SUMMIT FINANCIAL

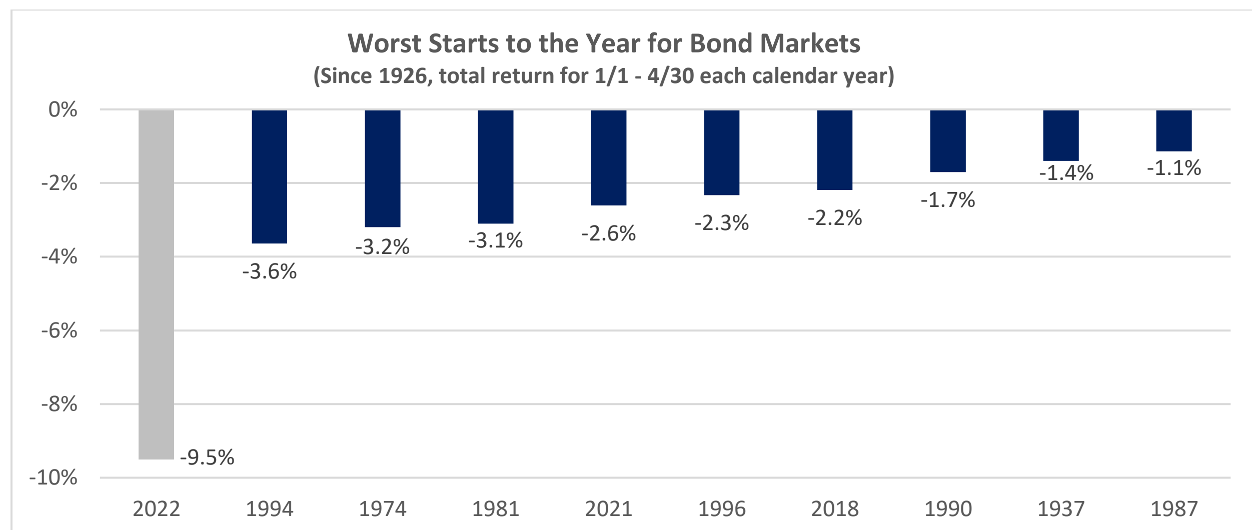
Why It's Not Time to Abandon Bonds

Quick take:

- Low starting yields have made the dramatic rise in rates particularly painful for nearly all duration sensitive fixed income assets in the short-term.
- Interest rates at the time of initial investment and those available when periodic coupon payments are received (i.e., the reinvestment rate) are important drivers of bond returns.
- Rising interest rates have a positive, not negative, impact on an investor's return over longer periods of time. Bond returns are often more impacted by starting yields than duration.
- The recent (and rapid) rise in rates prices in numerous rate hikes over the next year and beyond. It's possible that the actual number of rate hikes will be lower than expected.
- Despite being amid the worst bond market drawdown in decades, bonds still play an important role in diversified portfolios as both a stabilizer and return driver. Higher starting yields are expected to support future bond market returns and serve as a forward tailwind for investors.

It would be an understatement that bonds had a tough start in 2022. Through the end of April, this year has been the worst start for the Bloomberg U.S. Aggregate Bond Index ever. That's in addition to the current period being the worst drawdown for the broad U.S. bond market in over four decades. While it's easy to get discouraged with bonds given their recent results, there are a variety of reasons why it's not time to abandon an allocation to the asset class and why there may be a case for future enthusiasm.

Rapidly rising rates and low starting yields translated to the worst start of the year ever for bonds



