Does A Fixed Income Allocation Still Make Sense?

March 2021

OVERVIEW

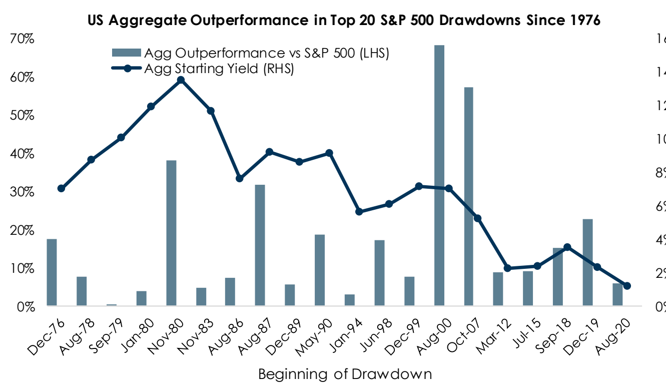
- **Investments in fixed income have historically generated solid risk-adjusted returns.**
- **Higher yielding sectors within fixed-income have performed well in rising interest rate environments.**
- **Following the recent surge in debt and money supply, are these historic relationships likely to hold going forward?**

Background

Amidst tight credit spreads, historically low total yields and uncertainty regarding the path of interest rates, investors have questioned the value of fixed income allocations within their portfolios. A fixed income allocation has traditionally provided three key benefits: (1) Diversification, (2) Capital Preservation, and (3) Income. While every economic environment has some unique characteristics, the historical performance of fixed income can still provide guidance for future outcomes.

Portfolio Stability

Since the inception of the Bloomberg Barclays Aggregate Bond Index in 1976, the index has generated positive returns 91% of the time over a rolling 12-month period. Importantly, core bonds have provided capital preservation and liquidity when equity markets are declining. This capital preservation component has persisted in providing protection of capital across a range of yield environments suggesting that low starting yields do not negate the diversification and capital preservation benefits of a core fixed income allocation.

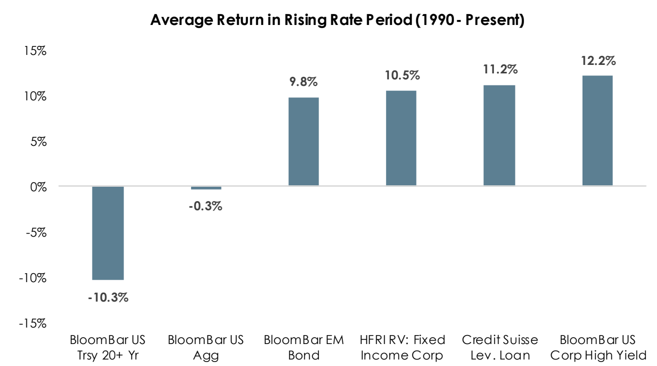


Source: Bloomberg, ACG Research

Historical results demonstrate that combining low to negatively correlated assets like equity and fixed income has resulted in better risk-adjusted returns. This correlation relationship has held throughout multiple market cycles and yield environments, but given low starting yields, it's worth re-examining the relationship to see if prior trends will persist. In the US, we saw evidence of this relationship holding in a low-yield environment as the Fed kept rates near zero in the period following the Global Financial Crisis, when the US Aggregate Index recorded a correlation of -0.04 to the S&P 500. This negative correlation continued when the Fed started raising rates in 2015, with a US Agg vs S&P 500 correlation of -0.16. Considering correlations in the context of negative interest rates (using Germany as an example), we see the correlations continuing to hold. German Sovereign bonds produced a correlation of 0.01 to the MSCI Germany equity index over the last five years.

Rising Rates and Return Generation

Rising interest rates also pose a potential hurdle for fixed income investors. Rising rates aren't uniformly negative for fixed income returns though. Higher returning, lower duration sectors like high yield, bank loans, emerging market bonds, and hedge funds can do well even as US interest rates rise. These sectors tend to have lower interest rate sensitivity, and in the case of some assets, such as bank loans, benefit from floating rate provisions that will directly adjust coupon payments as rates rise or fall. The tradeoff however, is increased credit risk, and a tendency toward higher correlation with equities. Historical results indicate that there are several solutions for investors seeking a middle ground between core fixed income and equity that can generate positive returns during rising rate periods.



