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Is it Still Worth Investing in Fixed Income?

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During the height of the coronavirus, fixed income markets did not serve as the portfolio ballast many investors hoped and expected. This, along with historically low interest rates, has caused more than a few people to ask whether fixed income should still be a part of their portfolio. In this brief I will discuss what changed in the marketplace in 2020 and whether it is still worth investing in fixed income. I will also touch on whether it may make sense to alter your long-term asset allocation.

The classic role of fixed income

Fixed income has historically provided the following key benefits for investors: diversification, capital preservation, income generation, capital return, and potentially favorable tax treatment depending on the type of investment.

Fixed income securities, particularly those with high credit quality, have historically been great for both preservation of capital and diversification – a hedge against volatility in the equity market. The primary reason for this is, like any loan, the borrower promises reliable interest payments and the return of your original investment at a set maturity date. This does not necessarily protect again losses, but makes fixed income investing a lower risk endeavor and one that can be quite appealing depending on the level of interest and capital return you can earn.

What changed?

- Interest rates are at historically low levels, so the income generation and capital return expectations for bonds are lower than they have been in the past
- In the aggregate, bonds did not protect capital as well as expected during the recent downturn

We can see quite clearly in the chart below of high-quality corporate bonds that yields have fallen considerably over the last 30 years. In the 1990s yields ranged from 6-9% while today, the average yield is around 2-2.5%.

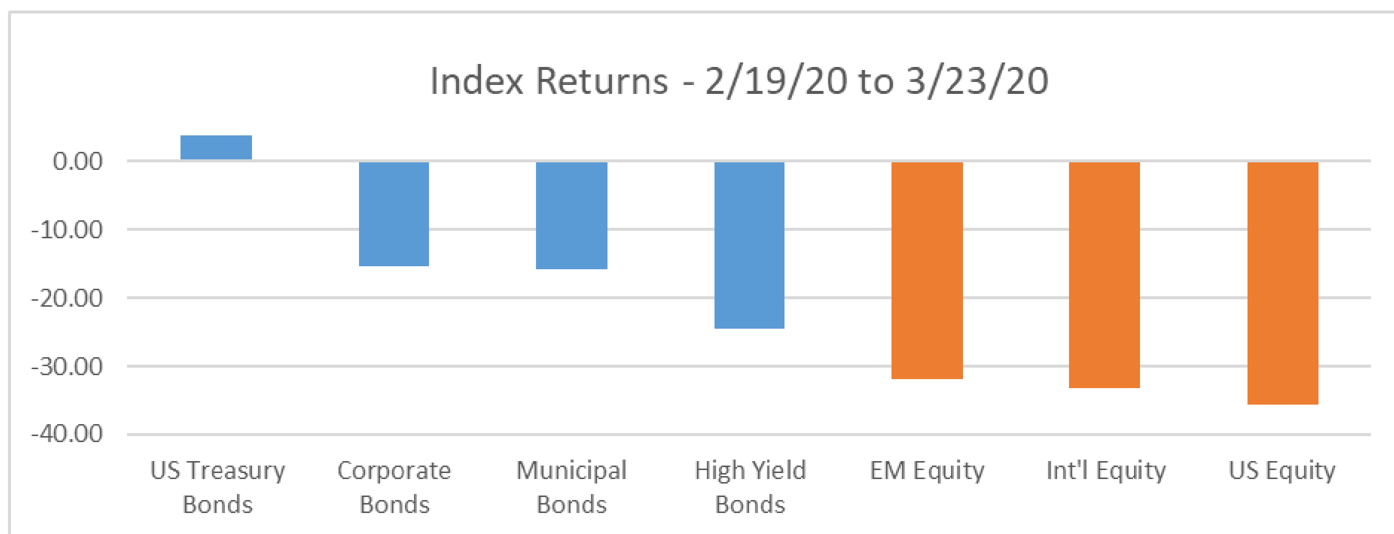
Source: U.S. Department of the Treasury - 10-year high quality corporate bond par yield

This is in part due to low government rates in the U.S. and other developed economies, low levels of inflation, excess global savings, and weak expectations for economic growth. The result is that people cannot get much in the way of safe income. $1,000,000 in a high-quality corporate bond portfolio in 2000 would have expected to kick off around $75,000 per year, in 2010 it would have been around $50,000, and today that number is $25,000 or less.

