Why keep bonds in your portfolio?

With inflation surging and rates on the rise, it's easy to discount the importance of bonds in a portfolio, especially when comparing them to equities which have seen significant returns over the past two years. It may even be tempting to underweight or divest from long dated assets (like government bonds) all together.

In this paper we explain why it is important to maintain an adequate allocation to bonds throughout the market cycle. From high growth environments with accelerating inflation and rising interest rates, like we're experiencing now, through to recessionary environments with inflation and rates contracting.

How did we get here?

Since the Global Financial Crisis (GFC) in 2008 the central banks of developed economies have kept interest rates at historically low levels to promote economic growth. While central bank mandates differ slightly from country to country, they generally have the same overarching goal: to maintain price stability by controlling inflation and maximise employment. In efforts to maintain price stability, the Federal Reserve (the Fed – the US central bank) targets inflation of 2%, while domestically the Reserve Bank of Australia (RBA) aims for an inflation range of 2-3%. From the GFC up until March 2021 inflation in most developed economies has been low. Quarter-on-quarter US inflation averaged just 1.6% and Australian inflation just 2%. Although inflation isn't the only measure central banks rely on to determine the cash rate, this does provide backing for the extremely low interest rate regimes we have seen across most developed economies. This period of low inflation came to an end when economic shutdowns due to the COVID-19 pandemic caused supply constraints which when coupled with significant government stimulus packages, drove up the prices of goods and services. The war in Ukraine has only exacerbated these issues and magnified inflationary pressure.

What is a bond?

Put simply, a bond is a loan made by an investor to a borrower, generally a company or government. Typically, the borrower pays the investor interest periodically over the term of the loan (these payments are called coupons) and then returns the initial value of the loan (the principal) back to the investor at an agreed upon future date (the loans maturity date).

Inflationary environment

Inflation is defined as a sustained period of rising price levels. Moderate inflation, generally between 2-3%, is a sign of a healthy growing economy, however persistent high inflation (4%+) erodes purchasing power, hurts real investment returns (returns after deducting inflation) and can lead to runaway inflation if not proactively controlled by central banks. To control inflation and cool an overheating economy, central banks increase interest rates to curb borrowing and lower the demand for goods and services, this in-turn reduces prices and lowers inflation. Central banks can also sell assets, usually government bonds, in the open market to manipulate supply and demand to control prices and regulate inflation – this is known as quantitative tightening. In recessionary environments central banks will reverse this and buy assets in the open market for the opposite effect, known as quantitative easing. This form of monetary policy is a relatively new tool for central banks, first used by the Bank of Japan in the early 2000s and subsequently by the US following the GFC in 2008.

Given the current situation in markets, with inflation around the globe trending upwards following economic disruptions and unprecedented government spending to support economies during the COVID-19 pandemic, several central banks have begun to adjust rhetoric and hint at increasing interest rates (some have already begun) and reversing the quantitative easing implemented throughout the pandemic. Given US inflation is at 40-year highs, the Federal Reserve began raising rates with a 25bps hike in March. With Australian inflation at 20-year highs of 5.1%, the RBA followed suit with a 25bps hike on May 3rd. We expect the RBA to be less aggressive than the Federal Reserve going forward given inflation isn't quite as severe and with significant household debt, smaller rate hikes will flow to larger debt repayments having a greater impact on households.

As rates rise, investors can experience initial capital losses as bond prices are inversely related to interest rates. That is to say, when rates increase the dollar value of your bonds will fall. However, these losses will be rapidly offset by higher income. Depicted in Figure 1, in accelerating inflationary scenarios, real returns on long term government bonds are lower as inflation offsets investment returns, but not the disaster that many people forecast – they tend to be flat or slightly positive.

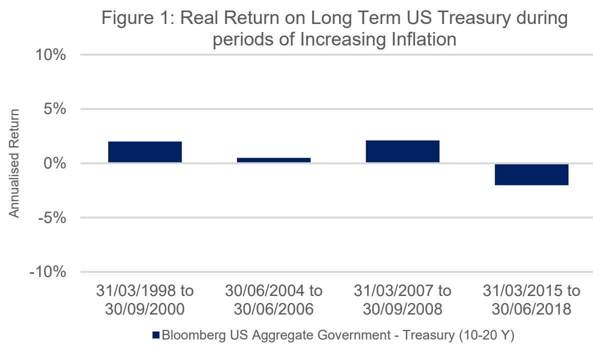

Figure 1: Real Return on Long Term US Treasury during periods of Increasing Inflation

Source Factset data, April 2022

Longer dated bonds are generally more sensitive to changes in interest rates than short term bonds. Investors will manipulate their portfolio's exposure to long/short term bonds during times of uncertainty to mitigate downside risk. As interest rates rise, investors will often move out of long-term assets, such as long-term government bonds, into short term assets such as short-term government bonds. Corporate bonds with shorter timeframes are also used in this environment; however, they will be more volatile than government bonds due to the increased credit risk and may not provide the same defensive benefits. As seen in Figure 2 below, longer dated government bonds are significantly more volatile than their shorter-term counterparts due to their higher risk.

