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Investing in a low-yield environment

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The current market environment poses a challenge to investors given the high valuation levels across many asset classes. The liquidity support provided by central banks throughout the world has reduced real yields on bonds and many equity markets are looking far from cheap. There certainly are cheaply valued investments available globally but to a large extent these are exposed to high levels of uncertainty either in cyclical industries or in Europe. Investors seeking low-risk assets are faced with very few attractively priced assets. In this environment investors should look broader than the traditional asset classes of cash, bonds and equities to find attractive investment opportunities.

Derivative strategies offer professional investors some additional opportunities to either enhance the yield on low-yielding assets or to take exposure to more attractively priced, but higher-risk assets through a hedged or protected strategy.

To illustrate a yield enhancement strategy using derivatives, consider an investment in South African listed property. Over the past three years SA listed property has generated an exceptional total return of 88% as the prices of listed property stocks have risen.

Unfortunately this means that the yields on these stocks have come down to very low levels. For example the yield that an investor in Growthpoint properties (GRT), the largest listed property stock in SA, can expect to earn over the next year is only about 6.1%. This does not compare favourably with the yield on the All Bond Index of 7.85% or on a one-year negotiable certificate of deposit (NCD) of 5.8%. An investor who has a positive outlook on the property sector but is hesitant to invest at such low yields may prefer to take their exposure through a derivative strategy of selling a put option on GRT. A put option is a contract that gives the holder the right, but not the obligation, to sell the underlying share at the strike price of the option at some future date known as the expiry date of the option.

If the share price falls below the strike price at the expiry date the holder will sell the share at the strike price, rather than the lower spot price, thereby protecting them from any loss on the share below the strike price. This protection comes at a cost and so an investor is required to pay an amount, known as a premium, to purchase a put option. Conversely an investor who sells a put option is obliged to purchase the underlying share at the strike price at some date in the future, but they are remunerated for taking this risk by earning a premium for selling the option.

An investor who would like to buy R10m worth of GRT shares can consider an alternative strategy of selling a put option at 80% of the current spot price with an exposure of R10m. The investor will earn a premium of 3.1% for the sale of this option and can place the R10m in a one-year NCD earning a rate of 5.8%. In total the investor receives a yield of 8.9% over the life of the trade compared to a yield of 6.1% on the GRT shares. If the GRT share price doesn't fall more than 80%, and ends the year above the strike price of the option, the investor earns a superior yield over the life of the trade. If the unit price drops to the strike price the investor still earns the yield and is able to purchase the shares at a more attractive valuation, at a forward yield of 7.6%.

Another similar strategy, known as call overwriting, involves an investor holding an investment and selling a call option on that investment at a strike price that is higher than the current spot price. A call option gives the holder the right to buy the stock at the strike price at the expiry of the contract. The seller of a call option is obliged to sell the underlying stock at the strike price if the share price has moved above that strike. Again, the seller of the call will receive a premium for selling the option which can enhance the dividend yield on the stock that they own, but they give up any return on the stock above the strike level if the stock moves higher than that level at expiry.

This strategy is not without its risks; it requires the investor to have a thorough understanding of the valuation of the underlying instrument as well as the mechanics of the option strategy, but it does allow suitably qualified and experienced investors to employ a non-conventional strategy on an investment and to potentially achieve a higher return for their clients.

Disclaimer: All pricing mentioned in this article is merely indicative and reflects market prices and assumptions at the time of writing.