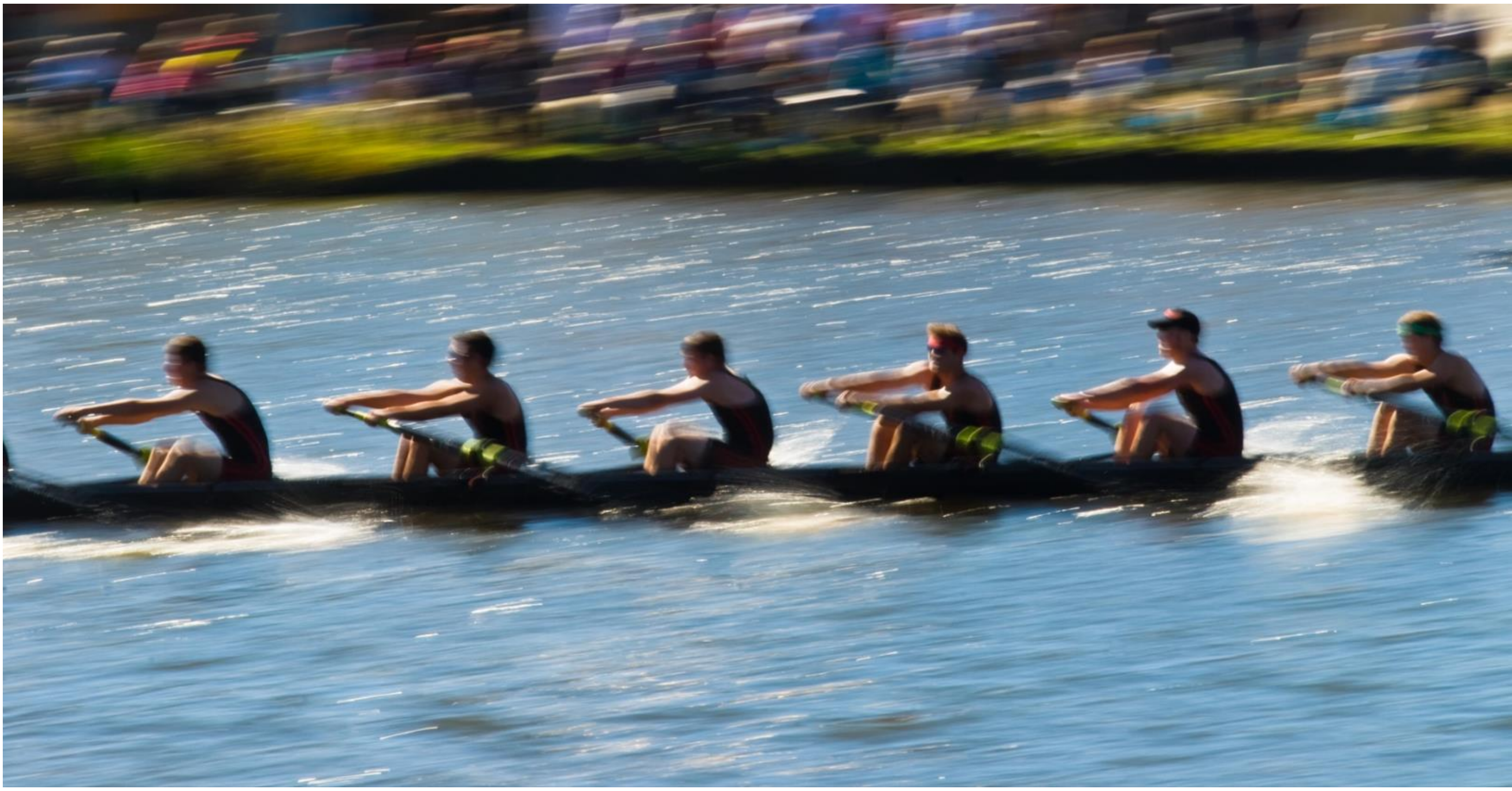
The dangers and challenges of

Investing in a Low Interest Rate Environment



Navigating the "new normal" as an accredited investor today

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There are always valuable lessons that come from adverse times.

2020 has brought very unusual circumstances, and unfortunately the world was not prepared for the force of its waves. The economic impact of this crisis has been second to none in terms of speed and breadth, and consequently its effects will also be long lasting and memorable. Sitting at the second act of this crisis and with the loudest shock behind us, we have had the opportunity to reflect and internalize the important insights that will help us successfully navigate its threatening effects. Although it is tempting to discuss the entire socio-economic impact of the global COVID-19 pandemic, as of course all aspects manage to some way or another infiltrate into the economy, we will narrow our analysis to those economic metrics that matter the most for investment purposes.