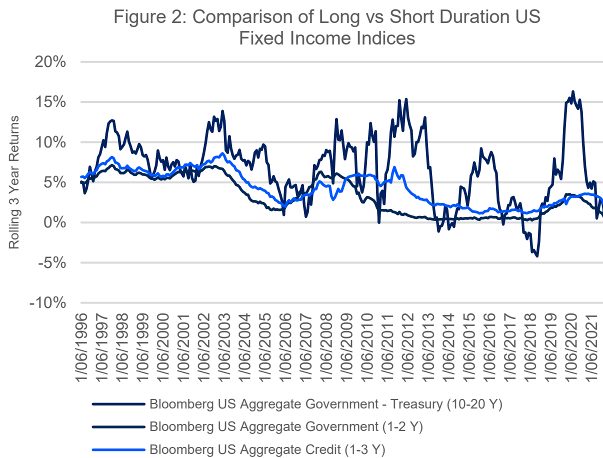

Figure 2: Comparison of Long vs Short Duration US Fixed Income Indices

Source Factset data, April 2022

Recessionary environment

We want to first clarify that a recession in the near future is not our base case expectation; however, it is not outside the realm of possibility given where we are in the market cycle with inflation high and rates on the rise. If this were to be the case, we expect long term bonds to perform well, and to be negatively correlated with equities, providing significant diversification, and dampening some of the downside risk.

As economic conditions worsen into a recession, investors tend to seek safety in high-quality long dated bonds, this increased demand pushes prices up. Furthermore, central banks typically respond to recessionary pressure by lowering interest rates to encourage spending and promote growth. This lowering of interest rates also strengthens bond prices as their fixed returns become more attractive relative to the decreasing market interest rate. As an economic recession is typically accompanied by decreasing inflation, real returns (returns after deducting inflation) on bonds become more attractive as inflation doesn't offset returns as severely. Whilst shorter term bonds can provide attractive returns relative to long dated assets, they are more correlated with equities and therefore don't provide the same defensive benefits when equity markets fall. This is especially true for pure short term credit assets, which are further up the risk curve than short term government bonds. As seen in Figure 3, long term bonds have typically provided powerful diversification benefits during falling equity markets, however shorter dated assets don't provide quite as good diversification.

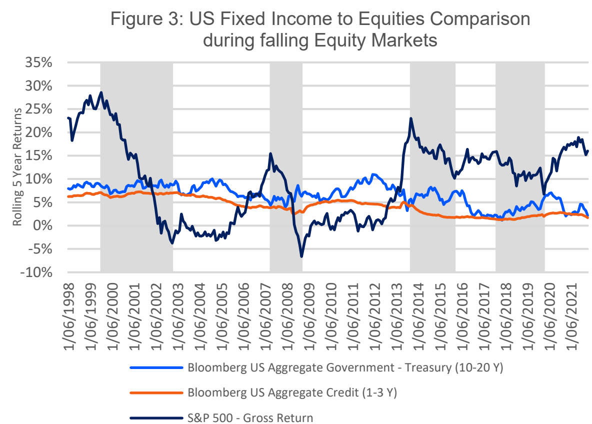

Figure 3: US Fixed Income to Equities Comparison during falling Equity Markets

Source Factset data, April 2022

Figure 4 gives a pictorial overview of how equities and bonds are expected to perform at different stages in the economic cycle.

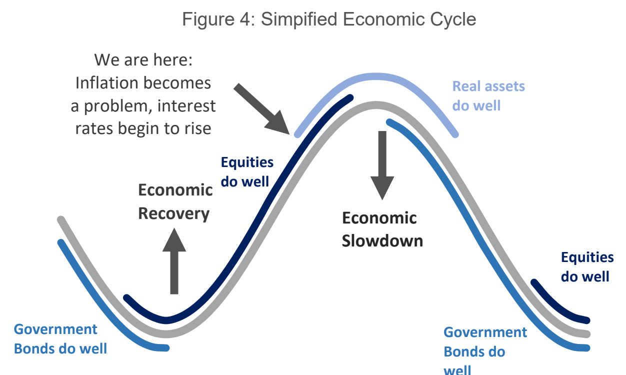

Figure 4: Simpified Economic Cycle

Active vs Passive

During periods of elevated inflation, and the higher interest rates that typically follow, active bond managers generally outperform their passive benchmarks. Speaking more broadly, active managers in the fixed income asset class more consistently outperform their benchmark than equity active managers. This is due to fundamental differences between the equity and fixed income markets. Although it gets much less attention in

