The Role of Bonds in a Portfolio while Interest Rates are Low

Abstract

Today's interest rate environment poses a challenge for investors and their fixed income allocation

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"How long can interest rates stay negative? Think about this. Not only are you lending your money to governments, but you are paying them interest for the privilege of doing so."

Mohamed El-Erian

"To make money in the markets, you have to think independently and be humble."

Ray Dalio

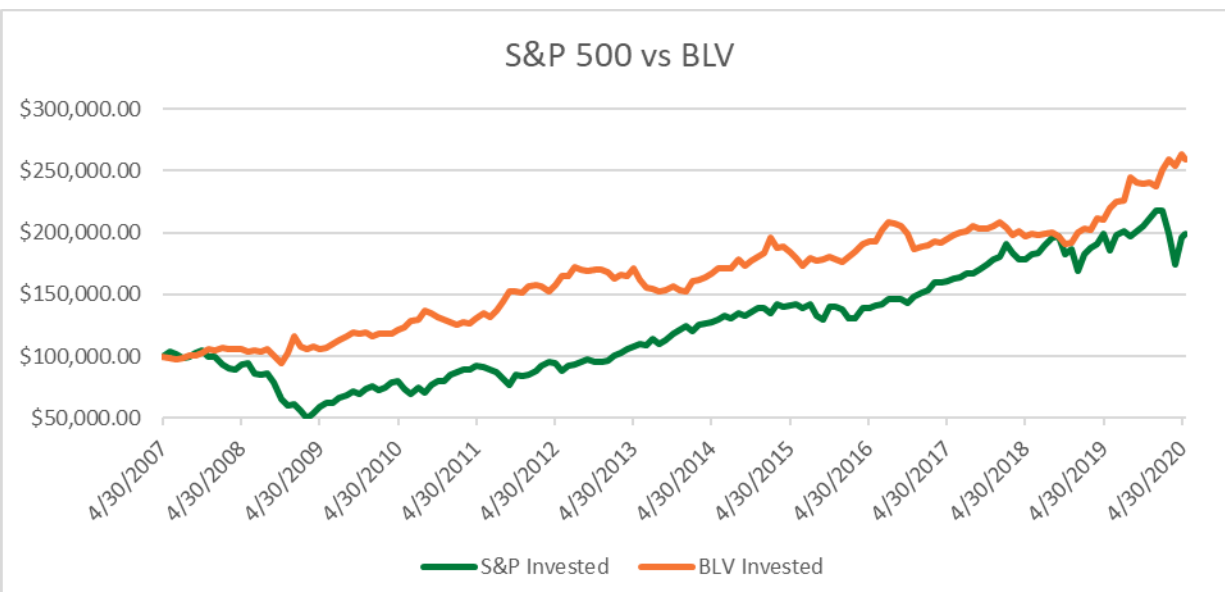
"If you are not willing to risk the unusual, you will have to settle for the ordinary."

