INVESTMENT INSIGHTS

Analysis, Insights, and a Different Perspective

December 2023

KEY POINTS

- With bond rates near their highest point in decades, investors today have some options for their savings.
- The total return of bonds is derived from yield and price change.
- Bonds act as a stabilizing force in an investment portfolio, offering diversification and potentially reducing overall volatility.

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WHY BONDS CONTINUE TO BE IMPORTANT

Bond rates are near their highest point in decades, rewarding savers who are putting away their money. However, an interesting dynamic in the fixed-income market has created relatively similar rates for both short- and intermediate-term bonds.[1] As a result, investors today have some options to get competitive investment returns. This issue of Investment Insights takes a closer look at why bonds continue to make sense as part of a diversified portfolio.

RETURN COMPONENTS

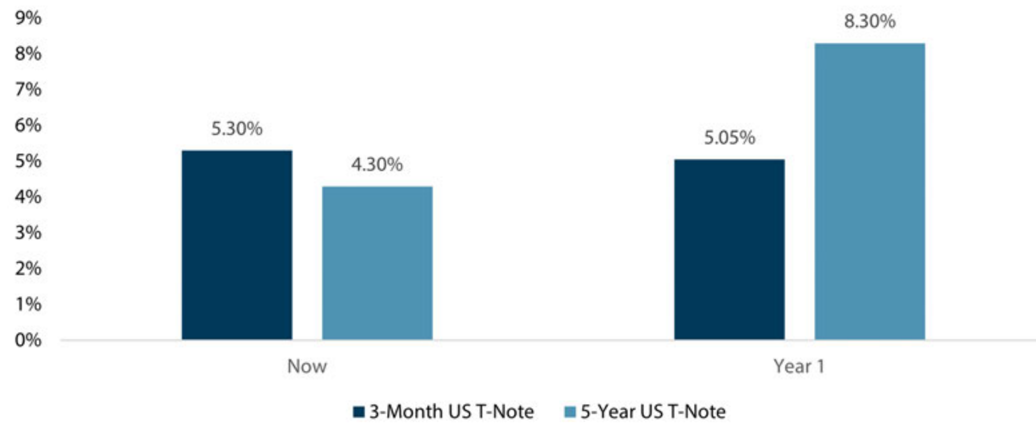
The total return for bonds has two components: yield and price change. In a hypothetical example where interest rates do not change, the bond return investors can expect is its yield. Changing interest rates, however, impact the price of bonds. Bonds already owned become more valuable when rates decrease because newly issued bonds will pay less than existing bonds. Similarly, when rates increase, already-owned bonds become less valuable than newly issued ones, which will pay more than existing ones. The bond's sensitivity to interest rate changes is measured by a metric known as duration.[2] Bonds with longer maturities typically have a higher duration or sensitivity to interest rates.

Various factors determine market rates and are difficult to predict with accuracy. With inflation cooling, many economists expect rates to hold steady or decline over the next year. Short-term bonds typically do not appreciate in price as much as intermediate-term bonds when rates decline. The hypothetical example on pg. 2 shows the impact of rates declining by 1% on 3-month and 5-year bonds. As you can see, the price change for bonds with a longer time to maturity is larger.

1 This phenomenon is known more technically as a flat yield curve.

2 Duration measures the percentage change in a bond's price in response to a 1-percentage-point shift in interest rates.

HYPOTHETICAL EXAMPLE OF CUMULATIVE BOND RETURNS FOLLOWING 1-PERCENTAGE-POINT DECREASE IN INTEREST RATES



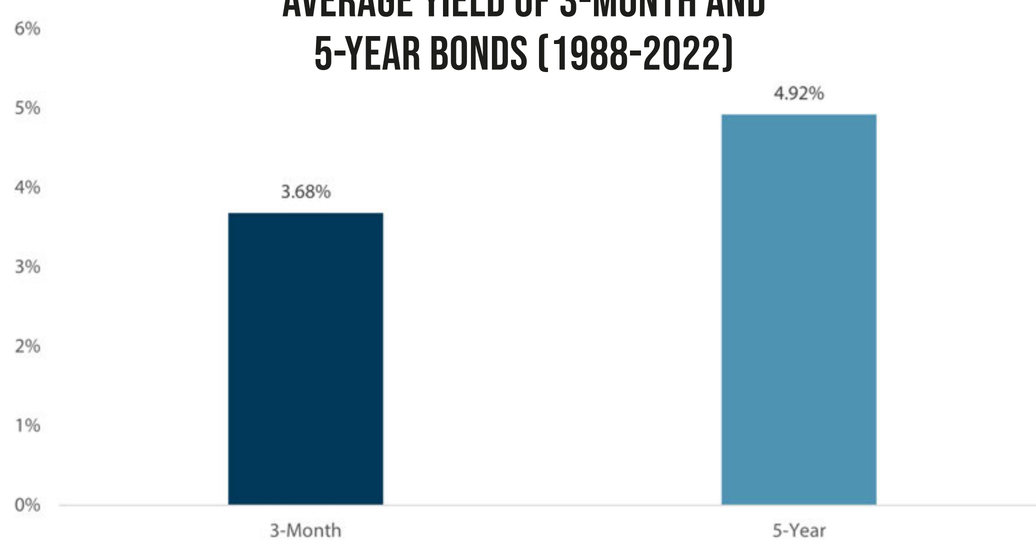
This hypothetical example does not represent the return on any particular investment. Assuming a one-time instantaneous parallel shift in the yield curve with no further changes in interest rates. It assumes a duration of 0.25 and 5 for 3-month and 5-year, respectively.

Given the difficulty associated with predicting interest rates, expected interest rate changes should not be the sole determinant of bond allocation for investors. Instead, in addition to price return, bonds' yield and diversification benefits should be considered when making portfolio allocations.

