REAL MONEY INVESTOR STRATEGIES IN A LOW-YIELD ENVIRONMENT

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AL MONEY INVESTOR STRATEGIES IN A LOW-YIELD VIRONMENT

me & portfolio risk – investors behavior

- recent drop in short rates in the US and UK kes it more difficult for global fixed income investors to source risk-free assets (ex credit & duration risk) with a positive yield. Even real capital protection strategies cannot be based purely on "risk-free" fixed income assets (Chart 1)
- The more negative yields get passed onto corporate and private clients on time deposits, the more the incentive to shift asset allocation if they require positive cash-flows
- Synchronized monetary policy in currency areas with major government bond markets, low or negative short rates and a similar shape of the yield curve make "carry-trades" on a hedged basis look less attractive
- Generating a positive real income stream via fixed income investment forces the acceptance of credit, duration and/ or currency risks and associated default risks and market price volatility

2YR GOVERNMENT BOND YIELDS IN MAJOR DEVELOPED MARKETS

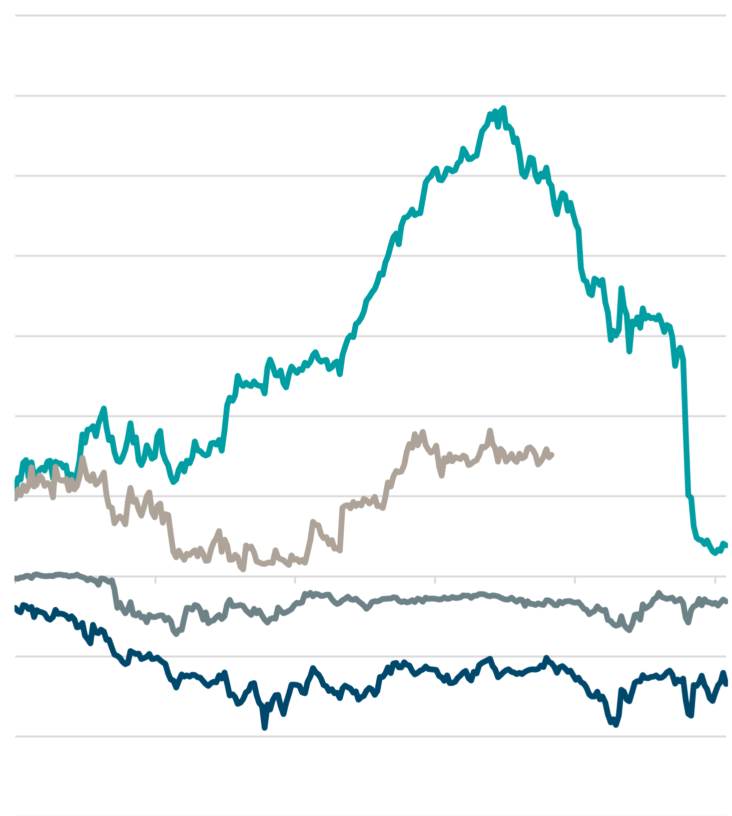

Chart 1: Source: Bloomberg, as of June 2020

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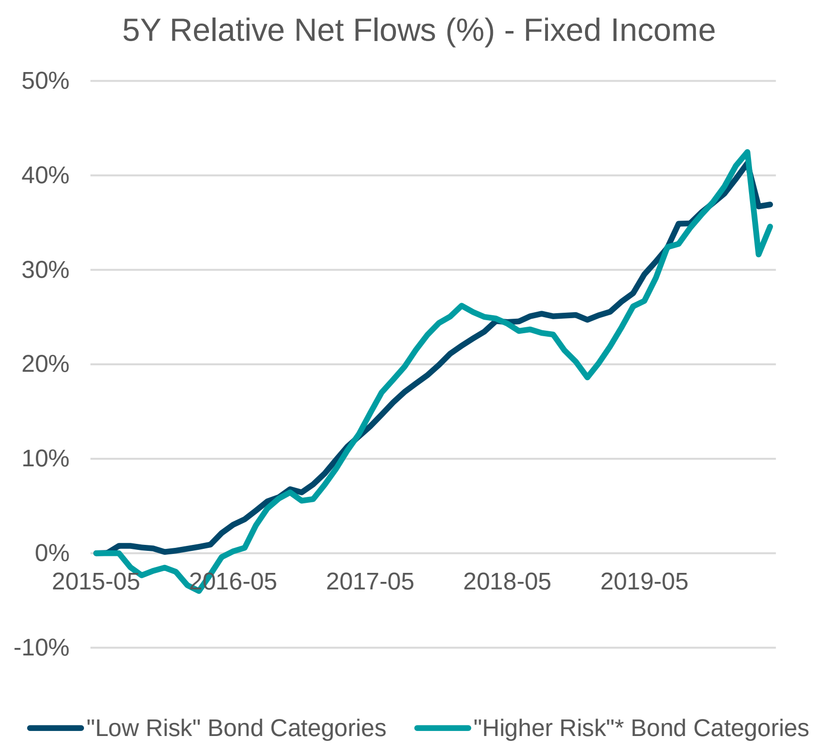
Income & portfolio risk – investors behavior

- European bond funds AuM grew from EUR 1.9 trillion in 2011 to EUR 3.4 trillion in in 2019 (ECB investment fund statistics)
- Morningstar data for the European retail market show that a substantial share of net flows went into Corporate Bond and Emerging Markets Funds with higher return expectations and higher price volatility (“Higher Risk” Bond Funds, Chart 2)
- Empirical studies find that changes in the interest rate level are a key determinant of flows into European bond funds. A decline in the yield of 10yr Bunds was accompanied by inflows into European bond funds (Bundesbank (2019), Monthly Report, October 2019)
