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Portfolio Insights

Why Own Fixed Income In A Rising Interest Rate Environment?

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Data as of 5/20/2022 and subject to change.

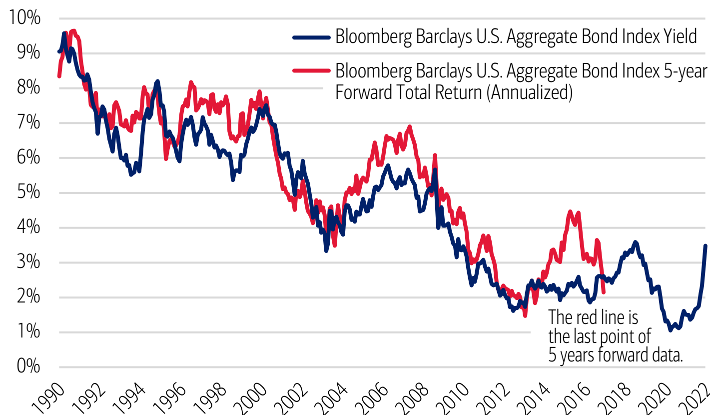
Investors generally use Fixed Income for three reasons: 1) to produce steady income, 2) to provide total return, and 3) to hedge against equity market declines. Since 1981 interest rates have been in a secular decline, and investors have enjoyed all three benefits. With many expecting a shift to rising interest rates, the usefulness of fixed income in portfolios has come into question. Such questions are legitimate, but high-quality Fixed Income remains an important defense for long-term investors who cannot simply own a portfolio composed entirely of riskier assets.

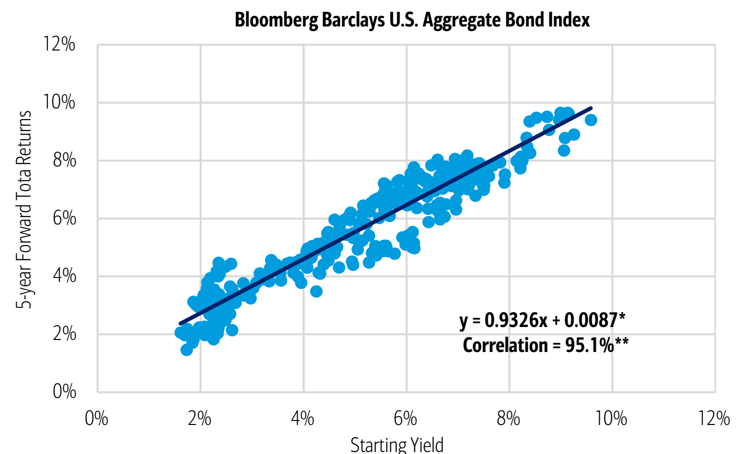
In market downturns, when prices of equities and other risky assets are under pressure, high-quality fixed income shines. When the issuers of bonds are the largest and best-known corporations in the world or the U.S. Treasury, the willingness and ability to pay coupons is as firm during recessions as it is during a growing economy. In fact, high-quality Fixed Income tends to deliver very little credit losses. Investors who have held bonds to term—either to the maturity of the bonds or average maturity of the bond funds—have historically seen total returns very close to the starting yield the investor acquired the bonds (Exhibit 1). This stability is what investors should be looking for instead of higher income that comes from bonds issued by lower-quality firms.

CIO FIXED INCOME VIEWPOINT

"We believe Fixed Income is there to provide reliable yield, diversification over longer time periods through steady cash flow, and, importantly, help shield from a worse-than-expected economic environment. Maintaining an up-in-quality bias, using higher yields as opportunities to redeploy cash, being pragmatic about market value declines, and tilting away from rate risk with lower duration but not abandoning Fixed Income remains the prudent course."

Exhibit 1: A Close Relationship between Higher-Quality Fixed Income Starting Yields and Forward Returns.





*Y=The straight line equation reflects the line of best fit that visualizes the general pattern of a set of data over time.
**Correlation is a statistical measure that describes the degree to which an independent and dependent variable are linearly related, or move in coordination with one another.
Sources: Chief Investment Office; Bloomberg. Data as of April 29, 2022. Indexes are unmanaged and do not take into account fees or expenses. **It is not possible to invest directly in an index.** Performance during periods of exceptional market conditions should not be expected to be repeated in a normal market environment. **Past performance is no guarantee of future results. Please refer to Index Definitions at the end of this report.**

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Concerned about a rising rate environment, some pundits propose alternative allocations to replace higher-quality Fixed Income. Common suggestions are equity bond proxies, like global high-dividend stocks, high-yield bonds and leveraged loans. Although these other asset classes help supplement portfolio income and reduce exposure to interest rate risk, their downside hedge is in no way comparable to high-quality Fixed Income.

Exhibit 2 demonstrates the value of high-quality Fixed Income during periods of market stress. Each period marks the peak-to-trough returns of the S&P 500 during a recession. While the losses for stocks were significant, high-quality bonds provided positive returns during those periods, also enjoying an advantage over different types of lower-quality bonds. This example includes 1973-1974, when interest rates were in a secular rising environment, and 1980-1982 as rates approached their peak.

Exhibit 1: Value of High-Quality Fixed Income During Periods of Market Stress.