Jim Rohn

The Role of Bonds

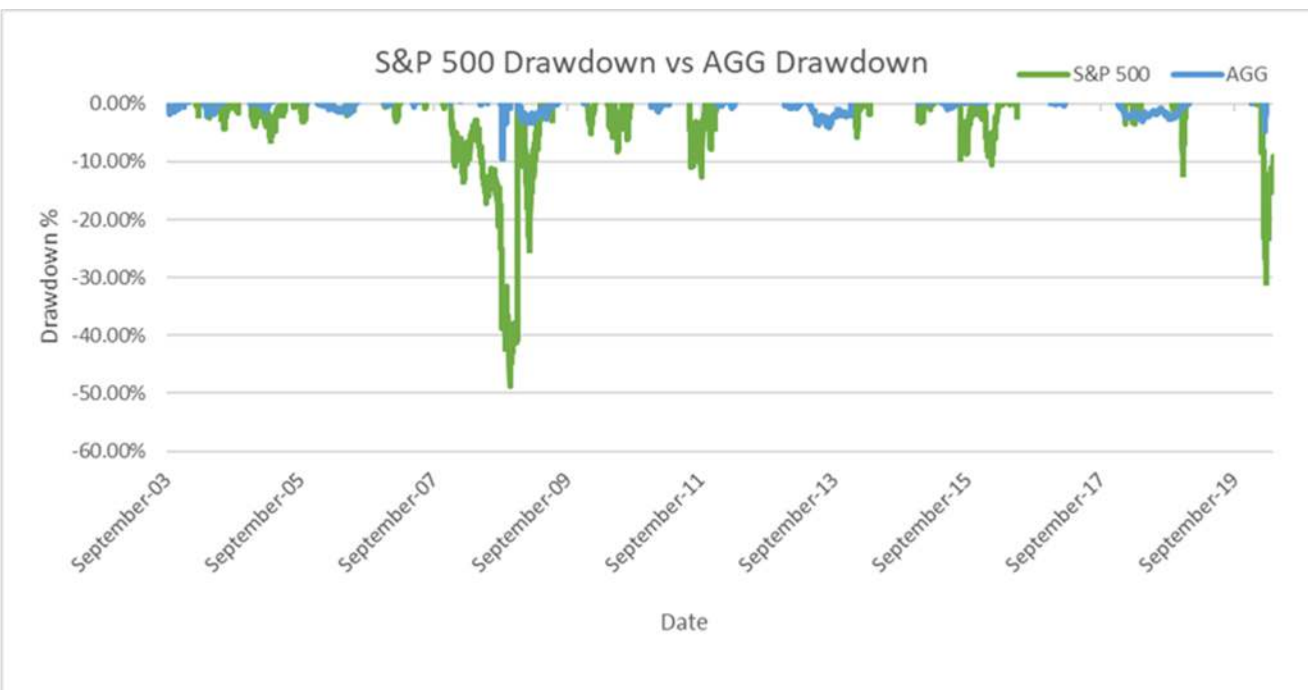
Today's interest rate environment poses a challenge for investors and their fixed income allocation. In the US and around the world government bond yields are at extremely low levels, at the time of writing this report, the US Treasury 10 year is at .70% and some other countries' yields are zero or negative. Over the years investors have looked to bonds for income, capital preservation and a hedge against inflation. Investors have enjoyed a bull market in fixed income securities/bonds over the last 40 years!

A little history on interest rates and how they arrived at these levels. In the early 1980's Federal Reserve Chairman Volcker raised US rates dramatically to curb extremely high inflation at the time. Treasury yields ranged from 20% short term to 15% long term at that time. Since that period interest rates in the US and world have steadily declined as inflation has receded to less than 2%. Contributing to rate declines was the substantial easing of monetary policy by central banks during the 2008 financial crisis. Structurally, economic growth has remained low since that period and world central banks have never really let their foot off the gas pedal. In addition, supply of notes/bonds have been removed from the market due to quantitative easing, demand by a retiring US population, and overseas investors buying US fixed income securities (as US rates have remained more attractive than foreign rates). Given the rally in US equities since 2009, one may be surprised that US long dated bonds have performed as well as the S&P 500 since 2007, as demonstrated in the chart below of the SPY(S&P index) and BLV the (Vanguard long bond index).



With the spread of the Coronavirus (COVID-19) world central banks have acted quickly to reduce interest rates further and build on quantitative easing programs from the 2008 period to keep the financial markets liquid. Near term and maybe longer, central banks will keep interest rates ultra-low to stabilize the markets from the economic effects of the COVID-19 pandemic. A crisis of this magnitude did produce a flight to quality, as investors purchased US treasuries for safety and sold other types of fixed income securities, i.e., mortgage backed, municipals, corporate bonds and preferred securities. Although the US Federal Reserve expanded their quantitative easing programs to include corporate, municipal bonds and high yield ETFs to back stop those areas of the market, there still exists some dislocation in treasury yields to other fixed income securities. As the economies of the world start to repair, I would expect investors will start to look at fundamentals, such as the level of inflation, negative real rates of return for US treasuries securities, and the increased supply of bonds as governments finance the unprecedented fiscal stimulus and as central banks gradually unwind quantitative easing.

