State of Fixed Income

Will Bonds Continue Fulfilling their Dual Role?

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An allocation to fixed income has traditionally been present in all but the most aggressive of portfolios, with conservative portfolios often being 100% fixed income. Certainly, many portfolios have benefited from their allocation to bonds over the last 35 years. But the wise investor should look forward, not backward, to determine if bonds will be able to deliver the dual role they have typically served.

But to look forward, we must examine the state of bonds today.

High Demand for Bonds

Yields have languished at historic lows and are slowly beginning to rise, but the demand for bonds has remained quite high ever since the credit crisis of 2007-08.

And why wouldn't the demand be high when the following drove investors to bonds:

- Investors' fears of equity markets in the 9+ year bull market
- Non-U.S. central banks maintained a healthy cushion of current account reserves
- Open market operations by the Federal Reserve Bank (i.e., "quantitative easing")
- A very accommodative monetary policy

As demand for bonds has soared, the yield plummeted. As every student of finance knows, the yield on bonds is inversely related to its price. While the Fed eventually started a policy of tighter monetary conditions, the overhang from a nearly a decade of loose monetary policy still haunts the market.

This has left bond investors with an unattractive set of options:

1. If rates stay low, bonds are unlikely to generate enough income to meet their spending needs.
2. If rates increase, current bond holdings are susceptible to losses in value.

The Income Challenge

Historically, investors averaged 6.25% from Treasury bonds over the last 40 years. With rates roughly a third of that since the Financial Crisis, many investors were forced to reach for yield in riskier assets.

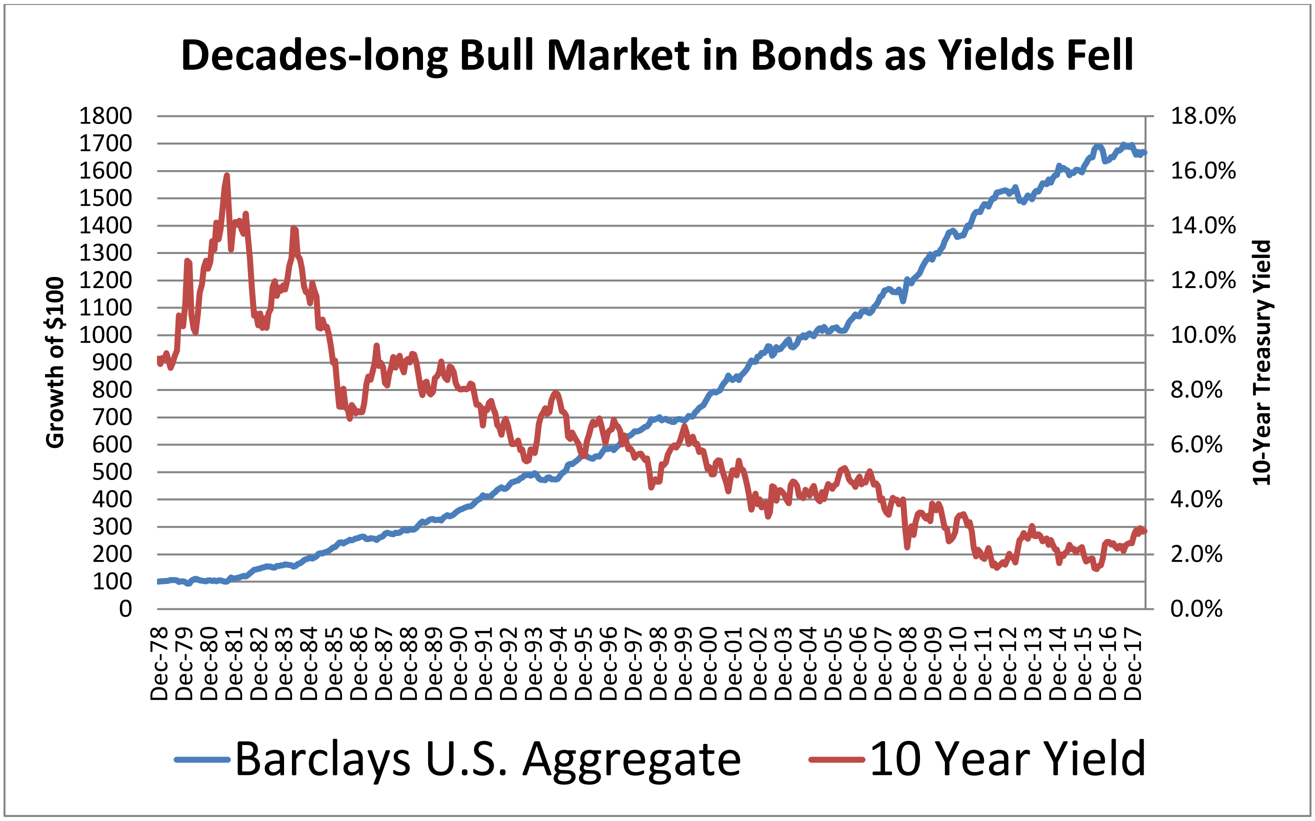
Think about it…at a 6.25% yield, a million-dollar position in ten-year Treasuries would produce $62,500 per year, or $625,000 over a decade. Alternatively, a 2.50% yield would produce only $25,000 per year. That's roughly the definition of poverty-level income for a family of four[1]….and that's on a million-dollar portfolio.

So investors should welcome an increase in rates, right? With an increase in rates, a decrease in value follows threatening the capital preservation role of bonds.

The Capital Preservation Challenge

Bonds have historically been able to provide not only capital appreciation but also capital preservation. Over the last 35 years (Jul 1983 – Jun 2018) the investment grade bonds of the Barclays U.S. Aggregate Index have averaged an annual rate of 7.03%. The graph below shows why.

[1] https://www.uscis.gov/sites/default/files/files/form/i-864p.pdf



Source: Zephyr StyleADVISOR, www.research.stlouisfed.org

As inflation was tamed and interest rates descended from an eye-popping 15.8% in 1981, the value of high-yielding investment-grade bonds increased dramatically. Today, with yields at 2.85% there is little upside remaining. In fact, many would argue there is much more downside to bonds than upside.

With such a long, steady fixed-income bull market, it is easy to forget bonds can lose money, especially when interest rates change. In 2018, the Barclays Aggregate Bond Index is down -1.62% through June 30th.

Duration Risk

The unfortunate reality is that the relationship between bond values and yields works in reverse: rising interest rates decreases the values of bonds. Duration measures the sensitivity of a bond's price to changes in interest rates. With a current duration of 5.29 (Morningstar category average: Intermediate Term Bonds, 6/30/2018), the typical bond fund is very susceptible to capital losses should interest rates rise from their current 2.85% to the historical average over the last 40 years of 6.25%.

Those relying on bonds for downside protection or protection for their often irreplaceable capital might be in for a rude shock.

Rethinking Fixed Income

Previously bond holders were able to have their cake and eat it too. They received both income when yields were higher. Bonds provided not only capital preservation when equity markets sold off, but capital appreciation when yields fell. With the current state of bonds the way it is, investors must choose between yield or protection. They cannot have both.

This forces investors and advisors to rethink how they invest for income and manage market risk and what it means for their long term financial plans going forward. Instead of relying solely on bonds, many may have to look to alternative funds or strategies to fulfill the two roles bonds have done in the past.

About the Author:

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