidity profile that approximates a liability path.

In a world of a zero—or very low—risk-free rate, a much greater share of investment returns will come in the form of forfeited liquidity: by foregoing the opportunity for current uses, you earn a return for giving up liquidity. For the last 30 years, we did not need to think this way; but now we do. Begin by establishing the amount of liquidity that you actually need, so that you can turn your attention to the much more difficult question of how much you should be compensated for giving up liquidity.

Third, having established your volatility and liquidity constraints, you can now turn your attention to your income objective and ask yourself: What part of the global income stack do you want to own?

Without the benefit of another 30 years of falling rates, we will not be consistently able to earn returns from leverage or from the increased present value of future cash flows caused by a falling rate of discount. Instead, you should begin by looking at the underlying cash flows being generated in the world economy.

Which cash flows would you like to hold? What portfolio of cash flows—by geography, by product market, by taxing authority, by labor market—will give you the overall income you would like to earn subject your volatility and liquidity constraints?

What part of the capital structure would you like to hold? Only debt? You only wish to earn a return on duration risk? Or are you willing to earn a return for taking credit risk? If you are willing to take credit risk, are you sure that you only want to own the debt part of the capital structure? Would you consider diversifying a part of your income holdings into variable (equity) cash flows? This type of analysis is what has led some central banks to begin holding equity risk on their balance sheets.

This investment approach is also completely different from one that begins by asking the metaphysical question: What are safe assets? Rather than a typology of assets, you should begin with an analysis of your own volatility and liquidity constraints, and then seek to achieve a reasonable income objective through diversification of assets subject to those constraints.

THE BALANCE SHEET CHALLENGE IS HARDER

The investment challenge that central banks face is relatively easy. The much more difficult challenge central banks will face is across their entire balance sheet.

We have all been concerned about the global imbalances. However, one reason that central banks are managing such large reserves is that a portion of the global imbalances has ended up on their balance sheets as a currency mismatch. The advent of quantitative easing policies has also now pulled another portion of global imbalances onto developed nation central banks in the form of large duration mismatches. It is unlikely that we will resolve the imbalances without these mismatches playing out in some way across central bank balance sheets.

The old ordinal ranking of safety, liquidity and return will be of no use to central banks as you begin to grapple with the balance sheet challenge ahead of you.

The framework of understanding your volatility and liquidity constraints, within which you can build an income-generating portfolio, is both a more useful way to approach the current investment environment and one that will help you when you begin to address the balance sheet problem that lies ahead.