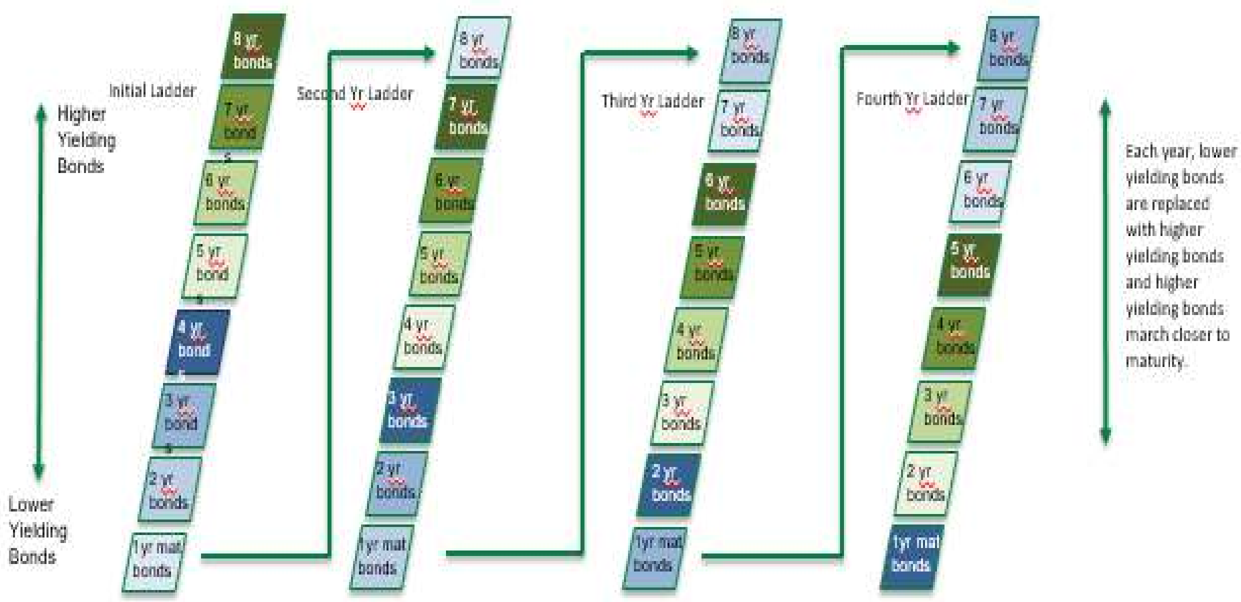
So now we will answer the question of what role bonds will have in a portfolio with interest rates at these low levels. Going forward, expect bonds to have a muted contribution to portfolios. Bonds will be used mainly as a diversification tool. As the chart blow illustrates, the drawdown of the AGG (Barclay's US bond aggregate) is much less than that of the S&P index in periods of extreme volatility. But expect the stream of income for bonds to be much less and there is a chance of a decline in value if interest rates start to rise. There is no one size fits all answer to an investor's allocation to bonds, it should be customized to that individual's risk tolerance and income needs. But for the sake of this paper it is safe to say that a conservative to moderate investor will continue to have some allocation to fixed income securities or perhaps a substitute alternative investment.



Given the outlook for bonds contribution to a portfolio, from a tactical standpoint I would recommend an underweight to fixed income/bond investment at this time.