	U.S. Large-cap Stocks	Global High Dividend Stocks	U.S. Government Bonds	U.S. Aggregate Bonds	U.S. Short Duration High Yield	Leverage Loans
February—March 2020	-33.5%	-32.1%	2.1%	-1.0%	-19.1%	-1.4%
October 2007—March 2009	-54.9%	-62.7%	15.0%	7.2%	-19.0%	-24.5%
March 2000—September 2001	-35.6%	-10.3%	18.8%	17.9%	11.9%	7.3%
July—October 1990	-18.8%	-12.2%	1.8%	0.2%	-1.3%	N/A
November 1980—August 1982	-7.6%	-11.2%	23.4%	N/A	N/A	N/A
January 1973—October 1974	-42.6%	N/A	4.9%	N/A	N/A	N/A

US Large-cap Stocks: S&P 500 Total Return (TR) USD; Global High Dividend Stocks: MSCI World High Dividend Yield Net Return USD; US Government Bonds: IA SBBI US Intermediate Government TR USD; US Aggregate Bonds: Bloomberg US Aggregate Bond TR USD; US Short Duration High Yield: Bloomberg US High Yield 1-5 Year TR USD; Leverage Loans: Credit Suisse Leveraged Loan USD. Source: Morningstar Direct as of May 18, 2022. Indexes are unmanaged and do not take into account fees or expenses. **It is not possible to invest directly in an index.** Performance during periods of exceptional market conditions should not be expected to be repeated in a normal market environment. **Past performance is no guarantee of future results. Please refer to Index Definitions at the end of this report.**

A Fixed Income strategy composed of U.S. government bonds, U.S. mortgage-backed securities, and U.S. investment-grade credit bonds, which represents a large portion of the Chief Investment Office (CIO) Fixed Income allocation in total portfolios, can be represented by the Bloomberg U.S. Aggregate Bond Index. As we can see in Exhibit 2, such a strategy held up well during all listed rising-rate scenarios, with its returns slightly dragged down relative to U.S. government bonds due to the lower-quality of investment-grade corporate bonds.

The CIO believes that Fixed Income helps diversify equity market risk and has the potential to provide significant defense during market downturns. Diversification is one of the pillars of portfolio construction because of the fact that returns in capital markets are by nature difficult to predict. Downside movements can be fast and furious, making it difficult to time the reallocation of portfolios. It is for these exact moments that an allocation to high-quality Fixed Income is suggested in portfolios. Investors need to be aware of the tradeoff that captures the downside when replacing higher-quality bonds with lower-quality and more volatile assets.

To be clear, the diversification benefits of a portfolio that combines Equities and Fixed Income doesn't come from returns of the asset classes being inversely correlated but from moving independently. In order for something to be truly inversely correlated, the "zero-sum game" would imply that their correlation would be "-1"; however, we know that nothing—outside of some derivatives and options—would really provide "perfect" correlation, both inverse or otherwise. In fact, looking at our 2022 Expected Correlation Matrix U.S. Large-Cap Growth has a correlation to U.S. Governments, U.S. Mortgages, and U.S. Corporates of -0.09, -0.04, and 0.01 respectively. U.S. Large-cap Value has correlations of -0.07, -0.01, and 0.05 to the same three asset classes in respective order. What does that mean? It means that they do not behave opposite of one another, but in fact tend to move more independently if anything at all. This independence has long been confused with inverse correlation and it is not at all the same thing. Sound portfolio construction theory, however, favors independent movement, but over long periods of

time. This means that there may, and likely will, be periods where both stocks and bonds perform similarly and times when they don't.

A useful way to manage these allocations is through an active manager[1] that is constantly reviewing and tweaking positioning as the investment environment changes. During a period of rising interest rates, several techniques may be employed to help mitigate losses coming from the Fixed Income portion of the portfolios. These include underweighting Fixed Income in favor of Equities or Cash; within Equities, having a preference for Value over Growth; and within Fixed Income, underweighting duration and having a preference for credit-sensitive bonds over developed sovereign debt.

The most important role of Fixed Income in a portfolio is to help mitigate losses in market downturns, and investors should try to resist the temptation to remove Fixed Income particularly high-quality Fixed Income from portfolios. We believe this is the only asset class that, through time, in periods of both rising and declining interest rates, has been an effective hedge during market sell-offs.

[1] Active management seeks to outperform benchmarks through active investment decisions such as asset allocation and investment selection.

Asset Proxies and Index Definitions

Securities indexes assume reinvestment of all distributions and interest payments. Indexes are unmanaged and do not take into account fees or expenses. It is not possible to invest directly in an index. Indexes are all based in U.S. dollars.

U.S. Large-cap Stocks/S&P 500 Total Return Index is a stock market index that measures the stock performance of 500 large companies listed on stock exchanges in the United States. It is one of the most commonly followed equity indices.

Global High Dividend Stocks/MSCI High Dividend Yield Net Returns Index targets companies with high dividend income and quality characteristics and includes companies that have higher than average dividend yields that are both sustainable and persistent.

US Large Cap Growth/ Russell 1000 Growth Total Return measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.

US Large Cap Value/Russell 1000 Value Total Return measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values.

US Government Bonds/Ibbotson Associates Stocks, Bonds, Bills and Inflation U.S. Long-term Government Total Return Index is a custom index designed to measure the performance of long-term U.S. corporate bonds.

US Aggregate Bonds/Bloomberg U.S. Aggregate Bond Index is a broad base, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the United States.

US Short Duration High Yield/Bloomberg U.S. High Yield 1-5 Year Total Return Index is an unmanaged, U.S. dollar– denominated, nonconvertible, non-investment-grade debt index.

Leveraged Loans/Credit Suisse Leveraged Loan Index tracks the investable market of the U.S. dollar denominated leveraged loan market. It consists of issues rated "5B" or lower, meaning that the highest rated issues included in this index are Moody's/S&P ratings of Baa1/BB+ or Ba1/BBB+.

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