- Anecdotal evidence suggests that negative risk-free rates” (e.g. negative yields on time deposits) and the perception of a persistently low-yield environment triggered additional flows into European bond funds

FLOW DEVELOPMENT EUROPEAN RETAIL BOND FUNDS



Scope: Morningstar Europe OE & ETF ex MM ex FOF; Broad Category : Fixed Income, * “Higher Risk” – High Yield Funds, Emerging Markets Funds, IG Corpporate Bond Funds, Unconstrained/ Flexible Bond Funds

Chart 2: Source: Morningstar, DWS Product Analytics, as of June 2020

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Market structure – investors behavior & supply side developments

- Low yields, historically positive returns & low realized volatility seem to be positively correlated with retail flows into bond portfolios and vice versa
- “Momentum-driven” flows increased in recent years while liquidity in some market segments while market depth decreased
- Measures: “Swing-pricing”, “Forward-pricing”, higher cash positions
- Index tracking portfolio management (ETF’s) plays a more important role for Euro bond investors
- Supply side factors are relevant in this context. Euro government bond indices show a substantial shift in average duration and composite rating (Chart 3)
- Portfolio managers had to adjust the portfolio composition at least partly to their benchmark, thereby increasing duration and credit risk over time

SAME INDEX, BUT CHANGES IN KEY CHARACTERISTICS

ICE BofA Euro Government Bond Index	Jun Index 6/16/2020	Jun Index 5/31/2010
Face Value (in mn. Euro)	5,981,823	3,851,138
Effective Yield	0.13	2.82
Effective Duration	8.42	6.40
Composite Rating	A1	AA1

Chart 3: Source: Bloomberg, Bank of America, as of June 2020

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Bond portfolio allocation – "Active" portfolio manager behavior

