The Risky Reach for Yield - Exhibit A

The reach for yield is the process by which individuals, and sometimes whole markets, take on a little more risk than wanted in the hope of achieving a little higher return. It's a particularly tempting carrot at the moment, with bank account and term deposit rates at historical lows.

We've warned against the temptation regularly. If you can't afford the forgone few percent in income because of lower interest rates, can you really afford the 20%+ hit to your capital if you buy riskier assets and they tank?

"*Because I can't live off 3%*" just isn't an adequate rationale for taking on more risk.

It might, however, be wrong to be black and white about it. After all, just because central bank policy is forcing your hand, doesn't mean it's not right to take on a little additional risk in response. Throughout history, people who believed that their cash, sitting in a bank account earning interest, would maintain purchasing power were regularly disappointed. Rates are currently set low with the indirect aim of eroding that purchasing power.

But we reiterate the call for investors to be cautious about reaching for yield, especially unconsciously. Think long and hard about the downside before committing a greater percentage of your wealth to growth assets.

No such caution was evident in George Cochrane's recent piece for Fairfax, titled What to do with a term deposit. The first dear reader explained a classic reach for yield temptation, and Cochrane simply encouraged 'R M' to set up the ladder and start climbing. I find Cochrane's entire answer irresponsible, in particular the third and fourth paragraphs:

However, with rates dropping, many investors are compensating by abandoning term deposits and looking to the sharemarket or to balanced funds, a move which I would favour at the current time.

Many balanced and diversified super funds offered by reputable fund managers are offering double-digit compounding returns over the past three years and although past performance is no necessary guide to future returns, I would like to think that the next three years offers similar returns in such funds.

My concerns?

Firstly, there is little more than a hat tip to risk.

Secondly, we need to banish the use of present tense language from discussions about historical return—‘are offering’ desperately needs to be replaced with ‘have returned’.

Finally, Cochrane’s inference of double-digit annual returns over the next 3 years from a balanced fund is quite likely to disappoint. With bond yields already down in the cellar, equities will probably have to generate well over 10% annual returns for a balanced fund to achieve 10% p.a. over the next three years. I’d generously put the probability at less than 30%.

I’m not licenced to offer individual financial advice. Because of that, I’m not allowed to provide financial advice to blog readers. I think that’s right and proper. In contrast, and based on barely 200 words of background information from R M, George Cochrane is allowed to provide such advice in the newspaper. I don’t think that’s right, even on occasions when the advice isn't rubbish.