The "new normal" of low growth and low interest rates

COVID-19 has exacerbated the conditions that many economic pundits have deemed the "new normal" of developed markets. The "new normal" has been characterized by lower growth rates, lower funding rates in developed markets, lower inflation expectations and the potential of high-priced liquid assets. Low growth and low interest rates mark a very particular investment environment that requires unique analytical risk-return considerations.

Before we delve into what we deem to be the correct strategies to invest in this peculiar environment, it is important to refresh the dynamics that brought us here:

Lower growth in the developed world is a function of deep-rooted economic forces that are difficult to reverse. Two of the major factors commonly and correctly discussed are: lower population growth and lower total private credit growth. Lower growth has led to lower investment returns, which consequently have brought interest rates down.

To this reality, we must add the default apparatus that has shaped macroeconomic policy since the end of the Bretton Woods agreement, which is a framework of monetary policy that targets low inflation and uses interest rates as its main tool to stimulate or decelerate the economy. As the world and, in particular, the developed economies have gotten in trouble, depressing real rates has been the preferred response policy. Real rates are nominal rates minus inflation.

As we have moved decade after decade through a path of lower and lower interest rates, Central Banks have had to adopt lower and lower policy rates. The idea of zero and negative Central Bank interest rates arose in the wake of the Great Recession and has now become part of consensus mainstream macroeconomics.

The “enemies” of fixed income investing

This move to the zero range bound rates in the US (and negative rates in Europe and Japan) has brought very difficult investment dynamics. The acknowledgment of the risks of negative interest rate policy, depressed inflation expectations and low carry (income from yields) are some of the most important issues that cloud investments in the fixed income space.

A popular reason why individuals have historically invested in developed market government bonds is because these securities have provided negative correlation to risky assets. When equities or other risk assets fall due to fears of faltering global growth or financial instability, interest rates also fall (as inflation expectations fall and or central banks lower policy rates); this pushes the price of government bonds up. This attractive “hedging” profile of government bonds disappears, however, when interest rates are already close to zero and, even worse, negative. Interest rates can be argued to be somewhat curtailed to the downside as we are dealing with very low inflation expectations and a natural tendency from central banks to avoid large negative policy rates. This is a very important and dangerous situation that needs special attention in the construction of balanced portfolios.

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Traditionally however, investors participate in government fixed income because these securities provide income and the promise to protect the value of capital. These two premises have, however, also almost completely dissipated. Yields on long-term bonds are below 1% in all developed nations, so income is essentially non-existent, and depressed inflation expectations put in jeopardy the future real value of the money invested. If inflation increases unexpectedly over the life of the bond, and inflation ends up being higher than what was priced in nominal yields (real rates + inflation expectations) at the time of purchase, the real value or the purchasing power of the capital falls.

This uncomfortable scenario of almost non-existent income and the threat of purchasing power erosion has pushed investors to take on higher credit risks. This natural shift to greater overall risk in search of higher yields is usually called "portfolio effect" and has led to insufficient risk compensation for investors in many markets. Our default approach to this reality has been to avoid taking higher credit risk and instead seek out bespoke opportunities to achieve higher income while preserving quality. Higher allocation to unconstrained fixed income strategies that attempt to profit from yield curve dynamics and capital structure mismatches has been one of our main tools.

