MAY 2021

BOND iQ
Intra Quarter Update

The Role of High-Quality Bonds in a Low Interest Rate World (Part 3 of 3)

In this month's "BondiQ," we conclude our three-part series on the role of high-quality bonds in a low interest rate world. In part-one, we explored how traditional bond portfolios might effectively "hedge" risk asset volatility given the historically low level of interest rates. In part-two, we provided a helpful roadmap to assess the fair value of interest rates given our outlook for inflation and the Fed. This month, we conclude this three-part series with a wholistic look at the role traditional fixed income plays within diversified asset allocations.

Low bond yields have tempted many investors to reduce or even remove traditional fixed income allocations from portfolios in search of more robust returns. While we can certainly sympathize with investors' hunt for yield, reaching further out the risk spectrum does not come without added risk. For investors that tilted allocations toward higher-return asset classes last spring, the rewards have been plentiful. Since the March 2020 lows, the S&P 500 has generated an annualized return of approximately 73%. Small Cap has done even better, with the Russell 2000 up over 100% over that same time period. The trouble is, these outsized gains have also stretched asset prices, leaving many riskier asset classes at or near historically high valuations. In fact, a simple regression of the forward P/E multiple against future returns suggests that the S&P 500 may only deliver low single-digit returns over the next five years – which is just marginally higher than traditional fixed income with a healthy dose of additional volatility. The same can be said of riskier bonds, as the yield differential between the Bloomberg Barclays High Yield Bond Index and the Bloomberg Barclays Aggregate Bond Index ("AGG") recently dipped below 200 basis points – the lowest spread since 2007.

	Standard Deviation	Sharpe Ratio	Max Drawdown
MSCI EM	22.80%	0.21	-61.44%
MSCI EAFE	16.68%	0.22	-56.40%
Russell 2000	20.41%	0.36	-52.89%
S&P 500	15.42%	0.46	-50.95%
BB BCAP HY	8.97%	0.54	-33.31%
BB BCAP AGG	3.41%	0.89	-3.83%

Source: Zephyr (1997-2021)

While many investors remain focused on ways to boost portfolio returns in light of the low interest rate environment, we believe that elevated market valuations favor risk mitigation over return enhancement. While portfolios tilted toward riskier assets such as equities or high yield bonds may offer modestly higher potential returns, the chart above illustrates that those asset classes also come with significantly higher volatility – one reason that the AGG has the highest Sharpe Ratio of any of the major asset classes listed above.

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The conclusion of our three-part series on high quality fixed income once again reinforces our goals of building high-quality fixed income portfolios. First and foremost, we believe that bonds are the cornerstone of a diversified asset allocation, meant to offer investors stability and protection, especially during volatile times. Second, we are always looking for ways to maximize the yield and total return in portfolios, but never at the expense of our quality investment discipline.

As always, should you have any questions please do not hesitate to reach out to a member of the Johnson Team.

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