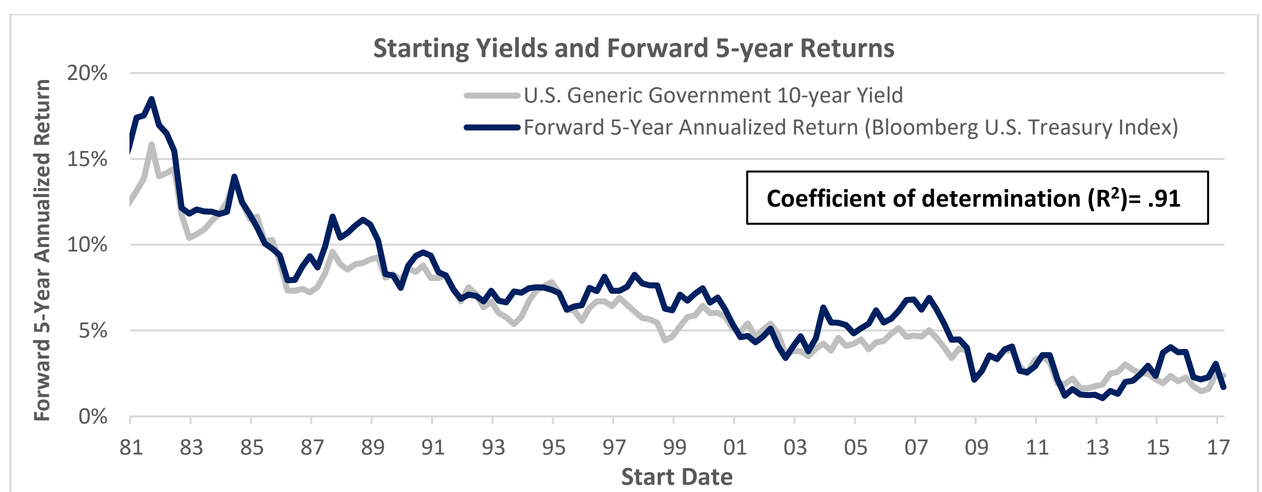
Source: Morningstar as of 4/30/22. U.S. bonds are represented by the IA SBBI U.S. Intermediate-Term Government Bond from 1/1/26 to 1/3/89 and the Bloomberg U.S. Aggregate Bond Index from 1/3/89 to 4/30/22.

After bottoming during the depths of the pandemic with the 10-year U.S. Treasury yield close to 0.50%, interest rates have shot up in response to an unparalleled level of government stimulus that has translated to high inflation. In the short-term, higher interest rates have contributed to negative fixed income returns reflecting losses from duration paired with a low level of income to offset those losses. This has caused many investors to ask a series of questions - How can this happen to my "safe" money? What is in store for interest rates now? Is the bond bull market over? What kind of returns can I expect from my fixed income portfolio? Should I own bonds at all, and, if so, how should they be managed?

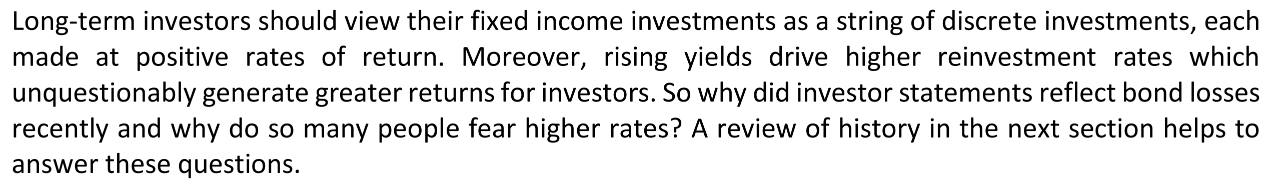
The following discussion aims to build a framework to help investors answer these questions. As you read, bear in mind that the fixed income space has many segments, each with its own unique set of characteristics, challenges, and opportunities. Likewise, each investor's financial situation, investment goals, time horizon, and risk tolerance are different. As a result, there is no one-size-fits-all solution to how much fixed income should be allocated to a portfolio or how it should be managed. The following discussion generally assumes an intermediate- to long-term investment horizon of at least five years and an investor with a moderate risk tolerance. To the extent your financial situation is different, please consult your financial advisor for appropriate adjustments.

First, a quick brief on bond mechanics. A bond's return is largely a function of two core factors: prevailing interest rates at the time of initial investment and interest rates available when periodic coupon payments are received (i.e., the reinvestment rate). In the most basic sense, an investor's return on a bond is the combination of the return streams generated by a series of investments (the original purchase and each subsequent reinvestment of received coupon payments). Provided prevailing interest rates are greater than zero, an investor is always locking in a series of positive returns if the principal is returned at maturity. Aside from untimely bond trading/liquidation, an investor is unlikely to lose money on an investment that simply strings together a series of positive interest rate payments. This fact alone illustrates a key difference between stocks and bonds and should start to ease investor concerns in today's volatile market. Furthermore, rising interest rates have a positive, not negative, impact on an investor's return for the life of a bond.

