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The Case for Core Fixed Income

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Bill Lawrence, CFA
Head and Chief Investment Officer
Traditional Asset Management

Snapshot

- Rising interest rates are currently causing investors to think about abandoning their fixed-income allocations in favor of cash.
- After what has been an extended bull market, an investor choosing cash over fixed income would be losing portfolio diversification that we believe is critical at this late stage of the economic cycle.
- Core fixed-income funds provide investors with a diversified fixed-income allocation that may not demand much adjustment over market cycles.

Rising interest rates are currently causing investors to think about abandoning their fixed-income allocations in favor of cash. The logic is based on the idea that higher interest rates generally result in lower bond prices, generating headwinds for the fixed-income market.

While SEI understands the concern, we look at the asset class through an entirely different lens—and believe investors should too. In our opinion, core fixed income is not an investment that is typically purchased in pursuit of absolute return. Rather, we view investment-grade fixed income as a hedge against volatility in the equity market. We believe that hedge has paid a premium over cash the last several years.

Consider that the Bloomberg Barclays US Aggregate Bond Index has returned 2.03% annualized over the last five years (as of November 30, 2018),

a period that fully includes the Federal Reserve raising interest rates by 2% and the 2-year Treasury yield climbing by more than 2%. In other words, despite the gradual increase in interest rates over the last several years, bonds have done reasonably well and still delivered a premium over cash, which has returned 0.59% according to the ICE BofAML US 3-Month Treasury Bill Index during the same period.

The Case for Fixed

An investor who dumps fixed-income holdings now may have little in their portfolio to offset a decline if the equity market sees a flight to quality. A flight-to-quality occurs when individuals sell assets they view as riskier and purchase less-volatile investments, like U.S. Treasurys. We believe this is of particular importance at this point in time (after what has been an extended bull market), as an investor choosing cash over fixed income today would not only be losing portfolio diversification but would be doing so at this critical late stage of the economic cycle—a time when most experts agree that we are far closer to the end of the bull market than to the beginning.

We believe that trying to time the market's moves is challenging, if not impossible. Maintaining a diversified portfolio as part of a long-term investment plan helps investors withstand the market's gyrations.

Diversification is essential when constructing an investment portfolio. A variety of asset classes (including both equity and fixed income) helps ensure that you aren't putting all of your eggs in one basket, and if one class dips, exposure to a different asset class can potentially mitigate loss.

While creating a well-rounded portfolio is an essential part of a long-term investment plan, it doesn't necessarily require holding a large number of different mutual funds. Core funds, for example, can be used as the foundation of a diversified investment strategy.

What are "Core" Funds?

Core funds usually consist of multiple underlying securities that provide access to a broad section of a given financial market in a single portfolio. This construct provides a convenient way for investors to create a diversified portfolio without having to buy a large number of individual securities. Core funds support investing discipline by supplying a focal point when making allocation decisions and promoting a balanced process to help meet long-term financial goals.

In the fixed-income space, core funds seek to provide investors with a fixed-income allocation that may not demand much adjustment over market cycles. They typically invest in investment-grade fixed income securities of U.S. corporate and government issuers, including mortgage- and asset-backed securities. Investment-grade securities are those with an equivalent rating of BBB- or higher from a nationally recognized credit rating agency.

Although investors may allocate some of their overall portfolios to noncore investments in an effort to improve total returns, core funds help support a reliable investment strategy.

Index Definitions:

Bloomberg Barclays U.S. Aggregate Bond Index: The Bloomberg Barclays US Aggregate Bond Index is a benchmark index composed of U.S. securities in Treasury, Government-Related, Corporate and Securitized sectors. It includes securities that are of investment-grade quality or better, have at least one year to maturity and have an outstanding par value of at least $250 million.

ICE BofAML US 3-Month Treasury Bill Index: The ICE BofAML US 3-Month Treasury Bill Index is a benchmark index that tracks the performance of U.S. Treasury bills with a remaining maturity of less than three months.

Important Information

This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice and is intended for educational purposes only.

There are risks involved with investing, including loss of principal. Diversification may not protect against market risk. Bonds and bond funds will decrease in value as interest rates rise.

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Index returns are for illustrative purposes only and do not represent actual fund performance. Index performance returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

The performance data quoted represents past performance. Past performance does not guarantee future results.

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