Contemporary Issues in Finance
Is risk being under priced?

Martin Upton

In recent years, as you've related, we've seen returns on investments fall; we've seen a low interest rate in environment globally; and we've also, in the last few years, seen credit spreads decrease. Is there a case then for arguing that risk is now underpriced?

Graham Honeybourne

I believe generally in the economic environment, because of the tremendous monetary stimulus that's being pumped into the economy, that risk is being underpriced because of the availability of money and because the economic programme actually creates lower interest rates. But, again, I also raise things like you know, we're all growing older and greyer; we all need more fixed income products. As we need fixed income products, we are pumping our money into the credit market, not into the equities market, and that money is chasing down the spread margins on bonds and increasing the demand for government bonds.

Marcus Davidson

That, if you like, is the practical and empirical dimension of the situation and I go along wholeheartedly with what you say. On the theoretical side, I think it's also the case that the whole question of the pricing of risk and the benefits of diversification, the significance and the extent of correlation between assets is less well researched and less perfectly understood in the area of debt products than it is in the area of equity products. The whole literature about rate of return, diversification primarily relates to equity markets and that is a very, very well trodden path and, by comparison, the same issues in the debt market are less perfectly understood. There are a number of crucial differences between debt and equity. One, of course, is that interest rates are in a sense mean reverting, whereas equities are not necessarily so. Another is that most of the models we use for equity returns take as a starting point that investors are fully diversified whereas I don't think the same assumption can be made in the debt markets, of full diversification. I don't think there is a definition of what would constitute a perfectly diversified investor in debt.

Graham Honeybourne

I do want to flag two other things; energy is a fundamental driver of our economy today and the availability of energy, or cheap energy is going to get more difficult right across all the different types of energy, and that means we're also going to start moving into a kind of commodity period. We've seen very low commodity prices for some time now and that might have encouraged low rates of return. But, if commodities pick up – and a lot of people believe we have a 10/15 year commodity cycle ahead of us – if that is the case, that will bring in more volatility and we can then expect to see a change in the behaviour of that rate of return expected by the market, which I think will force up absolute return rates and inflation potentially.