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Investment-Grade Fixed Income: An All-Weather Investment

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Snapshot

- With interest rates near record lows, some investors may be tempted to forgo their bond allocations and hold cash instead.
- While we understand the concern, we look at the fixed-income asset class through an entirely different lens—and believe investors should too.
- In our opinion, investment-grade fixed income is a core holding that serves as a hedge against volatility in the equity market regardless of interest-rate conditions.

Investors who watched as high-flying tech stocks took a hit in September may have been tempted to pull money out of the equity market. In prior years, the traditional choice for reallocating those assets would be to move them out of stocks and invest in bonds. Yet, with the yield on high-quality government bonds hovering much closer to 0.5% than 1.0%, those looking to diversify with fixed income face a tough decision: hold cash and wait for rates to rise or add to a fixed-income allocation with interest rates near all-time lows.

While SEI understands the concern, we look at the fixed-income asset class through an entirely different lens—and believe investors should too. In our opinion, investment-grade fixed income is not typically purchased in pursuit of absolute return. Rather, we view it as a hedge against volatility in the equity market; it is a hedge that has also paid a premium over cash the last several years. Think of it as insurance policy against declines in the equity market that may actually pay you (albeit not much) to avoid equity market volatility.

Consider that the Bloomberg Barclays US Aggregate Bond Index has returned 4.32% annualized over the last five years (as of September 30, 2020), while the ICE BofAML US 3-Month Treasury Bill Index, a proxy for an investor holding cash, has returned 1.15% during the same period.

Investment-Grade Fixed-Income: A Core Holding

In portfolio construction terms, “core” holdings 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 holdings 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 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 and are viewed as high-quality holdings with a low risk of default. Core fixed income offers diversification benefits when added to a portfolio of stocks. U.S. Treasurys, for example, tend to be more defensive and have historically been negatively correlated with stock market performance.

The Case for Core Fixed

An investor who avoids fixed-income holdings may have little in their portfolio to offset a decline if the equity market sees an extended flight to quality. A flight-to-quality occurs when individuals sell assets they view as riskier and purchase less-volatile investments, like government bonds. We believe this is of particular importance at this point in time as the market has been driven higher by a narrow group of stocks; an investor choosing cash over fixed income today would not only be losing portfolio diversification, but would be doing so at a time when most experts agree that there is plenty of uncertainty remaining as to the full economic impact of the COVID-19 pandemic and plenty of concern regarding equity prices in the U.S. technology sector.

If the economy remains in recession for longer than expected, or there is a long-term correction in equities, we believe that intermediate- and long-term Treasurys will see greater price increases than shorter-term investments like Treasury bills. If the economy returns to normal levels, we think that intermediate-term Treasurys should hold their value, given the likelihood the U.S. Federal Reserve will maintain low interest rates over the next several years.

The following exhibit shows the Federal Reserve dot plot. Each dot on the chart represents a Federal Open Market Committee participant's assessment of appropriate monetary policy over the next several years, with the light blue dots denoting the median expectation. Current projections suggest that the Fed will hold interest rates near zero through 2023.

FOMC members expect low rates for next few years

Source: U.S. Federal Reserve. Data as of 9/16/2020.

Even if the economic outlook improved considerably, we suspect the Fed would hold rates steady, especially after the central bank recently declared a change in the way it will manage inflation. In place of preemptively addressing inflation expectations, the change implies that the Fed will keep a zero-interest-rate policy for the foreseeable future until there is a confirmed rise in inflation. Keep in mind that rates remained in the same 0-0.25% target range for seven years after the global financial crisis. As long as the Fed keeps interest rates near zero, bond yields shouldn't rise much from where they are now.

Active Management Can Help

The halt to economic activity as the COVID-19 pandemic spread in 2020 drove significant bouts of illiquidity in financial markets, as well as mass unemployment for consumers and challenging fundamentals for businesses.

While the Federal Reserve reacted by moving interest rates to 0 and creating numerous lending facilities designed to restore proper market functioning and support market liquidity, plenty of challenges remained as of the end of September including widespread credit-rating downgrades, rising bankruptcies and a spike in mortgage forbearances. But we do not see these ongoing issues as cause for concern; at SEI, we see them as opportunities for active fixed-income investors.

We believe investment-grade corporate bonds present an opportunity to capitalize on their excess liquidity premium-mostly through new-issue debt, as new bonds coming to market have been more attractively priced than those available in the secondary market. We think this can represent a source of excess return generation through our active management.

Market Timing is Tough

Trying to time the market's moves is challenging, if not impossible. Once an investor has exited an asset class, they have to decide another asset class to enter; additional timing decisions must be made if the same market is later reentered. Mistiming any of these entries and exits can be costly.

Instead, 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. Although investors may allocate some of their overall portfolios to noncore investments in an effort to improve total returns, core funds can be used as the foundation of a diversified and reliable investment strategy.

Index Definitions

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.

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

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