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Why Bother Allocating to Fixed Income?

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It has been quite a run for bond markets over the last 40 years. Yields have fallen from 16% in 1981 to less than 1% recently, an astounding drop with a commensurate bull market rise in bond prices, which move opposite yields. Bonds have been a very reliable source of returns for a very long time. But with return expectations so low, is there still a reason include bonds in a portfolio?

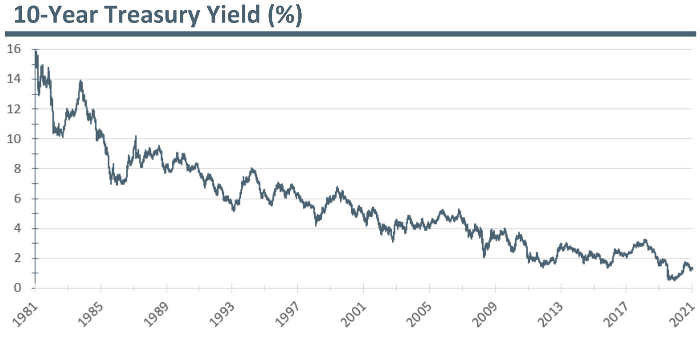
By example, a holder of long-term Treasuries has received a 7.7% annualized total return over the past 30 years—an impressive return for a risk-free asset and one that even beat foreign developed equity market returns.

The chart below clearly shows the downward trend in yields since the recession of 1981 when the Federal Reserve began raising rates to combat inflation. In more recent times, already falling interest rates have gone even lower due to US monetary policy stemming from government's response to both the Global Financial Crisis in 2008 as well as COVID. Global central banks have forced rates below their natural level.

With yields hovering around 1%, there's little room for them to keep falling and bond holders will not keep benefiting from rising bond prices. It is time for bond holders to reassess their expected future returns and the ultimate rationale for holding bonds in their portfolios.

We believe that there's still very much a place for high-quality bonds in portfolios, including Treasuries, high-grade corporate bonds, and municipal bonds.

10-Year Treasury Yield (%)



Source: Bloomberg

Diversification will always be key …

A well-managed portfolio aims to achieve the best return for a given level of risk, which is usually determined between an advisor and their client. This can be measured by what is called the Sharpe ratio, which is calculated by the return in the context of the risk taken.

Studies have shown that even in this low return environment for bonds, maintaining an allocation will enhance your portfolio's Sharpe ratio and may also allow you to take on additional risk within other asset classes. Bonds can still help optimize portfolios.

High quality bonds have historically been negatively correlated with equities and other 'risk assets.' This correlation holds true even in a low yield environment—when equities sell off investment grade bonds provide a positive return. Given that most portfolios will have a significantly larger allocation to equities than bonds, bonds are not able to outweigh the equity sell-off losses but can still dampen the impact, which is an essential role in a portfolio.

A valuable source of liquidity during periods of market turmoil ...

As high-quality bonds generally appreciate during periods of equity market turmoil, it stands to reason that investors should look to their bond allocation for liquidity. Selling stocks in a declining market is what everyone wants to avoid.

Selling bonds during equity market corrections, however, can provide a source of funds for:

- Private equity capital commitments,
- Investing in equities or other risk assets during periods of market dislocation, and/or
- Paying taxes and other external cash needs.

That kind of liquidity is important for portfolio flexibility and can help investors maintain equity exposure to capture the upside of volatile markets.

Low return potential, but still positive ...

Notwithstanding low future returns, there are three main sources of return for high quality bondholders, and we expect two out of these three sources of return to remain positive.

- *Income yield*: The income received by virtue of being a bondholder. If rates do rise, this income can be reinvested at higher income yields.
- *Roll yield*: The appreciation in price as a bond's maturity nears. In a normal environment the yield curve is upward sloping, meaning longer dated bonds have higher yields than shorter dated bonds (as is the case today). As those longer dated bonds age and naturally become shorter-dated bonds, their yields fall and their prices rise.
- *Duration yield*: The return from changes in the level of interest rates. Over the past 40 years interest rates have generally fallen, providing bond holders with a positive duration yield. We do not expect duration yield to continue to be positive as interest rates rise.

For high-quality municipal bond portfolios, there is a fourth source of return—providing a hedge against future increases in income tax rates. Municipal bonds can be more attractive as tax rates increase, since they are tax free investments. While current tax hikes are still being negotiated, it is likely at this point that income tax rates will rise, thus making the income from municipal bonds even more attractive and an important part of portfolios.

In Conclusion ...

The potential return from income yield and roll yield remains positive, albeit lower than before. Given our view that interest rates and the yield on bonds will rise modestly from today's low levels, we do not expect duration yield to be positive. However, for a high-quality medium duration bond portfolio, we expect the positive income and roll yields to outweigh the negative duration yield—resulting in a low, but positive, total return. The chart below illustrates the impact that changing 10-year Treasury yields have on the 1-year return for a municipal bond portfolio.

	10-Year Treasury Yield	1-year Expected Return Municipal Bond Portfolio
Rates Rise	1.75%	0.45%
Rates Constant	1.38%	1.55%
Rates Fall	1.00%	2.65%

Source: AllianceBernstein (September 17, 2021), expected return of a 5.4 year duration intermediate municipal bond portfolio. Based on a current 10-Year Treasury Yield of 1.38% that either rises 0.37% to 1.75% or falls 0.38% to 1.00%.

Even in today's low interest rate environment, investment in high quality fixed income remains an important portfolio diversifier and source of liquidity.

About the Author ...

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Robert is responsible for developing Market Street's investment strategies as well as providing guidance on portfolio construction. He is also responsible for manager research and selection. Prior to joining Market Street in 2008, Robert most recently worked within the UK's regulatory structure where he implemented a methodology to determine if a portfolio had been mismanaged against client objectives. Previously, Robert worked for Gerrard Investment Management (part of Barclay's Bank) where he served as a portfolio manager and fund analyst. He was responsible for manager selection and also provided internal guidance on portfolio construction. Robert has also held fund analyst and investment manager roles at Fidelity International and HSBC Investments.

Robert received a B.S. (Honors) degree in Business Management from King's College, University of London, and an MBA from Michigan State University. He is a member of the New York Society of Securities Analysts and also holds the right to use both the Chartered Financial Analyst® and Certified Financial Professional® designations. Robert most recently served on the Board of Directors for the Horseheads Family Resource Center. He has previously served as a member of the Investments and Property Committee for the Corning Community College Development Foundation, and has volunteered as a grants panelist for the Community Foundation of Elmira-Corning and the Finger Lakes.

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