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Even with Low Interest Rates, Your Portfolio Still Needs Bonds

High-quality bonds have an important place in a well-diversified portfolio even now, when interest rates and expectations for bond performance are low. Owning fixed income helps to stabilize portfolios when markets are volatile, provide liquidity when you need it, and buy time as riskier assets go through their up-and-down cycles.

U.S. interest rates are at historic lows, with the fed funds rate stuck in a range between zero and 0.25 percent. Further, Federal Reserve Chairman Jerome Powell has made it clear that rates will stay where they are for the foreseeable future. As he put it in January, "When the time comes to raise interest rates, we will certainly do that. And that time, by the way, is no time soon."[1]

This isn't exactly good news for investors with meaningful chunks of their portfolios in fixed income. Low rates mean low bond yields. The benchmark 10-year U.S. Treasury yields around 1.30 percent, just above the all-time low it reached last year. Low bond yields, in turn, hurt bondholders in two important ways. First, since bond prices move in the opposite direction of yields, price appreciation is limited when yields are so close to zero. Second, low yields mean that bonds generate correspondingly low income streams.

So how should investors address the problem? We believe that high-quality fixed income plays several essential roles in long-term portfolios regardless of where interest rates are, so we recommend that investors hold steady and avoid any rash moves. That said, it may be appropriate in some situations to consider replacing a modest portion of fixed income assets with other types of investments that offer potentially higher returns while targeting a similar overall risk profile (as measured by volatility). As always, investors should consult their financial and tax advisors for guidance.

Our outlook for interest rates should help put this view in clearer perspective.

Little Reason for Rates to Move Lower—or Higher

We expect U.S. interest rates—and thus bond yields and prices—to remain range bound near current levels for an extended period. Here's why:

- **The Fed is staying on the sidelines.** The Fed has declared for months that it doesn't intend to change the federal funds rate for a long time. It probably won't raise rates because near-term inflation concerns remain low (which might change if Congress's economic stimulus bill is especially large), and a recent adjustment in the Fed's approach to inflation, moreover, gives it much more flexibility than before in deciding whether to boost rates if it sees inflationary forces building up in the economy. Translation: The Fed will act more slowly (if at all) to fight inflation than it historically has done.

  As for cutting rates, the Fed has little room to do so with the fed funds rate near zero. It would have to deploy other types of measures to achieve a comparable result.

- **Demand for Treasurys remains high.** A number of factors are keeping Treasury debt in demand (and, as a result, yields low). For starters, Treasurys remain the asset class of choice for investors seeking relative safety as financial markets experience volatility. Not only is the U.S. considered the strongest credit among governments worldwide, but also the market for Treasurys is immense—about $20 trillion—and thus provides ample liquidity for buyers and sellers alike.

  There is major ongoing demand from corporate pension plans that need to have cash on hand to make payments to retirees, as well as insurance companies that must be prepared to pay out for claims they anticipate over the long term. Treasury bonds are ideal in this context, as they're available both in huge quantities and in long-dated maturities that match up well with pensions' and insurers' projected future outflows.

- **Treasury yields are attractive compared to other nations' bonds.** Investors in developed-market government bonds have few places to go if they want a positive yield and reduced credit risk. The U.S. is one of a handful of such places at the moment: The 1.30 percent yield on the 10-year Treasury is significantly higher than those on the 10-year bonds of high-quality credits such as the UK (0.57 percent), Japan (0.09 percent), and Germany (-0.37 percent).

  The negative yield on German bonds is not a typo, by the way. Yields are negative if buyers pay higher prices than they expect to receive when the bonds mature, and the interest paid by the bond isn't enough to offset the loss in price. This happened to German bonds last year when investors flocked to them for safety while markets crumbled in the early weeks of the COVID-19 pandemic. Those investors wanted to own a high-quality asset that would hold its value and thus were willing to pay whatever the purchase price was at the time.

  While we believe that demand for Treasurys will remain strong, we don't expect Treasury yields to decline into negative territory.

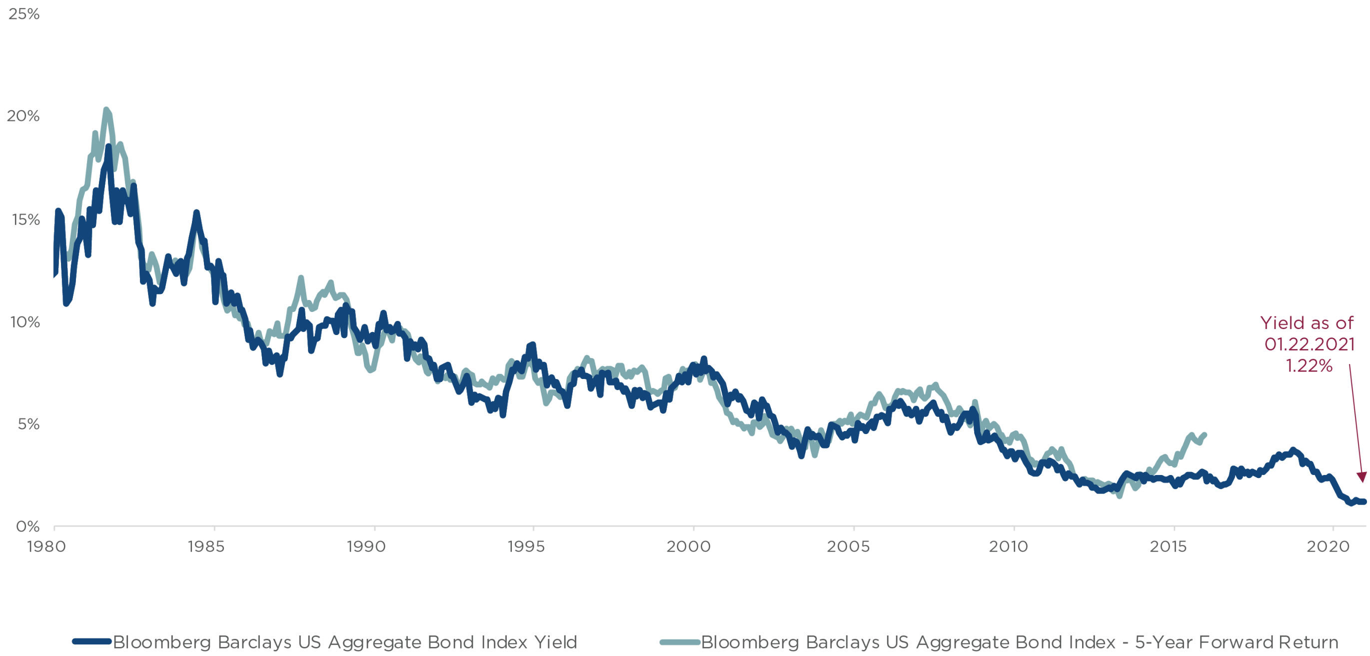
- **Improving economic growth shouldn't push rates higher.** Our view on the U.S. economy is that growth will be significantly above historical averages over the next 18 to 36 months, especially in the second half of 2021. Normally, this doesn't bode well for fixed income since investors expect turbocharged growth to bring higher interest rates, which would push bond yields up and prices down.