Regarding capital preservation (the "hedge"), bonds fell sharply during this market downturn along with all asset classes other than those supported by initial Federal Reserve efforts. Those negative returns were to a lesser degree than equity markets, sustaining some of the capital preservation and diversification benefits, but the outcome was an imperfect hedge. Bonds outperformed equity markets (from top to bottom in February/March the S&P 500 dropped -35% vs -17% for the high-quality corporate bond index), but those who believed that high-quality corporate and municipal bonds would zig when the equity market zagged at its lowest point were disappointed (see chart below).

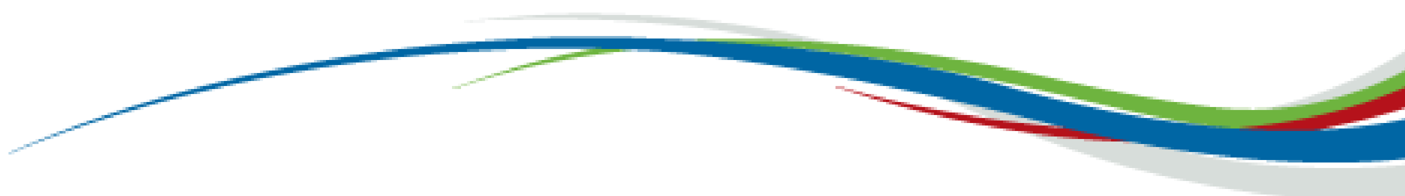
This happened in part because the market experienced an unprecedented shock as the coronavirus pandemic and economic 'sudden stop' of a global lockdown alarmed many investors. Liquidity, or the availability of buyers to match the number of sellers, dried up at an even faster rate than in 2008. At the time, there was little to no clarity on how severe the virus was or how widespread and long-lasting this pandemic and related shut down might last. Fortunately, the Fed intervened via aggressive bond purchasing, enabling most fixed income to recover in the succeeding months.

It should be noted that over time, the default rate has been low for high-quality bonds (0.74% and 0.02% for corporate and municipal bonds, respectively), and exceedingly low among the highest credit quality issuers (0.11% and 0.00% for AAA rated corporate and municipal bonds, respectively)[1]. We continue to believe this will hold true and consider bonds to have been an imperfect but effective diversifier in each of the last two recessionary selloffs. For those reasons we believe the capital preservation characteristics of high-quality bonds will remain robust through various market cycles.



Source: Morningstar.com; benchmark index price return data used as a proxy for index returns

[1] fdic.gov, avg 5-year period from 1970-2009



What now?

A major outcome of the lower interest rate environment is that high-quality bonds, at least at this time, cannot provide the same return expectation for portfolios as they have in decades prior. For this reason, fixed income has become more expensive to use as a hedge, so the decision and thought process for your portfolio allocation turns to center around the smoothness of the ride and return requirement of your investments. Key questions to consider are:

- If returns are going to be lower for fixed income, should I increase my weighting to equities or alternative asset classes?
- Am I comfortable with a smoother ride knowing I will likely have lower expected returns than I might have received in the past?

In the current market environment, should I change my portfolio allocation?

Ultimately those questions relate to the percentage of your assets invested in fixed income. Do you want or need to earn a higher rate of return, and, if not, are you comfortable earning a somewhat lower rate of return at this point for the security, diversification, and other benefits of fixed income? It is worth revisiting your financial plan and having a conversation to see if a change is warranted and, if so, what course of action may be best for you.

For those who want to strategically wait for rates to rise, the downside to that strategy is that an opportunity cost of missing compounding higher yields over time can be significant. If rates stay where they are, bonds give little income but do at least outperform cash given the positive slope in the yield curve and a federal funds rate that is expected to remain near zero for years. This difference can be quite significant over years of compounding, even at 1.5-2.0% vs 0.0-0.5% for cash.

Another option may be to develop a bond ladder, which invests in underlying bonds with the intention of reinvesting as they mature. This enables the investor to hedge against expected changes in rates over time as they are constantly rolling bonds as they mature into later dated issuances.

There are other alternatives to lower risk in your investment portfolio that can have certain levels of appeal at different times (e.g. commodities, preferred stocks, real estate, private equity, etc.). This is an area we do consider and will be writing more about in the coming months. Stay tuned!

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