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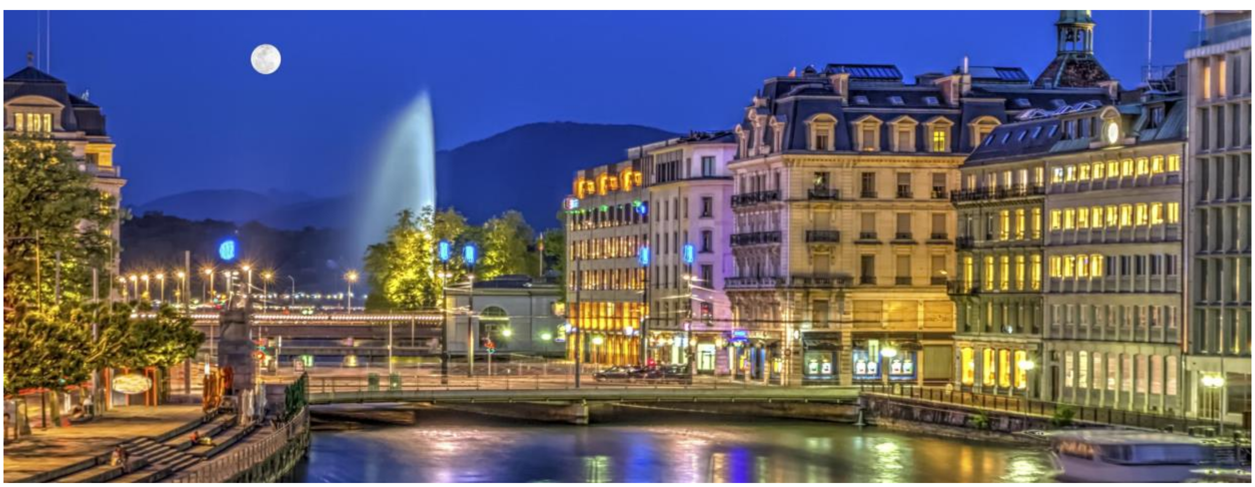
These unusual economic scenarios make passive-investment challenging and obsolete, and rewards allocators that take risk conscious bets on market dislocations. Our second most relevant tool in liquid fixed income portfolios has been to increase exposure to securities that benefit from interest rate increase scenarios. Within this depressed inflation expectation environment, sudden and abrupt moves in inflation can cause serious pain in fixed income portfolios. Inflation adjusted fixed income securities and floating rate fixed income securities, compensate investors in case inflation expectations and rates increase.



Private offerings as alpha opportunities

In addition to the two strategies in the liquid fixed income space noted above, one of our fundamental investment themes is to increase adoption of private credit. Based on the basic laws of supply and demand, liquid fixed income assets display lower yields as they have more demand from allocators. Contrary to popular belief, private credit does not necessarily mean more risk.

Yes, liquidity is a valuable characteristic, but private securities can offer a higher level of contractual flexibility that, in our opinion, can outweigh the drawback of lower liquidity. For some of our clients, IWA has concentrated in the sourcing of private credit strategies that allow creditors to establish stronger clauses, enjoy easier access to collateral and create more transparency of data which limit downside risk substantially.

It is important to highlight that the higher investment flexibility and lower accessibility are attributes that not only characterize private credit, but most private offerings. For this reason, our shift towards private offerings has not been limited to fixed income securities, but in all the asset classes we consider for our portfolios.

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Lower volatility is desirable

A clear difference between public and private securities is that the more liquid a market is, the faster assets react on a change to macro factors such as the decrease or increase of real rates or inflation. This is another very important reason as to why we have been pushing our thesis of overall allocation to private offerings within our clients' portfolios. Macro expectations change rapidly and strongly leading to significantly higher volatility in public securities. 2020 is a perfect example of public markets' overreactions to macro expectations. In particular, we can look at the recent dynamic of equity prices in the US from March 2020 to August 2020 as a perfect case for analysis. Growth oriented companies were very quick to rebound in price as expectations for global recovery improved in June and July and central banks reiterated their plans to leave interest rates low for a long time. Lower interest rates increase the present value of future income streams and, therefore, inflate equity values, all else being equal. Private equity securities did not fall as public counterparts in Q1-2020 and have not been as quick to rebound thereafter either.

Less liquidity has allowed private companies to be less volatile and in this situation of rapid appreciation, maintain their lower valuations relative to public counterparts. Within a world of highly valued assets, these structural opportunities in private equities allow for superior long-term returns.

Concentration to growth, industry leaders and innovation

As much as we incentivize higher allocations to private offerings to combat the "new normal" environment, there are regulatory and personal reasons why we cannot implement our thesis across-the-board with investors. Public securities are and will remain the bulk of our clients' and most retail investors' portfolios and, therefore, a clear strategy for how to invest within public equity markets is also essential.

Within equities there are two major themes that dominate the structural allocation of our portfolios:

1. Growth is scarce in developed markets
2. Inherent downside protection is critical

These themes bring important investment implications that shape our equity allocations. The most important incentive is to seek exposure to earnings consistency and earnings growth. We want to own companies where the demand/supply balance is positively inclined toward demand. Companies that have this trait enjoy competitive advantages because of their industry and within their industry. These companies have the pricing power, market dominance and, therefore, the tools and capital to grow and adapt to maintain their economic advantages. Our team believes that institutional leaders in industries that face significant barriers to entry is an attribute worth the cost as it naturally provides downside protection.