TERM PREMIUM

The price sensitivity of different bonds is one source of returns for a bond. Another source is the yield. Think of yield as the income a bondholder receives. This yield compensates investors for the risk they undertake by committing their capital. Investors typically demand a high yield for committing their capital for longer periods, known as a term premium. Historically, this has been the case, as the difference in yield between 3-month and 5-year bonds, on average, was 1.24% between 1982 and 2022. The term premium varies by market conditions, but longer-term investors are typically rewarded with higher expected returns for holding bonds with longer maturities.

AVERAGE YIELD OF 3-MONTH AND 5-YEAR BONDS (1988-2022)



Source: Board of Governors of the Federal Reserve System (U.S.), Market Yield on U.S. Treasury Securities at 3-Month Constant Maturity, Quoted on an Investment Basis, retrieved from FRED, Federal Reserve Bank of St. Louis; and, Board of Governors of the Federal Reserve System (U.S.), Market Yield on U.S. Treasury Securities at 5-Year Constant Maturity, Quoted on an Investment Basis, retrieved from FRED, Federal Reserve Bank of St. Louis.

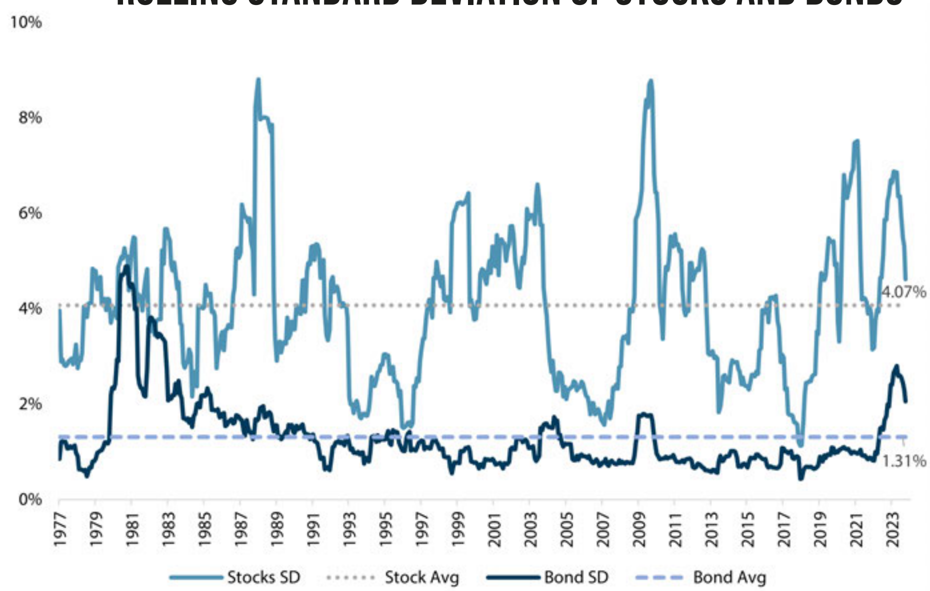
If longer-term bonds are expected to pay more than short-term bonds, why don't all investors buy at the longest maturity possible? It comes down to finding the right fit between a bond's duration and an investor's time horizon. Assume an investor with an investing horizon of 5 years owns bonds that mature in 30 years. Imagine interest rates increase when the investor needs their capital for retirement. Their bonds could experience a sharp price decline, and the investor may not have enough time to enjoy the new higher interest rates to compensate for the price decline. This is why we believe that while intermediate-term bonds are expected to provide higher returns than short-term bonds, long-term bonds may be too risky for some investors.

DIVERSIFICATION

Bonds are often said to act as a stabilizer for an investor's portfolio during volatility in 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 changes in interest rates or in credit quality, but the bond price variation generally tends to be smaller than the stock price variation. On average, the smaller variation in prices makes bonds less volatile than stocks.

The standard deviation can be used as a measure of volatility. A higher standard deviation indicates higher volatility, whereas a lower standard deviation indicates lower volatility. The graph below shows the average monthly rolling standard deviation for U.S. stocks since 1977, which is approximately 4%, whereas the standard deviation for U.S. bonds is approximately 1.3%. In other words, on average, U.S. stocks have been about 3.5 times more volatile than U.S. bonds over the last 46 years.

ROLLING STANDARD DEVIATION OF STOCKS AND BONDS



Source: Dimensional. Standard deviation is a measure of volatility. It may not be indicative of future risk and is not a predictor of returns. Stocks are represented by the Standard & Poor's 500 Index, and the Bloomberg U.S. Aggregate Bond Index represents Bonds.

CONCLUSION

Bonds continue to play an important role in investment portfolios. While the high rates on other securities like CDs have made them attractive, investors must remember that these rates are short term and change quickly with market dynamics. Intermediate-term bonds can appreciate if rates decline and have historically offered a higher yield when looking at long periods. Bonds also play the role of diversification. Although subject to market fluctuations, their price variations generally show less volatility than stocks. This makes them essential for stabilizing a portfolio, especially during market turbulence.

These combined factors demonstrate why bonds remain vital to a diversified investment strategy, offering a balance of returns, risk management, and stability. Like any investment strategy, bonds carry some risks. Investors must align their bond choices with their investment horizons to avoid potential mismatches that can lead to financial setbacks. Your financial advisor can help tailor your investment strategy to match your financial goals.

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Stock investing involves risk including loss of principal. The payments of dividends is not guaranteed. Companies may reduce or eliminate the payment of dividends at any given time. Standard & Poor's 500 Index is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Bloomberg U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market.

Bonds are subject to credit, market, and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.

Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value.

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