But the current environment is hardly normal. Because of the pandemic, individuals have saved more and spent less, and corporations have raised boatloads of cash by issuing more shares and debt. In other words, there's a lot of liquidity sloshing around the financial system—so much that we expect economic growth to absorb it without driving rates upward.

What Does This Mean for Fixed Income?

Given our lower-for-longer view on interest rates, our expectation for bond returns over the next few years is muted. Figure One illustrates our thinking. It shows the historical yield and five-year forward annualized returns for the Bloomberg Barclays US Aggregate Bond Index, a widely used benchmark for high-quality U.S. debt securities. The index's yield at the end of January was 1.22 percent. As shown below, absent any additional information, the yield has historically provided a fairly accurate prediction for future performance.

Figure One: Fixed Income Headwinds: Muted Upside and Low Yields



Past performance may not be indicative of future results.
Sources: CAPTRUST Research, Morningstar Direct

Why Fixed Income Remains Vital to Your Asset Allocation

The picture we've painted for fixed income isn't bright, so you may well be thinking that it's a good time to slash your portfolio's exposure. After all, why own bonds if they probably won't earn you much for several years?

Our response: History has shown that holding fixed income is strongly beneficial to one's asset allocation regardless of performance. We see three especially compelling reasons to own it now and going forward.

1) Stabilizing a portfolio via diversification is a core investment concept. The idea is that by spreading one's holdings across several types of assets—most prominently stocks and bonds—the less-volatile assets will tend to dampen the risk and potential downside of the riskier types of assets. A well-

diversified portfolio typically declines less than one that's more concentrated in assets with higher risk.

Over the long haul, high-quality fixed income has played this stabilizing role for stocks, as bond prices usually (but not always) rise when stock prices fall and vice versa. A significant reduction in your fixed income portfolio allocation, therefore, would expose your overall portfolio to greater risk of loss.

2) Bonds provide a second source of liquidity if you want or need to raise cash. Cash-flow planning is critical to long-term investment success, but we all recognize that surprises happen. High-quality bonds provide a source of capital that is easy to sell and generally less exposed to significant downside moves.

3) Owning fixed income buys you time as your more volatile assets like stocks go through their up-and-down cycles. With fixed income anchoring your portfolio, you can avoid selling your stocks, which could turn a temporary decline into a permanent loss.

Studies have long shown that holding on to stocks over the long term is much more profitable than selling and then buying again in an effort to time the market.[2] Having fixed income in your portfolio gives you the breathing room to weather market storms without selling stocks.

What to Buy If You Sell

Our research has identified several niche strategies that share key characteristics in this context:

- Their risk level, as measured by volatility, is similar to that of fixed income.
- Their potential annualized return is higher than that of fixed income, e.g., 4 to 5 percent versus the sub-2 percent that we expect fixed income to generate over the next few years.
- They're not highly sensitive to changes in interest rates, unlike most fixed income.
- Their performance is driven by specific events, and they are less sensitive than stocks to overall market volatility.

The alternatives we recommend are generally market-neutral strategies such as convertible arbitrage and merger arbitrage or hedged equity strategies that conservatively utilize options to generate growth and income. We recognize that these strategies can exhibit heightened downside risk during certain extreme market environments.

Summing It All Up

With interest rates near zero and unlikely to move much in the foreseeable future, performance prospects for high-quality fixed income look unappealing. Our research suggests that a modest reduction in fixed income exposure may allow investors to maintain portfolio diversification while creating opportunities for low-volatility investments whose expected returns could outpace those of fixed income.

We nevertheless believe that investors shouldn't significantly reduce their fixed income allocation. There are strong reasons why holding high-quality fixed income benefits portfolios regardless of a muted outlook for bonds. Fixed income acts to stabilize portfolios through diversification, serves as a second source of liquidity if investors want or need to raise cash, and buys investors time to allow riskier assets to go through their up-and-down cycles.

[1] "When Will Interest Rates Rise? Fed Chair Says 'No Time Soon'," *The New York Times*, January 14, 2021.

[2] MacKillop, Scott, "Market Timing Is the Enemy of Investment Success," advisorperspectives.com, January 27, 2020.

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