INVESTMENT INSIGHTS

Analysis, Insights and a Different Perspective

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KEY POINTS

- Bonds play an important role in a well-diversified portfolio.
- Two of these roles include the potential for regular income and possible lessening volatility in an investor's portfolio.
- Bonds are, however, not without risk. We discuss two of the possible risks associated with owning bonds.
- A professionally managed bond strategy may mitigate these risks.

THE ROLE OF BONDS IN A PORTFOLIO

Bonds represent the largest asset class in the financial markets globally and are in portfolios of many investors. Income and diversification are two of the main benefits of bonds in a diversified portfolio. This issue of Investment Insights discusses these benefits along with possible risks associated with bonds.

INCOME

One of the main features of bonds is that they typically provide regular cash flows, and regular income is an important goal for many investors. Bonds are simply a loan to an issuer. In exchange for borrowing investor's money, issuers (typically governments or corporations) agree to pay back investors their investment (par value) and, in most cases, also provide regular interest payments

	1 Yr	3 Yr	5 Yr	10 Yr
U.S. Large Stocks	21.68	14.54	12.37	13.97
U.S. Small Stocks	9.21	7.28	8.23	11.88
U.S. Bonds	9.64	4.62	3.01	3.79
Intl Markets Stocks	9.94	7.62	4.96	5.21
Intl Emerging Mkts Stocks	3.81	7.88	4.48	3.78
U.S. Inflation (CPI)	2.14	1.92	1.93	1.73

Source: Morningstar. Annualized returns for periods ended January 31, 2020. U.S. large stocks is the S&P 500 Index, U.S. small stocks is the Russell 2000 Index, U.S. Bonds is the Barclays US Aggregate Bond Index, Intl Developed Markets is the MSCI All Country World Index Ex-US, International Emerging Markets is the MSCI Emerging Markets Index. Returns include dividends and interest. Past performance is not an indication of future results. All indices are unmanaged and may not be invested into directly. The Indices mentioned in this report are unmanaged, may not be invested into directly and do not reflect expenses or fees.

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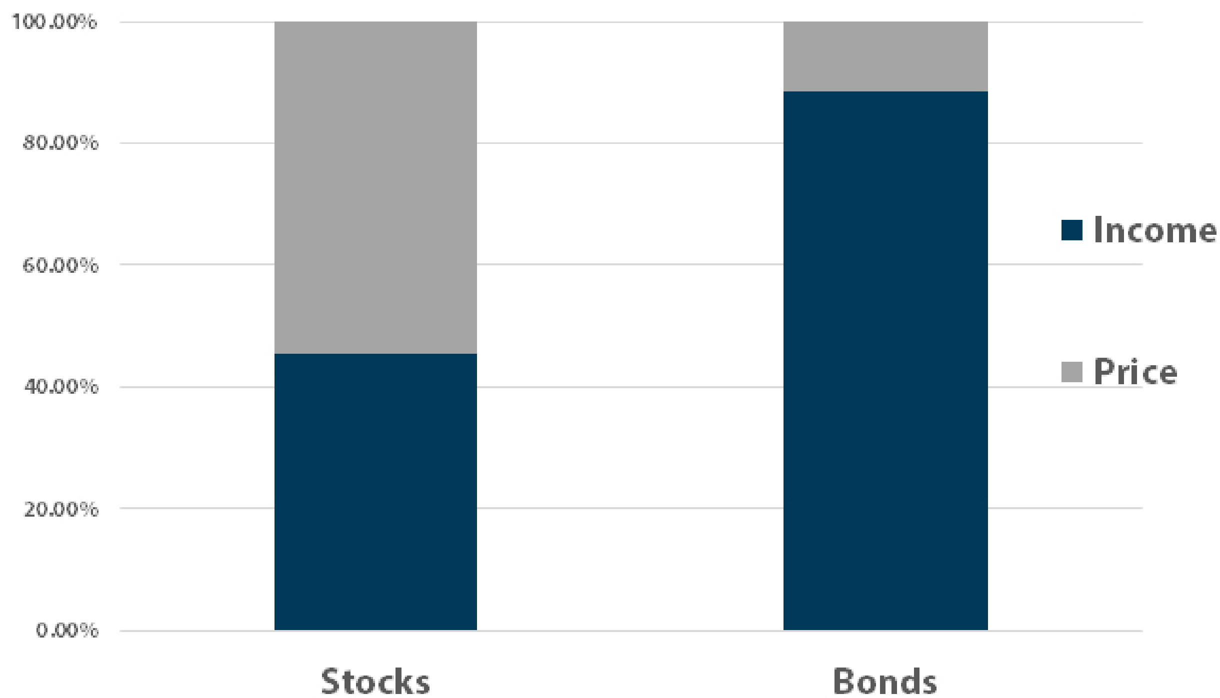
(coupon payments). The coupon payments typically make up a large portion of bond returns. **Exhibit 1** below shows the income and price return of U.S. stocks and bonds since the year 2000. As you can see, more than 88% of the bond returns were due to income, whereas less than half (about 46%) of the stock returns were due to income.