Source: Bloomberg, Credit Suisse, Hedge Fund Research, Inc., Morningstar Direct, MSCI, ACG Research

Balancing Preservation and Return

While evidence suggests that core fixed income can continue to play a diversifying and defensive role in portfolios, inflation creates an additional challenge for investors seeking positive real returns. Inflation in the US has remained contained (around 2%) for the last 25 years and forward-looking estimates (inflation break-evens) suggest this may continue for some time. However, over the next few years, investors remain concerned that a combination of fiscal stimulus, a "zero-bound" Fed, a decline in the COVID-19 virus, and pent-up consumer demand, could result in a near-term overshoot of the Fed's 2% inflation target. While longer-term return expectations may eventually return to normal, investors will need to seek allocations outside of core fixed income to generate returns in excess of inflation in the near-term.

ACG's Position

Despite expectations of lower return and higher volatility, we believe fixed income can continue to provide portfolio protection while offering opportunities for return enhancement. It is important to remember that different parts of the fixed income market react in dissimilar ways to changes in available risk premiums, inflation expectations, and shifts in interest rates. Fixed income portfolios can be customized to reflect individual investor's return objectives and risk tolerances.

Disclosures and Legal Notice

The views expressed herein are those of Asset Consulting Group (ACG). They are subject to change at any time. These views do not necessarily reflect the opinions of any other firm.

This report was prepared by ACG for you at your request. Although the information presented herein has been obtained from and is based upon sources ACG believes to be reliable, no representation or warranty, express or implied, is made as to the accuracy or completeness of that information. Accordingly, ACG does not itself endorse or guarantee, and does not itself assume liability whatsoever for, the accuracy or reliability of any third party data or the financial information contained herein.

Certain information herein constitutes forward-looking statements, which can be identified by the use of terms such as "may", "will", "expect", "anticipate", "project", "estimate", or any variations thereof. As a result of various uncertainties and actual events, including those discussed herein, actual results or performance of a particular investment strategy may differ materially from those reflected or contemplated in such forward-looking statements. As a result, you should not rely on such forward-looking statements in making investment decisions. ACG has no duty to update or amend such forward-looking statements.

The information presented herein is for informational purposes only and is not intended as an offer to sell or the solicitation of an offer to purchase a security.

Please be aware that there are inherent limitations to all financial models, including Monte Carlo Simulations. Monte Carlo Simulations are a tool used to analyze a range of possible outcomes and assist in making educated asset allocation decisions. Monte Carlo Simulations cannot predict the future or eliminate investment risk. The output of the Monte Carlo Simulation is based on ACG's capital market assumptions that are derived from proprietary models based upon well-recognized financial principles and reasonable estimates about relevant future market conditions. Capital market assumptions based on other models or different estimates may yield different results. ACG expressly disclaims any responsibility for (i) the accuracy of the simulated probability distributions or the assumptions used in deriving the probability distributions, (ii) any errors or omissions in computing or disseminating the probability distributions and (iii) and any reliance on or uses to which the probability distributions are put.

The projections or other information generated by ACG regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results. Judgments and approximations are a necessary and integral part of constructing projected returns. Any estimate of what could have been an investment strategy's performance is likely to differ from what the strategy would actually have yielded had it been in existence during the relevant period. The source and use of data and the arithmetic operations used for calculating projected returns may be incorrect, inappropriate, flawed or otherwise deficient.

Past performance is not indicative of future results. Given the inherent volatility of the securities markets, you should not assume that your investments will experience returns comparable to those shown in the analysis contained in this report. For example, market and economic conditions may change in the future producing materially different results than those shown included in the analysis contained in this report. Any comparison to an index is for comparative purposes only. An investment cannot be made directly into an index. Indices are unmanaged and do not reflect the deduction of advisory fees.

This report is distributed with the understanding that it is not rendering accounting, legal or tax advice. Please consult your legal or tax advisor concerning such matters. No assurance can be given that the investment objectives described herein will be achieved and investment results may vary substantially on a quarterly, annual or other periodic basis. There is no representation or warranty as to the current accuracy of, nor liability for, decisions based on such information.