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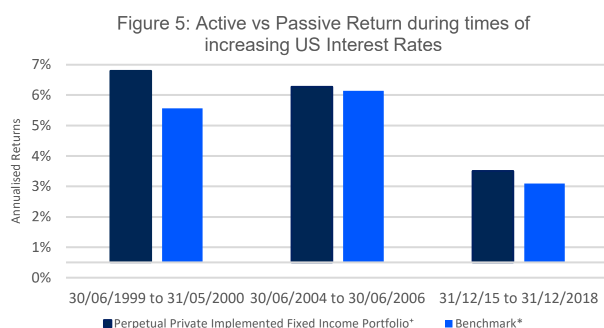
the media, the global fixed income universe is approximately 20% larger than the global equity universe. Additionally, the vast array of different fixed income assets means that constructing passive fixed income benchmarks is difficult and many segments of the investable market are often omitted. This broader opportunity set for fixed income managers to invest outside of their benchmark index, as well as the ability for managers to manipulate their portfolios to benefit from changes in interest rates, inflation and other macroeconomic factors far exceeds their equity market counterparts. For example, active managers are able to navigate high-interest rate environments by repositioning their portfolios to benefit from the increased rates/higher inflation and avoid the poor performance of longer dated assets. As passive fixed income exposure has a fixed allocation across sub-asset classes, the components of these portfolios with long term assets significantly hinders performance as rates rise. Conversely, as rates are falling it becomes increasingly difficult for active managers to produce significant outperformance as the strong returns from long dated assets outshine the excess return active managers can generate in other areas of the portfolio. In addition, managers tend to be structurally weighted towards shorter-dated assets, i.e. take less risk. Portfolio managers can pull a number of levers to avoid interest rate risk when rates rise, these include:

- Shifting to floating rate instruments to take advantage of increasing rates
- Introducing inflation-linked securities
- Increasing allocation to short term credit
- Reducing allocation to long term bonds – As mentioned above, bonds with longer terms are particularly vulnerable as interest rates increase as their fixed yield becomes less attractive relative to the market interest rate.

Simply sticking to a passive fixed income strategy with fixed allocations as we move into this phase of the market cycle can hinder performance as it doesn't allow you to sufficiently mitigate interest rate risk. As seen in Figure 5 below, our Implemented Fixed Income Portfolio has provided consistent excess returns net of fees in the recent periods of rising interest rates.

Figure 5: Active vs Passive Return during times of increasing US Interest Rates



Source Factset data, April 2022

*The Fixed Income Composite benchmark consists of 60% Bloomberg AusBond Bank Bill Index, 20% Bloomberg AusBond Composite Index & 20% Bloomberg Barclays Global Aggregate (AUD Hedged), reflecting our Fixed Income Implemented Portfolio's investment strategy.

+The Implemented Portfolios inception is dated 9 December 2013, from that date onwards actual performance has been used. Prior simulated performance was used for periods greater than the portfolios inception date. This performance was based off the underlying investment pools, and we have adjusted returns to reflect fee differences

Market outlook

Given where we are in the market cycle, and the expectation of continued volatility across asset classes, the importance of portfolio diversification is paramount. Within the fixed income asset class, we believe a shorter-term asset tilt should be beneficial in the medium term. We recommend maintaining adequate exposure to bonds more broadly through experienced active managers to help offset volatility and defend against market corrections when they occur.

We see a strong case for an overweight equities position over the medium term, especially to Australian equities given favourable macro conditions; however, with ongoing uncertainty around the war in Ukraine and the tightening of interest rates due to persistent high inflation we expect continued volatility and subdued returns relative to the bull-market over the last 2 years.

Alternative investments remain an important portfolio diversifier, especially when traditional markets are in flux, given the absolute return objective and low correlation with traditional asset classes.

Markets are heavily influenced by macro-economic factors at present. We see the following themes as key drivers of market volatility over the medium term:

- Ongoing geopolitical unrest and wide-spread market disruptions due to Russia's war on Ukraine. Commodity prices have surged as a result, potentially benefitting the Australian economy.
- Weakness in the Chinese real estate market amidst COVID-19 lockdowns as the Chinese government continues to pursue a zero COVID-19 policy.
- Inflation expectations continuing to rise as pressures in supply chains remain, pent up demand is also strong.
- US Monetary and Fiscal policy – the Fed raised interest rates in March as it struggles to manage inflation. The RBA followed suit in May.
- Bond yields will continue to be volatile, and push upwards, as uncertainty around inflation remains.

Conclusion

In line with our "Protect and Grow" investment philosophy we seek preparedness in the way we position client portfolios. We stand by our total portfolio approach to investing, which sees us maintaining adequate diversification across all asset classes throughout the market cycle to achieve strong risk-adjusted returns.

Traditionally, bonds act as an important diversifier in portfolios as they exhibit low correlation with equities and provide stable cash flows. Put plainly, an adequate allocation to bonds reduces portfolio volatility and improves risk-adjusted returns. We therefore believe they have a place in a portfolio throughout the market cycle. However, allocations may be tilted through time to take advantage of changing market environments.

We strongly advocate an active approach when it comes to fixed income investing to ensure our clients' portfolios are well positioned to take advantage of shifts in the economic cycle, especially as rates begin increasing and passive allocations are exposed to downside risk.

If you have any questions in relation to any of the content in this article, please reach out to your financial adviser or get in touch with us via the contact details below.

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