Unlike stocks, which are generally assumed to have an infinite life, most bonds have a finite life as they have a set maturity date. The finite life, in turn, makes valuing a bond relatively simple. It is the current value of the bond's future cash flows. Therefore, bonds can provide investors with some degree of predictability, as they know when they are expected to receive the par value (usually $1,000) as well as the timetable for when they may receive the interest payments.

EXHIBIT 1. INCOME AND PRICE COMPONENTS OF STOCKS AND BONDS RETURNS (2000 - 2019)



Source: Morningstar Direct. Stocks represent the Standard & Poor's 500 Index and Bond represent the Bloomberg Barclays US Aggregate Bond Index.

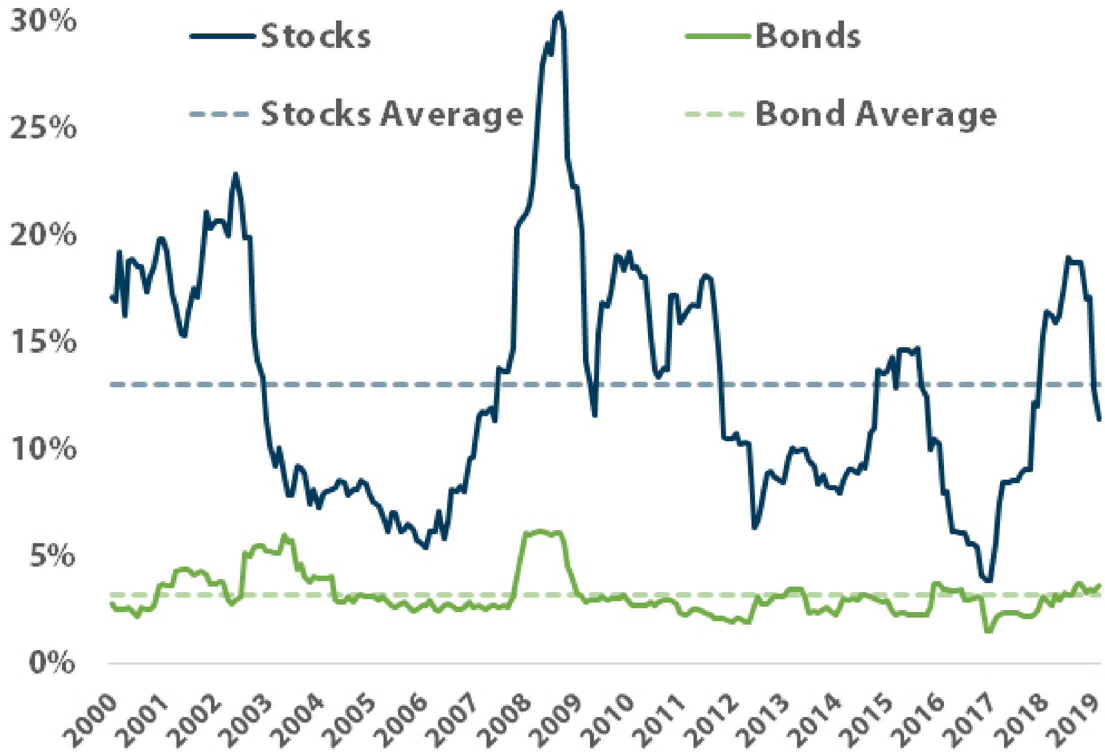
DIVERSIFICATION

Bonds are often said to act as a ballast for an investor's portfolio during times of volatility relative to other asset classes. There is a good reason for this analogy, as bonds offer the potential to dampen the volatility of a portfolio. The prices of bonds can fluctuate for a variety of reasons, including but not limited to changes in interest rates or changes in credit quality. That said, in general, the variation in bond prices tend to be smaller relative to the variation in stock prices. The smaller variation in prices, on average, make bonds less volatile than stocks.[1]