- Growing relevance of unconstrained (absolute return, total return) and flexible fixed income investment strategies without narrow benchmarks in active bond portfolio management
- Evidence that portfolio managers increased the share for corporate bonds in fixed income and multi asset portfolios vs. government bonds and bonds issued by banks
- Negative "risk-free"-rates and lower historical volatility might have changed the "optimal" risk-return portfolio composition for aggregate fixed-income portfolios in favor of more "risky" asset classes
- Low incentive to invest in bonds with a foreseeable negative total return
- Sudden spikes in price volatility or an increase in the risk-free rate might lead to quick adjustments in the optimal portfolio composition
- VaR-Limits might enforce selling pressure further

ASSTET ALLOCATION - LESS GOVIES MORE CORPORATES

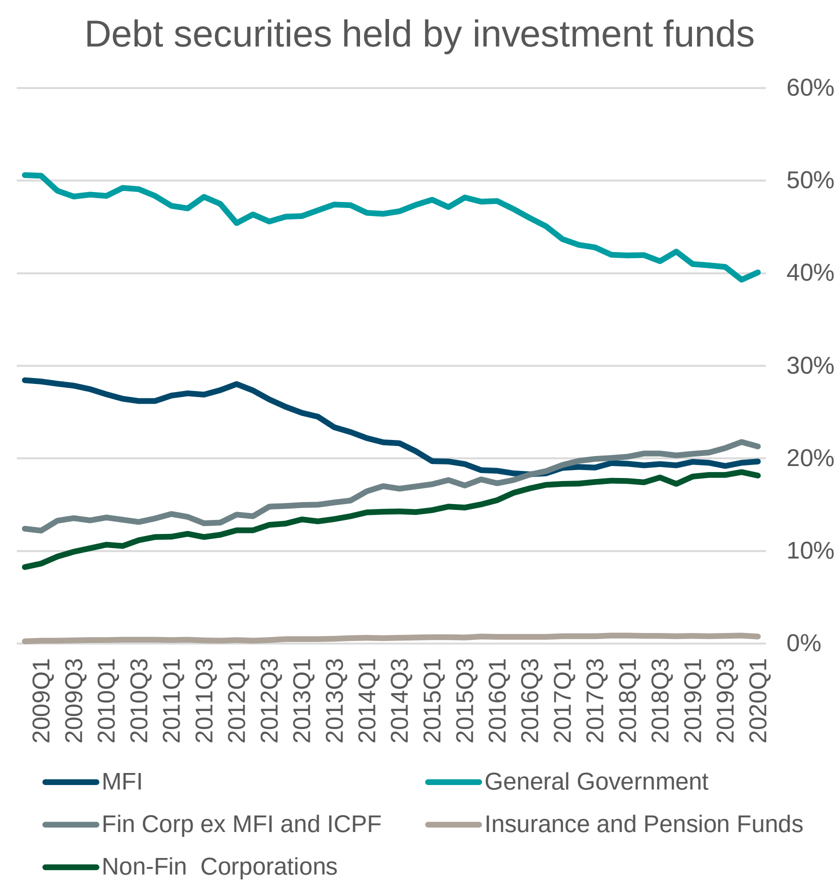

Chart 4: Source: ECB, DWS as of June 2020

Forecasts are not a reliable indicator of future returns. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect.

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Topics to discuss

- Will the negative correlation between interest rates and flows in favor of more risky asset classes increase if “risk-free rates” turn negative across broad-based developed government markets ?
- Given that short dated government bond yields in major markets are negative or close to zero and the shape of the yield curve does not differ significantly, will this make cross country carry trades less attractive in the future?
- Is the phrase of growing “risk-appetite” correct or is the change in the allocation of fixed income portfolios over time a rationale adjustment to changes in monetary policy and lower market volatility (“optimal bond portfolio”)
- Is the changing composition of fixed income portfolios mainly driven by demand side factors (investor/ portfolio manager behavior, growing importance of ETFs)) or also by supply side factors (lower issuer ratings, changes in benchmark composition and benchmark duration)?
- How to adjust VaR-Limits for portfolios if liquidity & volatility shocks become more “typical” events in the current market structure? How to define adequate risk portfolio risk measures in a changing market environment?

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