Laddering

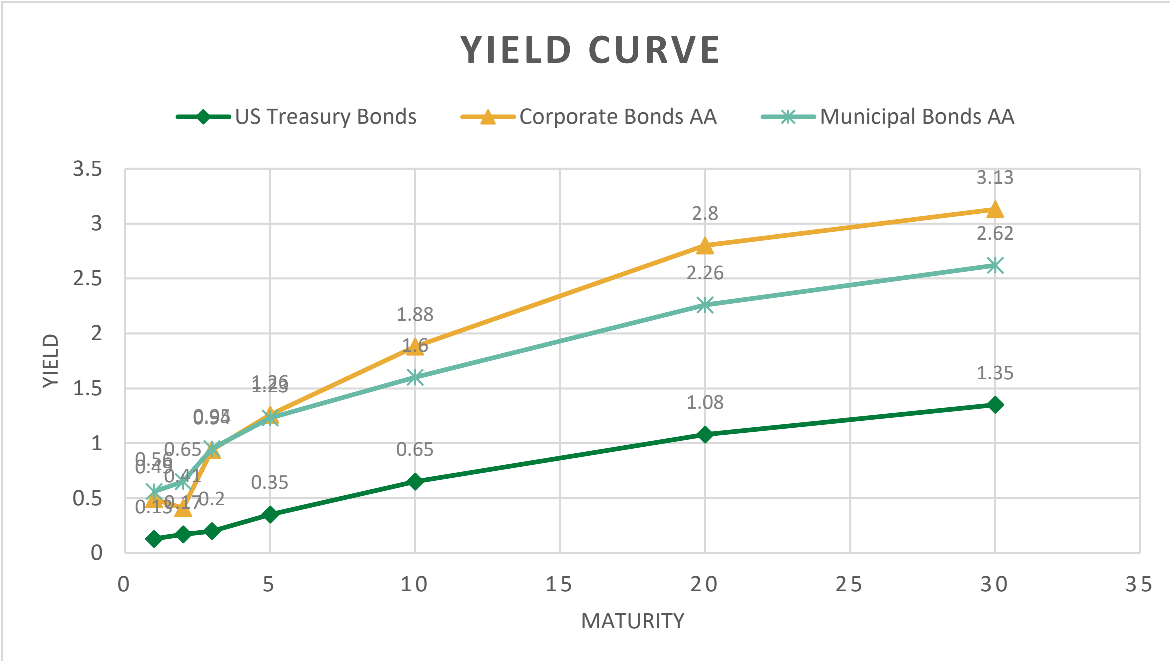
Over the years it was a common practice to use the ladder method to manage a bond portfolio. The theory was to purchase bonds with different maturities along the yield curve. As one bond matures you replace it with a new bond at the longest desired maturity with the expectations that the fluctuation in rates will have a minimum effect on your cash flow over time.



But since rates are ultra-low and possibly staying ultra-low for the foreseeable future, an alternative to a ladder would be to redeploy funds to a money market fund. Yes, increase your cash position! Treasuries and money market funds have similar correlations and you are not getting paid to move out on the yield curve. Another alternative to a ladder might be a barbell strategy.

Barbell Strategy

In fixed income a barbell strategy is investing in long- and short-term bonds, avoiding the intermediate sector of the yield curve. Taking a tactical approach, we suggest investing in the extreme short-end of the yield curve i.e. money market funds and look at longer dated maturities to take advantage of wider credit spreads (yield spreads between treasuries vs other debt classes) and invest in the sweet spots of the corporate or municipal yield curve. For example, looking at 5 or 10-year AA rated corporate bonds yielding 1.26% and 1.88% respectively, this is a pick-up of .92 and 1.25 over similar maturities in US treasuries. Or 10 or 20-year in AA rated municipals yielding 1.59% and 2.27% respectively, which is a yield pick-up of .97 and 1.23. Using the Barbell approach will give you the opportunity to fill in the ladder with the money market funds once rates start to normalize.



The Municipal Bond Advantage

Municipal bonds are excellent in taxable accounts as in most cases the income is federally tax free. If you are in the 37% tax bracket the tax equivalent yield on the above-mentioned municipal bonds are 2.7% and 3.8% respectively, a yield pick-up of greater than 4 times that of US Treasury's!

Highest yield currently being offered for the product and maturity range

Product	0-1 yr	1-3 yr	3-5 yr	5-7 yr	7-10 yr	10-20 yr	20+ yr
CDs	0.566	0.905	1.271	1.601	2.024	2.022	---
Agencies	0.153	0.663	1.182	1.603	1.950	2.407	2.865
Corporate (AAA)	0.243	0.712	1.136	1.621	1.994	2.868	3.497
Corporate (AA)	0.232	0.874	1.327	1.716	2.106	3.081	3.482
Corporate (A)	0.352	0.884	1.497	1.927	2.303	3.249	3.502
Corporate (BBB)	0.545	1.273	2.134	2.627	3.153	4.075	4.487
Municipal (AAA)	0.111	0.468	0.742	1.064	1.492	2.442	3.438
Municipal (AA)	0.116	0.401	0.692	1.046	1.461	2.100	3.452
Municipal (A)	0.185	0.574	0.892	1.385	1.940	2.809	3.715
Municipal (BBB)	0.708	1.066	1.512	1.878	2.697	3.569	4.201
U.S. Treasuries	0.349	0.643	0.979	1.250	1.303	1.108	1.972

Source: Warren Financial • Created with Datawrapper

In recommending using corporate or municipal bonds in a portfolio, use an active municipal bond manager that can take advantage of the best part of the bond curve as well as pay attention to the credit quality of the individual bonds.

