On The Mark

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June 2024

Back to Basics

Key Takeaways

- The role of bonds in a portfolio is generally either to produce income or to help manage volatilty.
- Today's yields on bonds are significantly higher than the past few years and offer a great alternative for portfolios given 85% of total return is driven by the income it produces.
- Bonds continue to offer lower volatility than other yield producing asset classes and tend to zig when equities zag helping to lower portfolio volatility.

As the Federal Reserve increased rates from essential 0% to 5%, the bond market experienced a significant fall. In fact, the Bloomberg U.S. Aggregate (the common index that represents the broad bond market) experienced its largest drawdown not only in magnitude but also in duration since its inception and still has a long way to go for a full recovery.

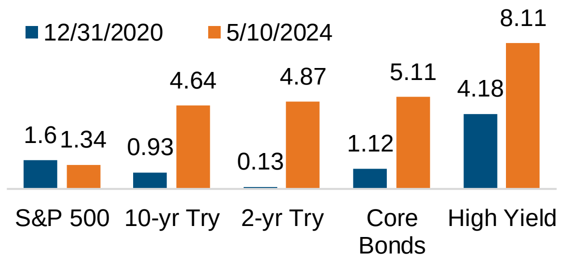
So why still consider bonds for a portfolio?

Bonds Role

Bonds tend to play one of two key roles in a portfolio - either providing income or helping to manage portfolio risk.

Over the past several years, we've seen bond yields significantly increase, as shown in the chart.

Yields Pre- and Post-Fed Hikes



Source: Factset. Bonds represented by Bloomberg indices

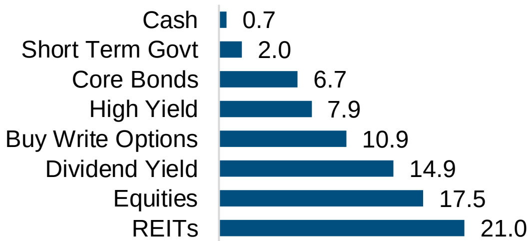
This is good for long-term returns, as a bond's return is based more on math than human emotions. To many investors, these yields provide an attractive alternative as they represent the future, and the yield on a bond tends to be indicative of a bond's return during its term. Getting a 5% return on core bonds is an attractive option, and layering in any potential price movement from falls in interest rates is a bonus. A 1% fall in interest rates would be expected to lead to an 11% return for core bonds.

But what if the Federal Reserve increases rates instead? These higher yields also offset any potential negative impact from rate increases. An increase of 1% in interest rates would expect to see less than a 1% fall in total return. It was a significantly different experience than what we saw in 2022.

Bonds Volatility

The Move index is a measure of short-term bond volatility–its bonds equivalent of VIX. In the past three years, the index has consistently been above its prior all-time high seen in 2020 (COVID-19 pandemic), running at 2.5 times its long-term average. Despite running at higher levels of volatility, though, why are we still seeing money flow into bonds? The reason for this is that in addition to the higher yield, bonds still offer a lower volatility option relative to other asset classes, as shown below.

Five-Year Annualized Volatility (%) as of 4/30/24



Source: Zephyr Style Advisor. Bonds represented by Bloomberg indices, Equities represented by S&P and MSCI indices, Buy Write represented by CBOE index.

Investors may be excited about the higher returns seen from some other defensive asset classes or strategies, like dividend yields, REITs, and buy-write options. However, they have much higher volatility than bonds and may not be the best place to hide when the equity market sees a large loss.

On top of continuing to provide a lower level of volatility, we've also seen bonds correlation to equities move back to a more normal relationship. This should allow bonds to zig more when equities zag and help to manage total portfolio risk.

Bonds as Ballast

Bonds are a critical component of a diversified portfolio, providing ballast when times get rocky. A higher yield today allows them to provide greater stability and help to reduce overall portfolio volatility.

But the key to remember is to diversify that bond exposure as not all bonds are created equal and spreading out the bets will help limit the exposure to not only the equity bear but also the bond bear.

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