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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 actually pays you (albeit not much) to avoid equity market volatility.

Consider that the Bloomberg Barclays Global Treasury Index and Bloomberg Barclays Global Aggregate ex-Treasury Index have returned 7.1% and 7.4% annualized, respectively, over the last five years (GBP unhedged, as of September 30, 2020), while the ICE BofA Sterling 3-Month Deposit Index, a proxy for an investor holding cash, has returned just 0.5% during the same period (Source: Bloomberg).

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-

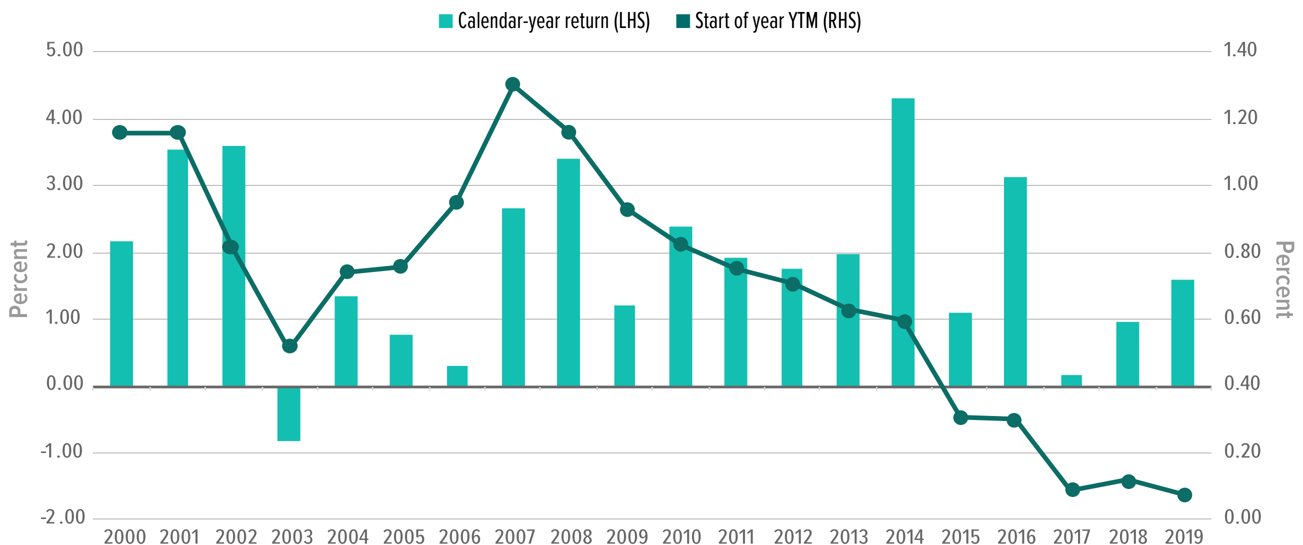
income allocation that may not demand much adjustment over market cycles. They typically invest in investment-grade fixed-income securities of corporate, government and provincial issuers, including insured mortgage- and asset-backed securities. Investment-grade securities are those with an equivalent 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. High-quality government bonds, for example, tend to be more defensive and have historically been negatively correlated with stock market performance.

The Case for Core

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.

To understand how low bond yields today do not necessarily imply lower returns tomorrow, we look at the example of the Japanese bond market. Japan has experienced decades of disinflation, including extended periods of deflation, which has manifested in a long-term decline in yields. In 2016, the yield-to-maturity (YTM) on the ICE BofA Japan Broad Market Index was negative for the first time, and it has straddled the zero mark ever since. However, the Japanese benchmark still managed to generate positive returns in each of the following calendar years. In fact, 2003 was the last time the Index fell over a calendar year.

ICE BofA Japan Broad Market Index



Source: ICE BofA. Data as of 12/31/2019.

The average YTM at the start of each year from 2000-2009 was 0.95%, compared to 0.44% for the period 2010-2019. However, in spite of the lower starting yields, the average calendar-year return for 2010-2019 was 1.93%, slightly higher than the 1.82% average over the period 2000-2009. This suggests that lower yields do not necessarily result in lower ex-ante returns.

Global investors can take further comfort in the fact that the 0.90% YTM (as at 13 October 2020) on the Bloomberg Barclays Global Aggregate Index is currently considerably higher than the Japanese benchmark, suggesting positive returns are certainly achievable going forward, particularly as central banks are effectively committed to keeping interest rates on hold for at least the next few years. While we do recognise that ever lower yields can potentially diminish the efficacy of bonds as a hedging asset, the analysis reaffirms our view that core fixed income should remain a cornerstone of any multi-asset portfolio.

To develop this argument further, it is important to recognise that fixed income is a heterogeneous asset class, comprising a number of sectors that exhibit different risk-and-return characteristics through an economic cycle. For example, core fixed income includes the highest-quality government bonds—like US Treasurys and German bunds—that are interest-rate sensitive and tend to perform well when the economy is in recession or equity markets are falling. At the other end of the core fixed-income spectrum are credit-sensitive BBB corporate bonds, which do well during economic expansions, when credit spreads tighten because their perceived default risk recedes. Fixed income is therefore a versatile asset class that provides skilful active managers the scope to rotate between sectors in a way that can increase return and/or reduce risk.

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 Bank of England reacted by moving interest rates to an historic low and made other moves 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 and rising bankruptcies. However, 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 re-entered. 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 non-core investments in an effort to improve total returns, core funds can be used as the foundation of a diversified and reliable investment strategy.

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