Danger Ahead: The Reach-for-Yield Behavioral Transmission Mechanism Across Risky Assets

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Citation

Abstract
This paper argues for the existence of a reach-for-yield behavioral transmission mechanism which, during low-interest rate periods, drives a higher willingness to pay for dividend yield in various yield assets like high-yield bonds, high yield closed-end funds, yield companies and real estate investment trusts. We argue this effect is particularly notable for investors who have not correctly updated their priors for reasonable market returns given the macroeconomic outlook or for those investors who have fixed nominal return mandates i.e. pension funds. We present an uninformed/informer trader model that illustrates how in a low-interest rate environment, assets migrate to uninformed traders who do not correctly price the risk of the assets they are buying. This model also illustrates how macroeconomics shocks may arise from yield instruments whereby the owners of assets, realizing they did not fully understand the risks of what they own, seek to liquidate their positions at distressed prices. This can cause systemic risk in a similar manner to the market unraveling of mortgage-backed securities (MBS) sales during the 2008 Great Recession. We then empirically test a variety of yield assets in time-series to evaluate if a reach-for-yield phenomena exists during low-interest rate periods. We conclude that there exists a statistically significant reach-for-yield effect in which investors consistently pay a higher premium for yield in a low-interest rate world across a variety of yield assets.

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