AUGUST 2021

BOND iQ
Intra Quarter Update

Five Points to Consider Before Tactically Shortening Core Fixed Income Allocations

The bond market was in a full-blown inflation panic to start the year. Vaccines, reopening, and lingering stimulus all combined to push long-term bond yields sharply higher during the first quarter. As a result, the Bloomberg Barclays Aggregate Bond Index ("AGG") had its worst quarterly return since the 1980s. Suffice to say, duration sentiment had grown sour to start the year. Precisely when investors began to shun duration, however, long-term yields quickly reversed course. Since March 31st, the 10-Year Treasury has rallied nearly 60 basis points (bps) and is quickly approaching year-end levels. This has helped most major bond indices recuperate their first quarter losses. Many investors that we speak with have been wondering if they should consider tactically shortening the duration of their Fixed Income allocations as a result of this rally. In this month's "BondiQ," we offer 5 key points that may cause you to reconsider how worthwhile tactical duration adjustments actually are.

- Over the past 25 years, the AGG has outperformed the Bloomberg Barclays 1-3 Year Government Credit Index (a proxy for Short Duration strategies) during 72% of rolling 12-month periods, 94% of rolling 3-year periods, and 100% of rolling 5-year periods.
- Over the past 25 years, the AGG has experienced only 8 instances (including today) where trailing 12-month total returns were negative. On a monthly basis, trailing 12-month total returns have been positive 89% of the time.
- The worst rolling 12-month drawdown in the last 25 years was just -2.47% experienced in 2013's "Taper Tantrum."
- In the past 7 instances where trailing 12-month returns were negative, the average total return one year forward was 6.69%.
- Over that same 25-year time period, the AGG has never experienced a negative 3-year trailing return. In other words, trailing 3-Year total returns have been positive 100% of the time.

We certainly understand the temptation for investors to consider short duration strategies as a tactical alternative to Core Fixed Income given the level of rates. History demonstrates that the window for short duration strategies to outperform are relatively narrow. Prematurely shortening duration can lead to significant tracking error and dramatically reduce the "hedge" benefit of fixed income allocations. As the bullet points above highlight, negative fixed income returns are a relatively rare occurrence, and when they do occur, the impact of reinvesting at higher interest rates can lead to above average returns one year forward. So instead of playing the tactical duration game, we would urge investors to allow fixed income duration decisions to be driven by liability and time horizon matching.

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For allocations with longer-term time horizons, Core Fixed Income strategies are likely to lead to better results over full market cycles. For assets with shorter term time horizons, short duration strategies can be an excellent way to out-earn money markets while also limiting downside risk and volatility. Of course, no two situations are the same, and we encourage you reach out to anyone at Johnson Asset Management to discuss how we may custom tailor portfolios to best align with individual risk and return objectives.

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