In line with the idea to overweight earnings growth potential, we believe equity investing should not be limited to certain regions of the world. The concept of growth scarcity applies to developed nations more than the world in its entirety. There has been a pronounced shift in the past decades where the bulk of global real growth has come from emerging economies. We are vast proponents of investing in global markets, including emerging equities, and we will continue to construct portfolios that reflect our thesis against local bias.

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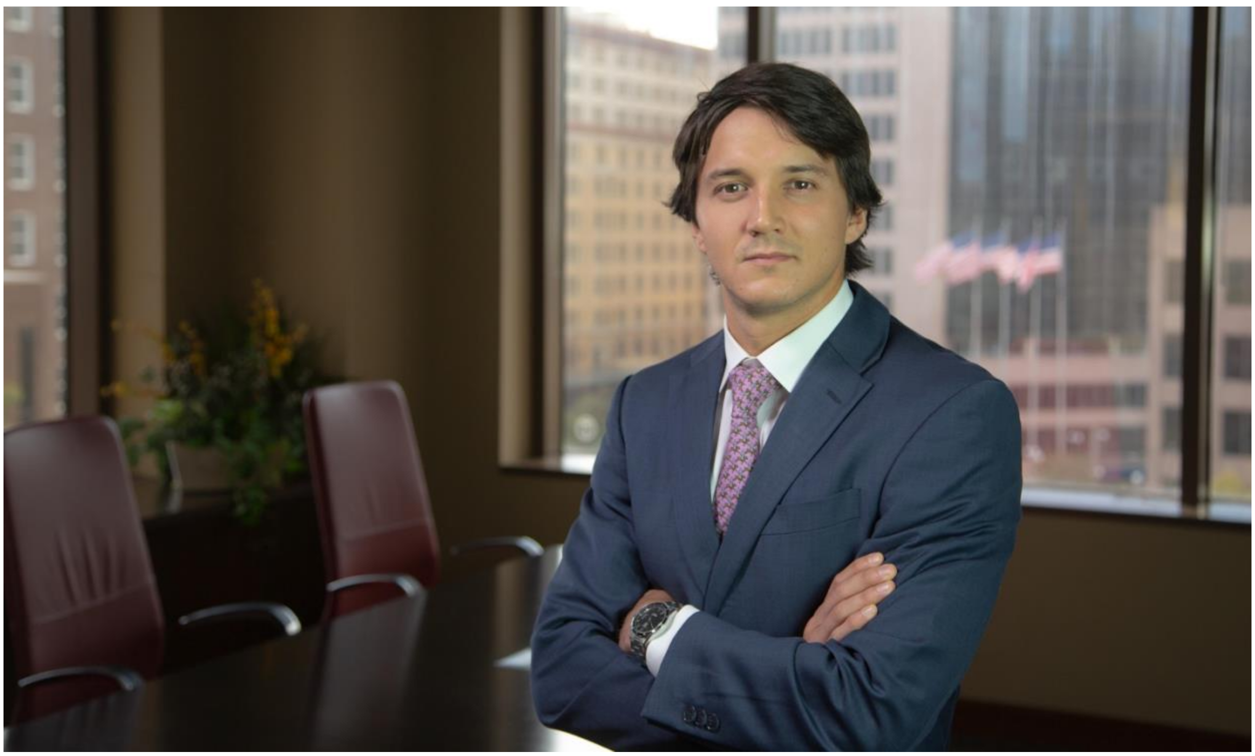
Active and nimble management and the pursuit of bespoke opportunities

As with our view in investment strategies, we believe being active and innovative is critical to overcome the challenges of a low growth and low interest rate environment. Intercontinental has deployed significant human capital to source those strategies that are better positioned to provide alpha for our clients. Capital preservation and sustainable capital growth are more than ever before the result of ingenious and active investment decisions. We are continually dissecting the market in search of neoteric strategies that are designed to overcome the dangers and challenges of this "new normal."

About the author and Intercontinental Wealth Advisors



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Originally from Bogota, Colombia, JP grew up in Venezuela and Ecuador. He came to San Antonio in 2008 to study at Trinity University, where he obtained a BA in Economics and a minor in History. With a keen interest in economics, he recently completed his Master's in Financial Economics from Maastricht University in the Netherlands. He also holds the Chartered Financial Analyst (CFA) and Chartered Alternative Investment Analyst (CAIA) designations.

JP was in 2020 quoted (extensively) by *The Wall Street Journal* regarding the case for alternative investments and how this is an opportune time for deals and diversification. Outside of the office, JP enjoys spending time with his family, wakeboarding, golfing, and playing soccer.

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