1 Disclosure: There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not protect against market risk.

The standard deviation[2] can be used as a measure of volatility. Overall, a higher standard deviation indicates higher volatility, whereas a lower standard deviation indicates lower volatility. **Exhibit 2** below shows that the average annualized standard deviation for U.S. stocks for the last 19 years was approximately 13.1%, while the average standard deviation for U.S. bonds was approximately 3.2%.[3] In other words, on average, U.S. stock returns have been four times more volatile than U.S. bond returns since the year 2000. That's why it is often said that the worst years in the bond market are usually better than the worst days in the stock market!

EXHIBIT 2. ROLLING 1-YEAR ANNUALIZED STANDARD DEVIATION OF STOCKS AND BONDS (2000 - 2019)



Source: Morningstar Direct. Stocks represent the Standard & Poor's 500 Index and Bond represent the Bloomberg Barclays US Aggregate Bond Index.

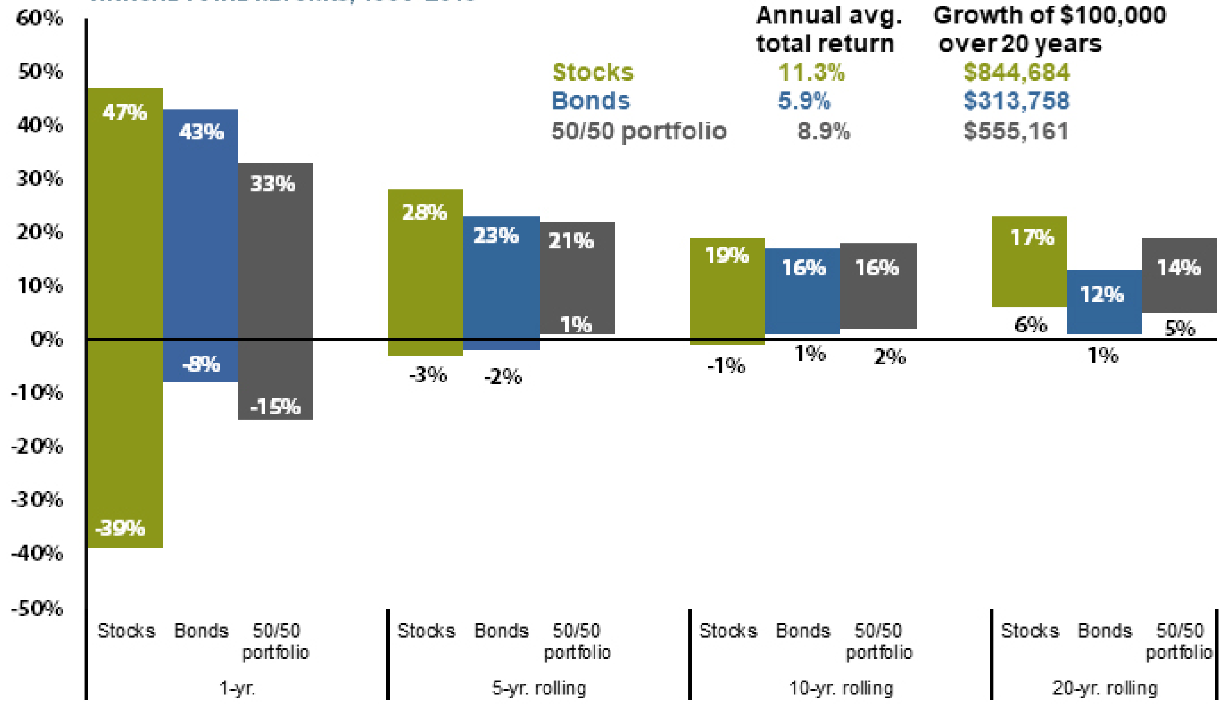
The relatively less volatile nature of bonds can provide diversification benefits when combined with other assets. An example of the diversification benefit of having bonds in a portfolio can be illustrated using a 50/50 stock and bond blend portfolio.