Avoiding Bond Funds and Bond ETFs

Bond Funds and Bond ETFs are areas you want to avoid with interest rates at these levels. The average maturity of bond ETF funds has increased over the last decade. As investors, you have no control over the maturity of the bonds the mutual funds hold, and you can lose money as interest rates rise.

Alternatives to enhance Bond returns

Another area that accredited investors can use to enhance their bond portfolios is non correlated-low volatility alternative investments such as Life settlement contracts, Short-term Commercial Bridge loans and Professionally Managed Commercial Real Estate. These investments tend to have yields in the 5 to 9% range. Using these type investments in a 5-15% portfolio allocation can enhance cash flow and return at the same time, while diversifying risk.

Summary

Right now, as the US economy recovers from the COVID-19 crisis, you will want to stick with quality bonds. Avoid the bank loans, floating rate debt and high yield markets as those areas have greater credit risk. Governmental debt may not be the best fixed income vehicle to invest in with yields at these levels. On a relative basis corporate, mortgage backed and municipal bonds make sense depending on your tax bracket. Stick with quality credit and avoid the pitfalls of reaching for yield, in both stocks and bonds!

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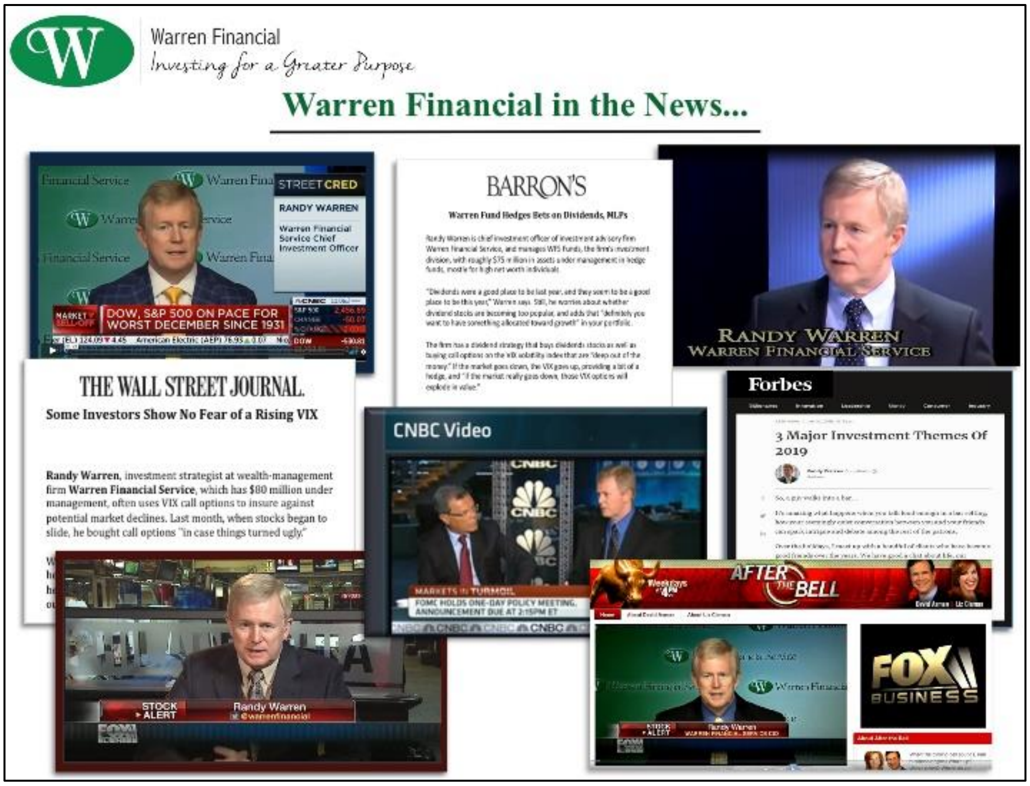

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