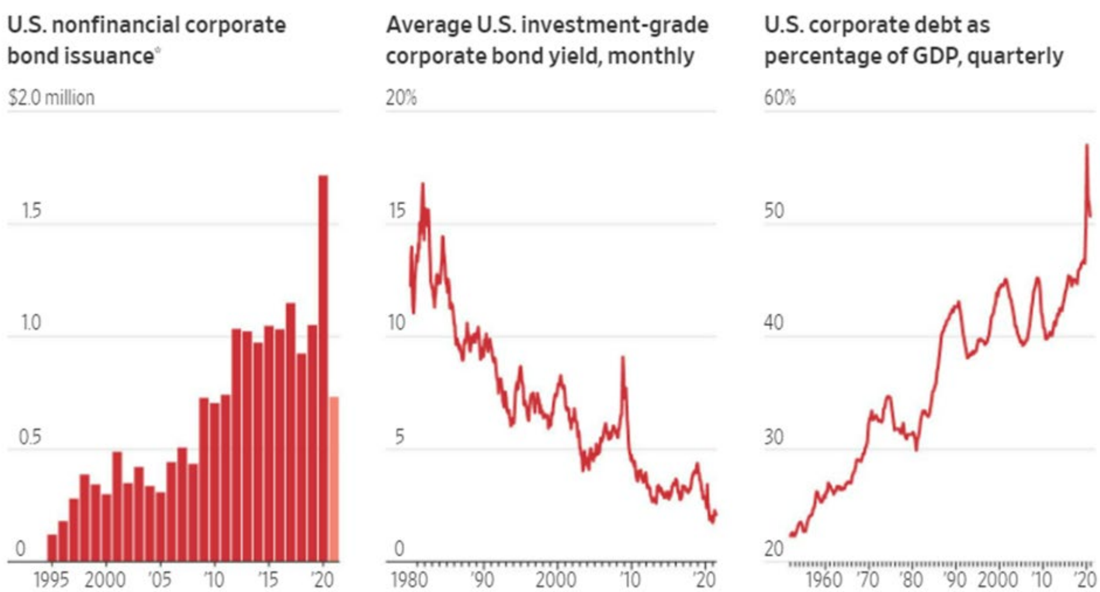
Bonds: Ballast or Burden?

The purpose of fixed income as an investment is to preserve principal and provide predictable income while minimizing portfolio risk. Investors earn interest income and are repaid the bond's principal at par if held to maturity. Risk is minimized at the security level, as bond prices are less volatile with low or negative correlation to equity prices, and at the portfolio level, when part of a diversified asset allocation. With these characteristics, fixed income works as a ballast in a portfolio against equities which carry higher risk and price volatility. Despite its benefits, fixed income can also be a portfolio burden. Historically low interest rates have made returns less attractive. Additionally, with rising inflation, a loss of purchasing power is also a concern. For example, the consumer price index, one measure to track inflation, increased 5.4% from a year earlier in June which is the fastest pace since 2008. The collective yield for the junk bond sector, as measured by the ICE Bank of America High-Yield index, was below the rate of inflation for the first time in history. Seen as an anomaly, this situation still raises the question of the role of bonds in the current environment.

The challenges in finding attractive yield within the bond market are partially related to rise in corporate debt issuance since the 2008-2009 financial crisis. The Federal Reserve cut its benchmark rate to near zero and began a period of quantitative easing ("QE") to support economic growth. Companies took advantage of the environment to issue new debt at lower rates and pay off higher interest rate debt. At the onset of the pandemic the Federal Reserve cut its benchmark rate to near zero again and started the current period of QE. The Fed is currently purchasing $120 billion in assets per month, including U.S. Treasuries, mortgage-backed securities, and corporate bonds, of which the latter was not included in previous periods of QE. Thus far, the Fed has expanded its balance sheet by more than $3.9 trillion since March 2020, which is more than the three prior periods of QE combined.[i] These moves by the Fed, coupled with the economic uncertainty around the pandemic, led to a record $1.7 trillion in U.S. nonfinancial corporate bond issuance for 2020. Since the financial crisis, the average corporate bond yield has continued its trend downwards, with an average yield of 2.04% as of June 30, while the average duration has increased from 6.4 to 8.7 years over the same period, per Bloomberg. Notably, the amount of U.S. corporate debt is now more than 50% of U.S. GDP. [ii]



RMC typically structures a fixed income allocation as a laddered investment grade bond portfolio. This structure and credit quality are utilized for specific reasons. The bond ladder will hold a range of maturities, with short-dated maturities that anticipate short-term cash needs, and longer dated maturities held for potentially higher yield and long-term income. This strategy also spreads out the duration of the bond allocation, which is the measure of a bond's price sensitivity to a move in interest rates. As interest rate changes are not predictable, a laddered bond strategy spreads interest rate risk across the yield curve, with the bonds purchased with the intent they will be held to maturity. In a rising rate environment, as is the expectation today with elevated inflation and economic growth, a laddered strategy allows the proceeds of maturing bonds to be reinvested at higher rates, driving interest income higher. As bond prices move inversely to interest rates, if rates do rise, the market value of bonds will decrease. With the average duration of investment grade corporates around 8.7 years, a 1.0% increase in rates will lower values by almost 9.0%. By laddering with the intent to hold to maturity, however, an investor will receive par value of the bond regardless of price movement, while collecting interest income during the investment period.

Portfolio needs and objectives will determine the role fixed income plays in the portfolio. Investors with a long time horizon, higher risk tolerance, or limited reliance on distributions from the portfolio may choose to have little or no allocation to fixed income in favor of equities. While, historically, stocks generate higher return than bonds, there is greater risk and price volatility, and long-term investors have more time to make up for value loss during market downturns. In this case, bonds may be an unnecessary burden that would weigh on overall portfolio return. A bond allocation is appropriate when an investor has a shorter time horizon, is more risk averse, or has a greater dependency on portfolio distributions. In this case, the role of a bond allocation as a ballast for stability and protection of principal, as well as for predictable income, is key for portfolio construction. Investment grade bonds carry lower risk of default but therefore lower yields than more risky bond issues. Additionally, investment grade corporate bonds, and even more so, municipal bonds and U.S. Treasuries, provide a greater ballast to a diversified portfolio given lower correlation to equites. Non-investment grade high-yield, or "junk bonds", those likely to carry a higher risk of default but with higher yields, are more closely correlated with equities. As such, this tradeoff of credit quality for higher yield removes some of the ballast that is sought with a fixed income allocation. While past performance is no guarantee of future results, equities have outperformed the rate of inflation when held over long periods of time, and with the average dividend yield of the S&P 500 at 1.4%, certain stocks can provide more attractive yields with greater price potential. Diversifying a portfolio with the appropriate equity allocation allows bonds to provide a ballast while offsetting their potential burden.

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[i] Federal Reserve

[ii] Dealogic (issuance); Bloomberg Barclays (yield); Federal Reserve Bank of St. Louis (corporate debt)