Exhibit 3 on the next page shows various ranges of stock, bond and blended total returns. As the chart shows, a 50/50 blend portfolio composed of stocks and bonds has not suffered a negative return over any five, ten, or twenty-year rolling period in the past 69 years. In contrast, a portfolio comprised of 100% stocks and a portfolio comprised of 100% bonds has experienced negative returns over a five-year rolling period during the same 69-year time period. Furthermore, the range of returns for a 50/50 portfolio has been smaller than a portfolio comprised of 100% stocks, or a portfolio comprised of 100% bonds for any one, five, ten, or twenty-year rolling period in the past 69 years.

2 Standard deviation is a historical measure of the variability of returns relative to the average annual return. If a portfolio has a higher standard deviation, its returns are said to be volatile whereas a low standard deviation indicates historical returns have been less volatile.

3 Source: Morningstar Direct

EXHIBIT 3. RANGE OF STOCK, BOND AND BLENDED TOTAL RETURNS
ANNUAL TOTAL RETURNS, 1950-2019



Source: Barclays, Bloomberg, FactSet, Federal Reserve, Robert Shiller, Strategas/Ibbotson, J.P. Morgan Asset Management. Returns shown are based on calendar year returns from 1950 to 2019. Stocks represent the S&P 500 Shiller Composite and Bonds represent Strategas/Ibbotson for periods from 1950 to 2010 and Bloomberg Barclays Aggregate thereafter. Growth of $100,000 is based on annual average total returns from 1950 to 2019.
Guide to the Markets – U.S. Data are as of December 31, 2019.

POTENTIAL RISKS

So far, we have illustrated two possible benefits of owning bonds. These benefits include the potential for earning regular income and the potential to dampen volatility. With these benefits in mind, it is also important for investors to beware of potential risks involved with owning bonds. Two of the potential risks of owning bonds include credit risk and interest rate risk.

Credit risk is the risk of bond issuer going into default before the bond reaches maturity and being unable to pay some or all of par value or coupon payments. Credit rating agencies, such as Moody's, Standard & Poor's, and Fitch, analyze the financial stability of the issuer and its ability to pay par value and coupon payments. Based on their analysis, the credit rating agencies assign a bond rating. Overall, bonds with higher credit ratings indicate a lower likelihood of issuers not meeting their payment obligations. Conversely, bonds with lower credit ratings indicate a higher likelihood of issuers not meeting their payment obligations. Investors should keep in mind that credit ratings are not a recommendation but merely an opinion of credit rating agencies about an issuer's ability to pay par value at maturity and coupon payments.

Bond investors should also be aware of potential interest rate risk as bond values are inversely related to interest rates. The inverse relationship between bond prices and interest rates can be confusing. To clarify, let us examine this relationship from the perspective of the bondholder. Imagine you own a bond, and interest rates decrease. New bonds issued in the market will have lower yields as compared to the older bonds you own. Therefore, the older bonds you own are worth more. Conversely, when interest rates increase, the new bonds in the market will have higher yields, making the older bonds less valuable, resulting in lower bond prices. If a bondholder sells their bond before maturity, it may be worth more or less than its original value.

PROFESSIONAL MANAGEMENT

In the previous section, we discussed two of the possible risks associated with investing in bonds. While the risks mentioned above cannot be completely avoided, we believe that professional management can mitigate these risks.

Starting with credit risk, the credit ratings provided by credit agencies are subject to review and can be changed at any time. A professional manager monitors these ratings and may also conduct in-house credit analysis to manage credit risk. Next, regarding interest rate risk, the Federal Reserve controls short-term rates, whereas bond prices reflect long-term rates. These rates do not always move in the same direction at the same time. A professional bond manager can continuously monitor the prevailing interest rates and help determine the optimal mix of bonds for the portfolio, given the current interest rate environment.

CONCLUSION

Geopolitical, fiscal and monetary uncertainties are on minds of many investors today. We believe that while the future cannot be predicted, investors can plan for it by diversifying their portfolios. Due to their potential for regular income and possible volatility dampening benefits, bonds play an important role in a well-diversified portfolio. These benefits are, however, not without potential risk, which includes credit and interest rate risks.

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