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## Get used to world without 'risk free' rate

By Gillian Tett

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Earlier this week, I pointed out in a column that the cost of insuring the US government against default in the credit derivatives markets is now higher than for many major companies. More specifically, data from Markit shows that no less than 70 US corporate names currently command lower credit default swap spreads than the sovereign contract (currently running at 50 basis points.) A few years ago, there were none.

Unsurprisingly, that observation prompted a flurry of e-mails: some readers suggested that this pattern simply demonstrated what a poor guide CDS prices can be; others argued that it showed instead what a poor job American politicians were doing in relation to US debt.

However, one of the most interesting observations came from Bruce Tozer, a senior official at Crédit Agricole Investment Bank, who suggested that the most important aspect of this swing is that it should force investors to rethink their concept of the "risk free" rate.

More specifically, in recent decades, western investors and asset managers have been raised to assume that the US Treasury yield was the "risk free" benchmark, against which other assets could be measured; this consequently formed the bedrock for their investment approaches, such as their use of the capital asset pricing model.

But, these CDS swings, Tozer adds, raise three questions: firstly, can we really consider Treasuries an appropriate "risk free" rate today?

Secondly, is this concept of "risk free" even appropriate in today's world?

And thirdly – and most crucially – if the answer to the first two questions is "no", then what "does that mean for portfolio theory and the capital asset pricing model?"

It is worth considering each of these three questions in turn, since they are absolutely fundamental.

On the first issue – namely whether US Treasuries really offer a good “risk-free” rate – I personally think that there does need to be an investment rethink. On paper, the idea that the US would actually default on its debts currently looks odd; quite apart from the fact that the dollar is the world’s reserve currency, the US fiscal problems would not be impossible to solve if only politicians could produce an intelligent, collaborative fiscal plan.

But therein lies the rub: what matters in the US today is not economic and financial volatility, but rising political volatility too. Hence the fact that S&P recently downgraded US debt (entirely understandably, in my view); and the widening of those CDS spreads.

Of course, some observers might retort that even amid these woes, the US still looks less risky than most rivals. True enough. Japan’s debt to gross domestic product ratio, after all, is heading over 200 per cent. Germany’s fiscal situation is better, but clouded by turmoil in the eurozone. And while a country such as Switzerland is now being treated by investors as a safe haven, its bond markets are too small to provide any alternative “risk free” benchmarks.

And there are not many obvious candidates elsewhere. At a meeting of chief investment officers that I attended in New York, for example, some CIOs suggested – half in jest – that the investment community should start asking whether some large companies (such as IBM) could provide an alternative benchmark. Another leading CIO proposed coal as the best new risk free asset: after all, he argued, coal (unlike food) does not depreciate over time; however, it (unlike gold) has a tangible use that transcends cultures.

But unless asset managers are ready to start loading up on the black stuff, the more realistic conclusion is that we could be moving into a world where there is no real “risk free” rate at all. If so, as Tozer says, it may now also be time to recognise that all of those capital asset pricing model techniques to which 20th century finance was so addicted need to be reconsidered too.

Would that be such a bad thing? Some might argue not. After all, as Emanuel Derman, the well-respected financial “quant”, argues in a powerful book that will be published next month, while models are essential for the modern world, they are always illusory to some degree\*. And in the case of that “risk free” benchmark, that always incorporated some element of fiction. If the current debate about US debt – and the CDS spreads – is now forcing investors to clearly recognise this, then it might be a positive thing in a long term.

But in the short term, at least the main impact of these swings is that it has left many investors feeling profoundly uneasy, albeit in ways that they cannot always articulate. After all, nobody likes losing their long-cherished compass, when the landscape around them looks scary; risk is a four-letter word.

*\*Models Behaving Badly is being published by Free Press on October 25 in the US and Canada, and by Wiley in the UK*

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