The starting yield is often the most important determinant of forward bond market returns



Source: Morningstar and Bloomberg as of 4/30/2022; The coefficient of determination (R^2) represents the proportion of the variance for a dependent variable that's explained by an independent variable. The higher the measure, the better the data fits the model.



Long-term investors should view their fixed income investments as a string of discrete investments, each made at positive rates of return. Moreover, rising yields drive higher reinvestment rates which unquestionably generate greater returns for investors. So why did investor statements reflect bond losses recently and why do so many people fear higher rates? A review of history in the next section helps to answer these questions.

Contrary to popular belief, the storied "30-year bond bull market" was only a material advantage to investors with medium-term time horizons, generally less than six or seven years. For most others, the impact of falling rates ranged from a neutral to a negative due to the reduction of future returns stemming from lower forward income rates. The reasons most people fail to realize these facts are quite simple. The principal gain (loss) from a drop (rise) in rates is immediate and easily quantifiable. Conversely, the detrimental (positive) impact of lower (higher) reinvestment rates works through a slower, less transparent, process that is harder to quantify and only observable over time.

Why the history lesson and what does this have to do with today’s rising rate environment? The previous three plus decades were defined by high starting yields but disappointing reinvestment rates. The future is likely to be the mirror image. Starting yields are low, but reinvestment rates will probably be higher. Under this scenario, long-term investor returns will be more than acquisition yields-to-maturity, greater than current yields, and far from widespread predictions of doom and gloom. Of course, long-term gains will only come following the short-term pain of principal pressure. We have seen the reality of this movement in recent weeks and months, but it is a necessary evil for expected returns to move higher.

The only way to achieve more attractive long-term returns on bonds is to run the gauntlet of rising rates. This process must take place for investors to be adequately compensated for both risks as well as their sacrifice of current spending for greater future wealth. How far off are we from adequate compensation? In other words, how much do interest rates need to rise to return to normalcy? Considering historical compensation rates is a good starting point.

There are reasons to believe the future will not be the complete reverse of the past 30 to 40 years. At the very least, even the most pessimistic forecasters are not suggesting a return to 15% plus interest rates experienced in the 1980s. Should rates back up to more benign levels, the investment time horizon for higher reinvestment rates to overcome initial principal hits will be shorter than what was witnessed when rates were in continuous decline. The current yield on the Bloomberg U.S. Aggregate Bond Index is approximately 3%. Under the scenario described, it is reasonable to assume fixed income returns will compound over the next six to seven years at about that rate. The early years will likely be lower due to price declines, and perhaps even negative at times. The later years will likely be higher due to higher levels of income and more stable prices. Following this necessary, and desirable, acclimation period, fixed income returns will hopefully stabilize at higher, more consistent levels.

Rates have also moved up considerably in a very short time and reflect the expectation for numerous further rate hikes throughout 2022 and possibly into 2023. While inflation data has surprised to the upside, it was driven by a combination of heightened demand fueled by excessive stimulus paired with supply side restrictions, the former of which is less likely to be alleviated by increasing interest rates. Longer-term demographic and productivity trends likely point to a slower pace of growth into the future suggesting that rates might not increase as much from here as expected. Stable, or even falling rates, into the future would further support bond market returns, assuming default rates remain low.

In closing, the fixed income market is currently the source of great investor concern, and rising rates are a prevalent discussion topic. Consideration of the negative impact on bond prices from a rise in rates, however, is only half of the story. Higher rates also enable investors to reinvest interest payments, and maturing bonds, at higher rates of return. For long-term investors, the initial pain of downward pricing will be overcome by higher reinvestment rates in the future. While the process to get there may be uncomfortable, the transition is necessary for expected fixed income returns to revert to more appropriate levels. Importantly, the historical fundamentals of the fixed income market suggest much of the likely adjustment has already taken place, and the expected cumulative return on fixed income will remain positive, albeit low, during the adjustment period remaining. This is a critical fact for those wishing to hold cash in place of bonds.

Bonds have an important place in diversified portfolios and possess risk/return characteristics unlike any other asset class. With few exceptions, unfortunately including the recent period, bond return streams are often less correlated with many other traditional asset classes, which makes them advantageous in portfolio designs. Although the recent decline in bond market values was painful, it should contribute to higher long-term returns for the asset class in the future. The sector's important role paired with a likelihood for higher forward returns make now an important time to maintain fixed income exposure in your portfolio at a level suitable for your long-term goals.

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